

# Knightsbridge Asset Management, LLC

July 28, 2009

## Summer Quarterly Commentary

*"For years I thought what was good for our country was good for General Motors and vice versa."*



Charles Erwin Wilson, 1890 - 1961

President, General Motors, 1952

Director, War Production Board, 1944

Secretary of Defense, Eisenhower  
Administration

Statement made during Senate  
confirmation hearings, 1953

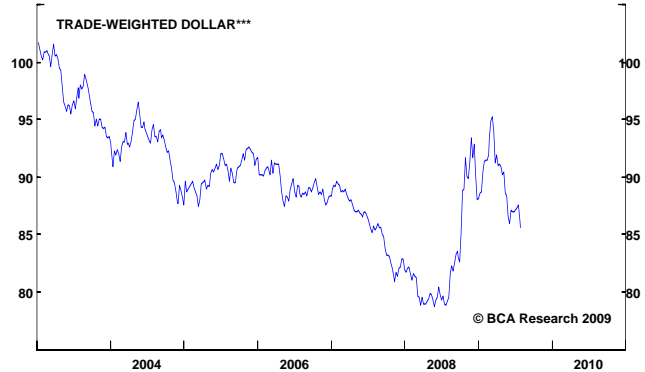
This statement was supposedly corrupted into "As General Motors goes, so goes the nation". We ask, does it then follow that the United States is to soon find itself in the General Motors predicament? Recent evidence is not especially encouraging with ballooning deficits and trade partners wanting to ditch sole reliance upon the dollar.



**Cyclically Adjusted Budget Deficit,  
Pct of GDP**



Source: Strategas Research Partners, LLC



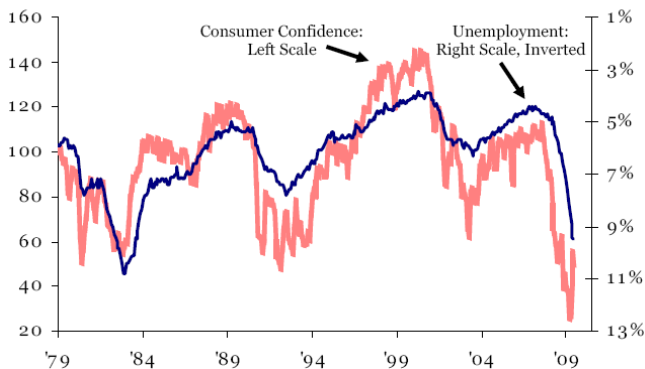
\*SOURCE: FEDERAL SURVEY OF SENIOR LOAN OFFICERS  
 \*\*AVERAGE OF SMALL, MEDIUM & LARGE BUSINESSES  
 \*\*\*SOURCE: J.P. MORGAN CHASE & CO.

This past quarter saw the venerable and vulnerable General Motors enter bankruptcy, be partially nationalized, and exit bankruptcy within a biblical forty days. That was fast! Professor Edward Montgomery has just been appointed "auto czar", presumably after a scouring of the landscape for auto industry-knowledgeable careerists. We envisioned the selection process something akin to combing through piles of resumes, or perhaps not unlike the admissions committee at Cal Tech trying to sort through stacks of applications from genius children. But it turns out Dr. Montgomery's auto-industry qualifications were that he was Dean of the College of Behavioral and Social Sciences at the University of Maryland. He could also be an auto buff. Of this we are unsure. He and his entourage from eight federal agencies immediately beat buns to Grand Rapids, Flint and Warren, Michigan for a self-imposed cram course on the auto industry. We hope he brought his Cliff Notes. Perhaps the good professor and his team of bureaucrats can learn in a few days what had escaped the unfortunate ex-CEO Rick Wagoner in his thirty year career. But we doubt it. Recent reports are that the new GM sub-compact product, originally destined to be built in Shanghai, has now been redirected to be built in...guess where...Michigan! It seems that employment, or should we say 15% Michigan unemployment, "considerations" became the number one concern in locating this plant, rather than profit per auto. Since none of the "formerly Big Three" makes a sub-compact anywhere in the USA, we see these decisions made with government interference, or assistance if you prefer, as being at best sub-optimal, and at worst, disastrous.

