Knightsbridge Asset Management, LLC

July 15, 2008

Summer Commentary

"Humpty Dumpty sat on a wall,
Humpty Dumpty had a great fall,
All the king's horses and
all the king's men,
Couldn't put Humpty together again"

English Nursery Rhyme
First in print, 1810

Humpty was reckless and had it coming. An egg should know better than to sit on a wall, right? But maybe Humpty had seen others negotiate the dangerous balancing act, and it looked like fun. Maybe no one had fallen off before. Now, with the benefit of twenty-twenty hindsight, observers saw the dangers inherent in that balancing act. And it is not particularly surprising that an object with no flat surfaces, such as an egg, would become the first victim. And so it is with our financial system today.

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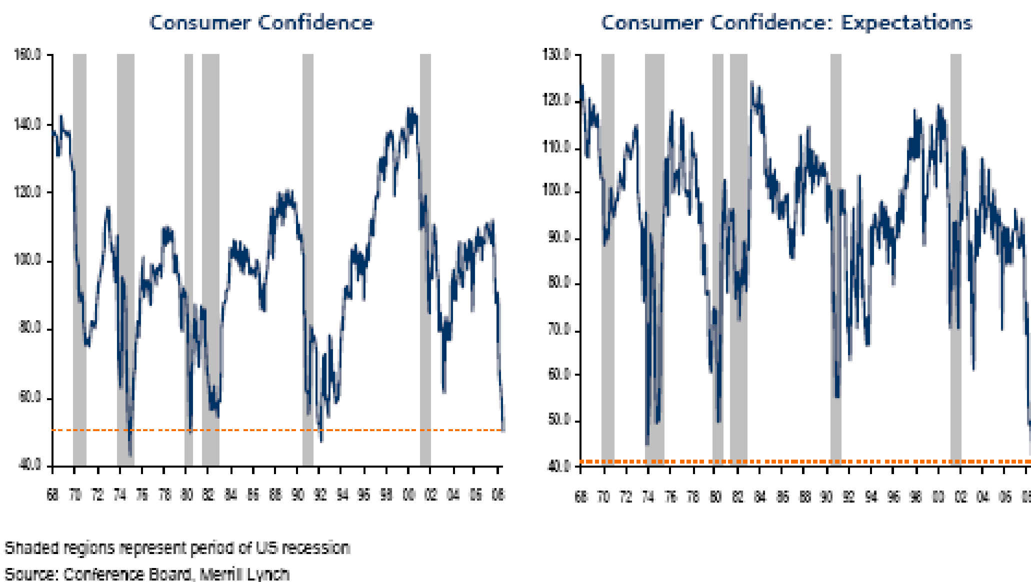
The Federal Reserve, with Benjamin Bernanke on the white horse, is charging into battle using all tools at its disposal and some new ones of its own invention. The "discount window" which was originally conceived to extend credit to only the largest commercial banks under emergency circumstances, has now been opened to investment banks like Goldman Sachs, Morgan Stanley, Lehman and Merrill Lynch, in the wake of the Bear Stearns collapse. Moreover, the recent swan-dive in stock prices of the GSE's (Government Sponsored Enterprises) Fannie Mae and Freddie Mac raised the question of potential insolvency to the point where the Fed and the Treasury felt compelled to consider opening the discount window even wider to include these mortgage lending institutions which control some 48% of the mortgage market domestically.

With leverage the primary culprit, deleveraging attempts only exacerbate the problem as there are few buyers for what needs to be sold. However, it is a very safe assumption that the deleveraging story will be the primary focus for some time to come. One only need look at the prices of some financial company stocks relative to their book values to catch the flavor of what is going on. Local NYSE-listed mortgage lender Downey Financial, has a book value of $39 and is trading at $2 per share! Moreover, on July 11th, IndyMac Bank was seized by federal regulators, the third largest bank failure in U.S. history. Clearly, the contagion initiated by the sub-prime lending fiasco, now almost a year old, is not yet over. We doubt the broad market will be able to sustain an upward move until the carnage among the financial stocks abates.

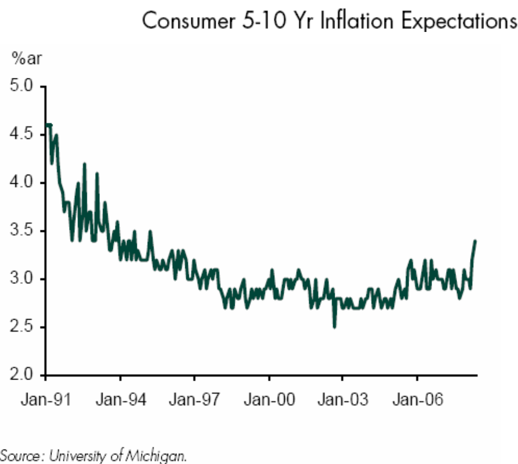
Newspapers, for those who still read them, sported headlines last week that the S & P 500 had dropped 20% (now 21%) from its October 2007 peak, thereby heralding to all who may have been oblivious to the current investment scene, that we are in a bear market. There is no shortage of negative news, to wit (those prone to suicide may wish to skip this section):