While we are on the subject, we once again remind our readers that the "senior secured lenders" who should have been first in line to get their money back in a bankruptcy, basically got strong-armed by the government into getting almost nothing. We believe there is ultimately a price to pay for upsetting this bankruptcy appletart, and it will work out something like this: in the future, senior secured lenders will demand higher rates of interest to offset the extra uncertainty established by the "Government Motors" bankruptcy precedent. Once bitten twice shy. Of course, nobody is worrying much about this when ten-year Treasuries are trading at yields of 3.6% and the only party willing to lend money is the federal government.

Investors had begun to feel a bit better about things at our last writing. Terms like "green shoots" had started to pepper the financial commentaries. Unfortunately, some of those "green shoots" appeared to be wilting, reinforced by four weeks of consecutive market decline in June and July. The University of Michigan consumer sentiment survey rolled over to the downside once again as seen below, prompting some to declare that this "V" shaped market recovery was now going to be shaped more like a "W", an "L", or a square root sign. Unemployment numbers seem to be headed higher, as can be seen in the inverted blue line below. A more careful reading, however, shows initial claims for unemployment insurance, the chart at right, to have already peaked.

Consumer Confidence vs. Unemployment



Monthly Initial Claims for Unemployment Insurance, State Programs, Wkly Avg



Source: Strategas Research Partners, LLC

Individual investors were recently stunned with the prospect of having the administration's much vaunted universal health plan

financed by an income tax surcharge of 4% on household incomes above \$200,000, and an additional 0.6% on household incomes above \$500,000. Although made obsolete by several subsequent revisions, shockwaves reverberated among high-earning investors. We are sure many variations will surface prior to a final version being settled upon. One thing is clear: this program has the potential to be one expensive budget-buster. This conclusion has been supported by Doug Elmendorf, Director of the CBO (Congressional Budget Office), the government's own bipartisan watchdog agency. Although the seating of Mr. Al Franken of Minnesota to the U.S. Senate gives Democrats a theoretically veto-proof majority, completing the power troika in House, Senate and Executive branch, we are hopeful some of these more outrageous economy-depressing and investment-discouraging proposals can be modified by more moderate Senate Democrats. Nevertheless, we believe these more activist forays have been taking their toll on stock market confidence in a very tentative economic environment. We are of the opinion that a steady hand is what is needed at this point, rather than further market-upsetting legislative acrobatics.

We see continued evidence of financial healing, on balance. The "TED" spread, i.e., the difference between three-month Treasury and LIBOR lending rates, is now down to 0.4%, below the fifteen year average of 0.6%, and way, way down from the

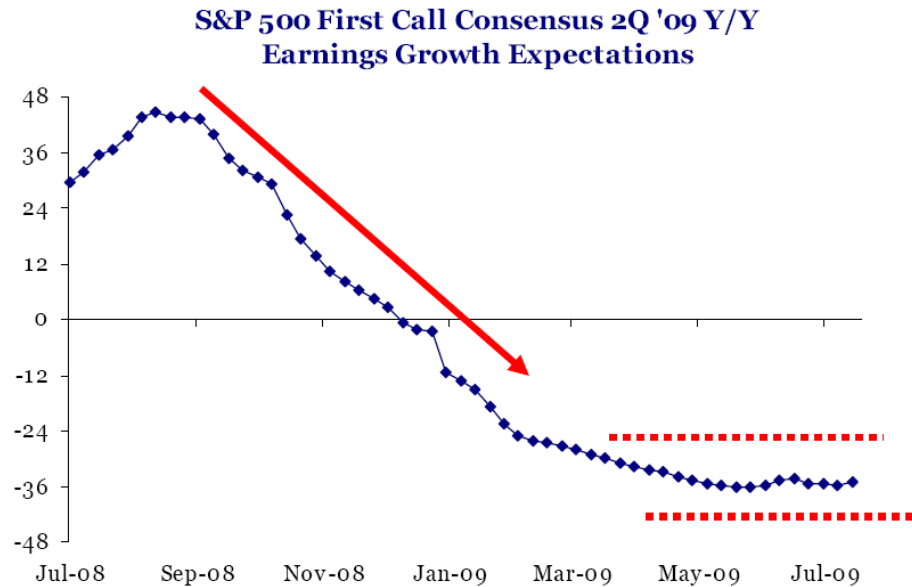
unprecedented 4.6% reached last October. Also, credit availability for consumer loans and commercial and industrial loans is loosening up. The percentage of banks reporting "tighter lending standards" is dropping, as can be seen above.



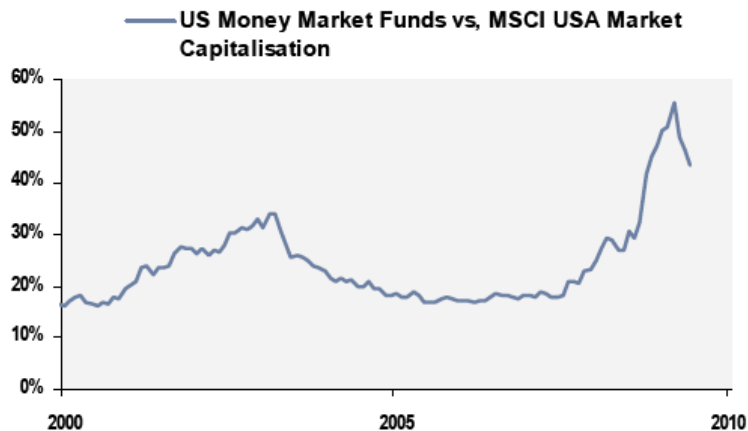
Source: Federal Reserve, U.S. Treasury, FactSet, J.P. Morgan Asset Management

Second quarter earnings have now been reported for some firms, and initial indications make good reading. Lead by firms such as IBM and Goldman Sachs, fully 71% have reported positive

surprises while only 20% reported negative surprises so far as of July 20<sup>th</sup>. As can be seen in the chart below, negative year-over-year earnings growth expectations have flattened out and are starting to turn upward.



Source: Strategas Research Partners, LLC



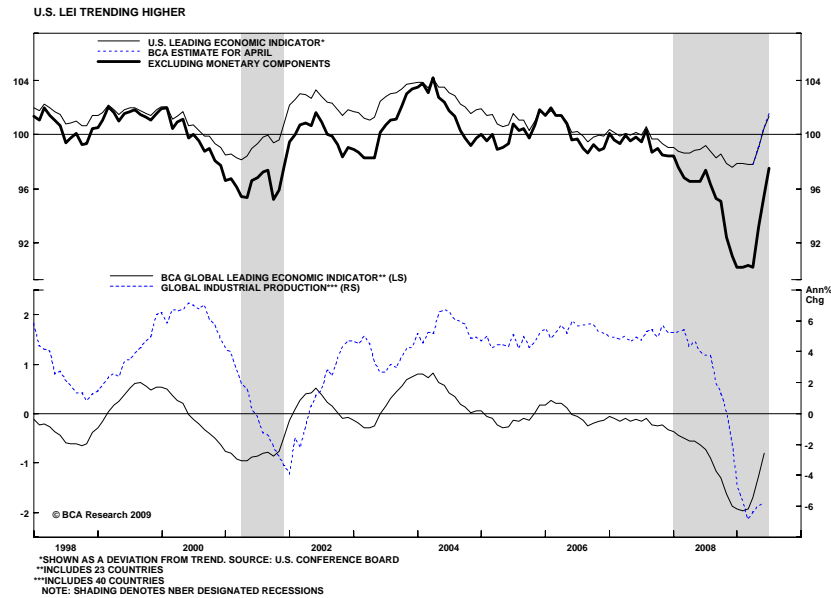
Source: Thomson Datastream, MSCI, HSBC Private Bank

We also are of the opinion that the stock market has been driven higher and will go much higher yet due to the enormous quantity of money market funds and other forms of sidelined cash as seen in the chart on the left.

We remind our readers that the value of all money market funds slightly exceeds the \$4 trillion value of all equity mutual funds in the U.S.