- Housing starts are at a 17 year low, even though the U.S. population is up 20% in that interval,
- Two-year treasuries dropped in price the week ending June 16th, the most in 26 years, as inflationary fears gripped the bond market,

- Both the Conference Board and the University of Michigan consumer surveys show consumer confidence expectations at a 28 year low as seen below (good news: such plunges tend to be coincident with stock market bottoms),



- Inflation expectations 5 to 10 years out are at a 14 year high as seen in the chart to the right published in Lehman Brothers' <u>U.S. Economics</u> on June 13, 2008,



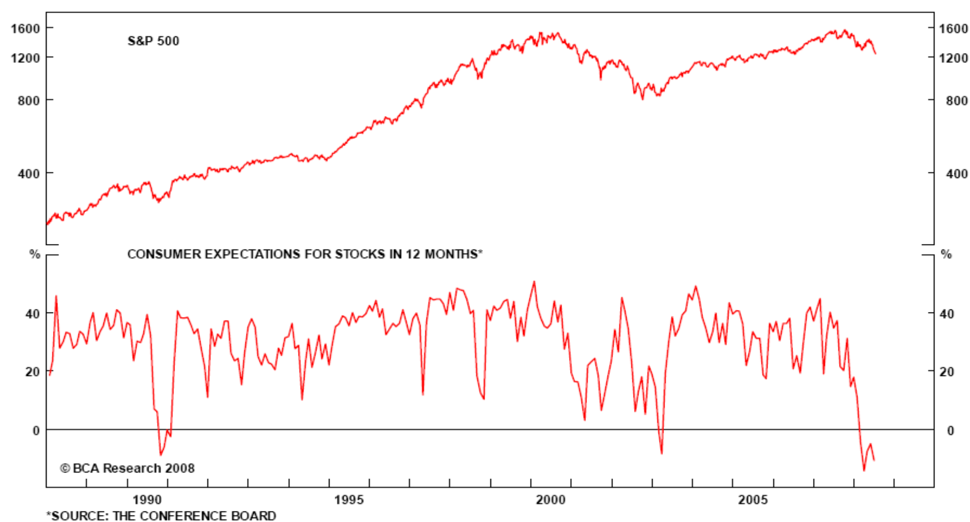
- Existing home prices dropped at a faster rate in the month of May than at any time since the 1930's,

- An ABC poll which asks "Do you think the economy's direction is improving" recorded a 3% positive response, the lowest since the survey began in 1980, 28 years ago,

- Single family home sales are the lowest in 24 years,

- Ten percent of all homes built since 2000 are vacant,

- Housing vacancy rate at 2.9% is the highest in 54 years,
- Import price inflation at 17.8% year-over-year is the highest in over 26 years,
- Money market fund assets reached 26% of the broad-based Wilshire 5000 index of stocks, the highest in 30 years with the exception of the December 2002 high of 28% (good news: the market had just bottomed after a 2-1/2 year slide in October of 2002),
- The AAII (American Association of Individual Investors) survey finds 47% bearish (what's wrong with the other 53%, don't they know what's going on?) and consumer expectations for stocks in 12 months have turned negative as reflected in this Conference Board chart from BCA Research,



- Eurozone inflation is at a 16 year high,
- A CNBC survey finds 92% think the economy is "fair to poor",
- The Dow Jones Industrial Average experienced its worst first-half performance in 38 years, down 14.4%,
- The Dow Jones Industrial Average experienced its worst June performance in 78 years, down 10.2%

We will spare you any further items of cheer, and simply declare that we have not seen the likes of this degree of concentrated negativity in many moons.

It is worth commenting that we have yet to see the recession that had been so widely predicted at the beginning of the year. The

"real" (after inflation) GDP growth numbers have come in anemically but still positive, yet not sufficiently positive to prevent unemployment from going higher. Since the stock market is trading at levels that one might conclude would be predictive of recession, this leaves observers to choose among one of several conclusions:

1) There will be no recession, but rather an extended period of exceptionally slow growth, or

2) There will be recession, but it is still in front of us, or,

3) We are in recession now, and subsequent revisions to GDP numbers will show this retroactively, or

4) We are in recession now, and government inflation estimates are faulty so that their derived calculations of "real" GDP are likewise faulty, or

5) The stock market is wrong and predicting recession like it did in 1987 when none occurred, or

6) The stock market is not predicting recession but rather price declines mean P/E ratios have shrunk due to higher expectations of inflation or belief that current inflation is higher than the government would have us believe. This conclusion is hard for some to accept because when one looks at the yield difference between 10-year treasuries and 10-year TIPS (treasury inflation protected securities), currently about 2.5%, this implies bond investors expect 2.5% per annum inflation for the next decade, certainly not high enough to be shrinking P/E ratios, or

7) The stock market is down not because it is predicting recession or inflation per se, but rather because it is fearful of a partial collapse of the banking system and as such is raising the "equity risk premium", the extra return demanded by equity owners over and above treasuries for the incremental risk assumed in equity ownership.