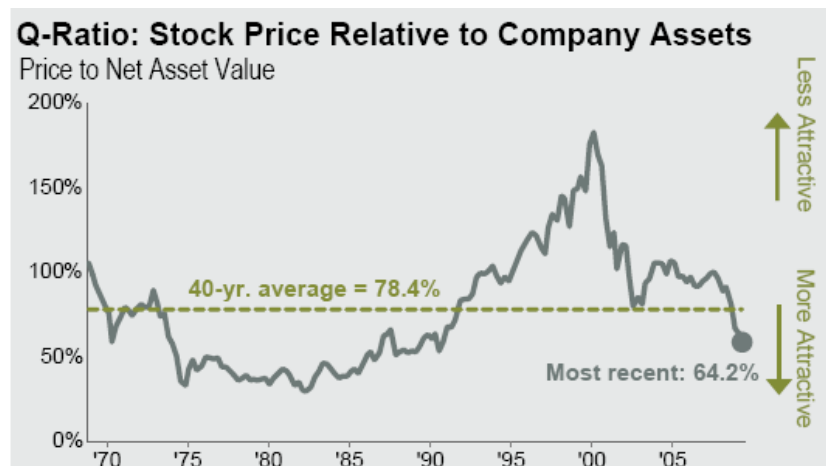
Leading indicators have turned upward in decisive fashion, and are supportive of the conclusion that the recession has just

ended or will be ending imminently. Ned Davis Research has stuck out their neck and declared as of July 20<sup>th</sup>: "We now believe that the economy has bottomed in June and that July will be the first month of recovery". We are inclined to agree.



Investors have been caught flatfooted with too much cash and too little equity exposure. Even more defensively positioned investors are asking if investment policy shifts might be in order. Now they are asking themselves whether it is too late to jump on this train since the S&P 500 is up over 40% from the March 9<sup>th</sup> lows. Most likely it is not too late.

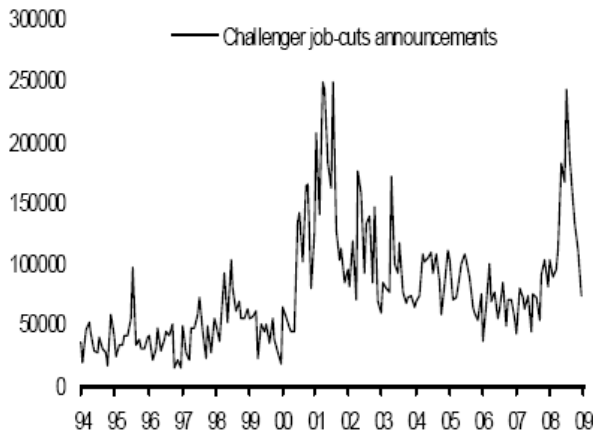
Nobel Laureate James Tobin created what is referred to as Tobin's Q. Tobin's Q measures the ratio of the market's capitalization to the net asset value of corporate assets. A low ratio indicates investors are unwilling to pay much for assets; a high ratio indicates investors are willing to pay up for corporate assets.



Source: Federal Reserve, table B.102, J.P.Morgan Asset Management

Although one cannot really use this indicator as a timing tool, it is a good and reasonable indicator of value. If Tobin's Q were to stay at or below its current level of 64.2 for as long as it did during the high inflation period of 1973 to 1990, it might be useful to reflect that the S&P 500 returned 6.8% per annum even in that terrible period. If Tobin's Q were to revert to its 40-year average of 78.4 within one year, then the S&P 500 would return 24.7% for the next twelve months.

U.S. job-cuts announcements have peaked in January



Source: © Datastream International Limited ALL RIGHTS RESERVED, Credit Suisse research

Lastly, we note that the survey of layoffs conducted by outplacement firm Challenger, Gray & Christmas is showing that the maximum layoff announcement month so far has been January of this year, and has been declining ever since. This is one more piece of evidence suggesting we have seen the worst. The fact that only a small portion of stimulus funds have been released by the

federal government into the economy suggests further economic recovery. The real question to ask is what happens once the stimulus is depleted.

We thank our readers for their interest, and look forward to the possibilities of a better market.

Very truly yours,

Alan T. Beimfohr

John G. Prichard, CFA

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