And what investment letter could possibly be worth its salt without the obligatory mention of oil prices. Who among us is not surprised by oil prices of $148 a barrel? Only the CEO of Russian oil giant Gazprom, who is predicting $250 per barrel. Three months ago we were in Beverly Hills to hear Texas oilman T. Boone Pickens speak on the subject, and he said (oil was about $115 at the time) he expected prices of $125 to $150 in the fall of this year. We

are there and it’s barely summer. Of the many analyses we have read, the one that offers the most plausible explanation goes something like this:

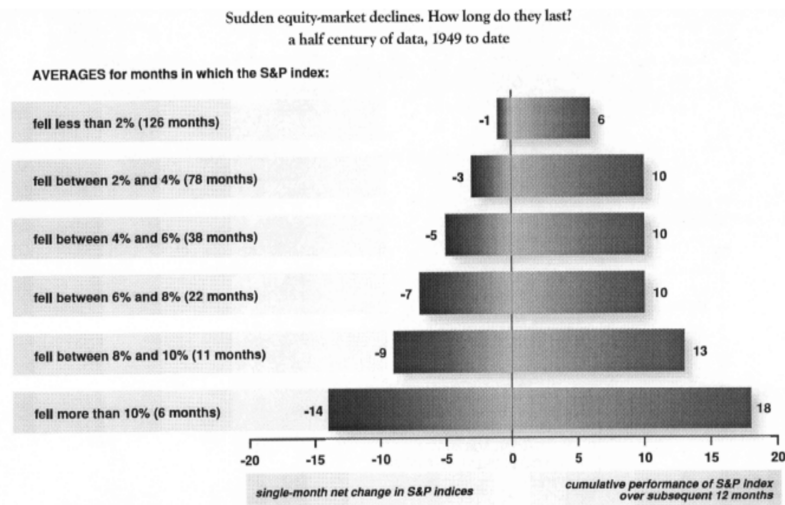
- Most oil exporting nations have very high indigenous population growth rates: Kuwait, 3.9%; Nigeria, 2.9%; Saudi Arabia, 3.4%.
- Worldwide oil production probably peaked in 2006, and is thought to be declining at a rate of “several percent per annum” according to some.
- Producing countries heavily subsidize oil prices for their own populations which encourages local oil consumption to grow in line with population growth.
- Therefore, the “exportable balance” is declining roughly by the sum of population growth rate of producing countries plus rate of production decline, which taken together might be something like 7% per annum, other factors equal.

Seven percent per annum decline in oil available to the U.S. would quite rationally be expected to have a dramatic impact on price. Layer on the declining value of the dollar relative to a world basket of currencies and it becomes easy to see why we are in the current state. We are pleased to see Boone Pickens lead the charge with his current energy independence campaign. Certainly the political leadership of this country has been completely ineffectual and guilty of dereliction of duty in addressing these problems, and that goes for Democrats and Republicans alike.

Recently we heard someone say, “It’s always darkest before it turns pitch black”. Cute, we thought. Nevertheless, we are reminded that all bull markets are born from despair and a loathing for stocks. Certainly that was the case in the first quarter of 2003 as we awaited the unpopular invasion of Iraq. We do not expect it to be much different this time, so we turn our attention to issues of timing and expectation, and look for the market to discount the worst of the realities.

The financial system is reeling under the stress of what has now proven to be excess leverage among certain institutions, and we believe the landscape will be very much changed coming out the other side. In that sense, Humpty’s fragile shell will not be reassembled to allow him another attempt at scaling the wall.

There is a danger in becoming too bearish, as one never really knows at what point all the bad news has been discounted. This Wainwright Economics chart shows that for months (like June 2008) where the S&P 500 Index dropped between 8% and 10%, a reasonably rare occurrence, the subsequent one-year return was a positive 13%!



A recent J.P. Morgan research piece shows that over the last twenty years the average individual equity investor achieved a total return of 4.5% per annum, yet the S&P 500 total return was 11.9% per annum. The 7.4% difference is mostly attributed to attempting to "time" the market, a fatal exercise for the majority. Such temptations are strong in the current intensively negative environment.

As it says in Ecclesiastes, Chapter 1, verse 10 (writings attributed to Solomon about 950 BC), "Is there *any* thing whereof it may be said, See, this is new? It hath been already of old time, which was before us."

Particularly in these trying times, we thank our clients for their forbearance and understanding.

Very truly yours,

Alan T. Beimfohr　　　　　　　　John G. Prichard, CFA

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