Knightsbridge Asset Management, LLC

July 15, 2011

Summer Quarterly Commentary

"I am another so weary with disasters,
Tugged with fortune
That I would set my life on any chance
To mend it or be rid of it."

William Shakespeare
MacBeth
First murderer to second murderer

Investors too are growing "weary with disasters" as macro forces whip them side to side, up and down. Be they of the sovereign risk variety or closer to home such as the potential extension of the $14.29 trillion federal debt ceiling. Rational heads assume the debt ceiling will be increased at the last minute prior to the August 2nd deadline.

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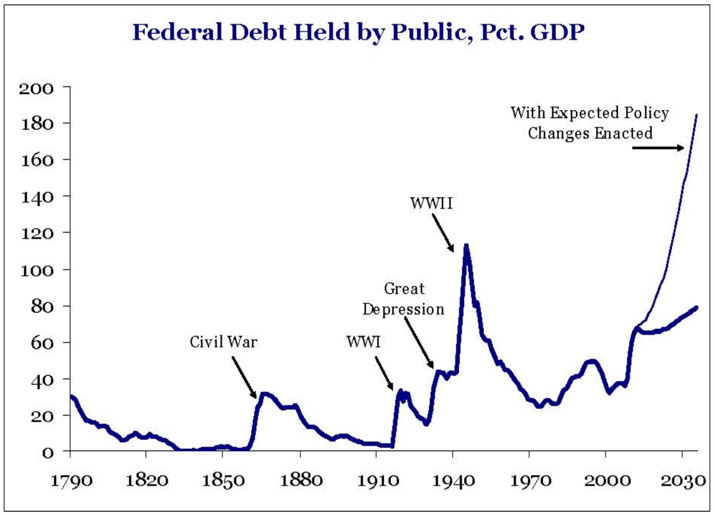
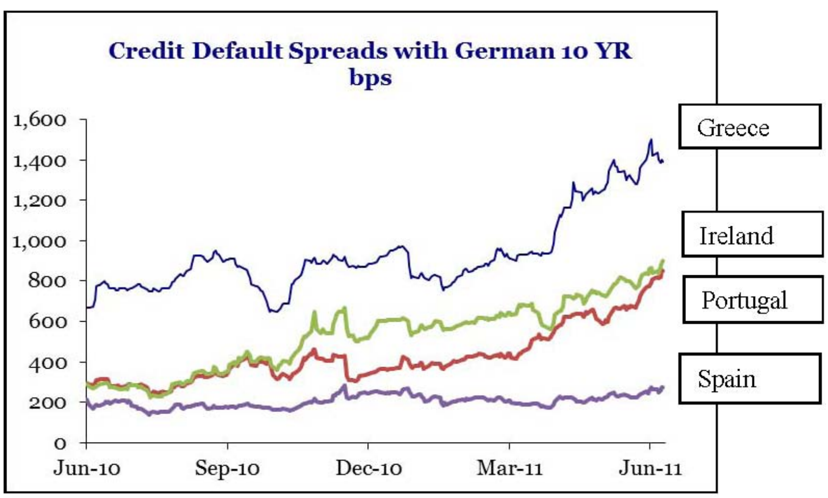


*Source: Strategas Research Partners

Lines in the sand have been drawn. This episode pits President Obama against Eric Cantor, leader of the "Tea Party" movement in the House of Representatives. Both Moody's and Standard & Poors have issued stern warnings that a downgrade from AAA is imminent should progress not materialize quickly. In the face of this political conundrum, few investors want to do anything other than sit on the sidelines and wait until it's over.

The European sovereign debt issues have only intensified since we last spoke of them here. As can be seen in the chart here, Greece is paying an incremental 14% on their 10-year notes beyond what the thrifty Germans pay on theirs. This cannot last.

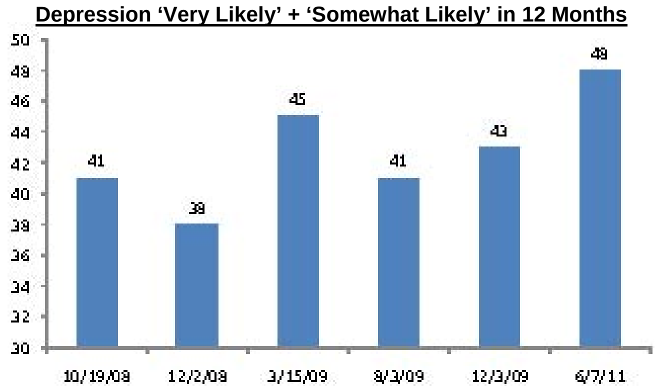


*Source: Strategas Research Partners

One way or another there will be a Greek default of some sort. The IMF and ECB are working to do something, and such precedent

setting steps have the eyes of the other "PIGS" and now Italy in full focus. Suffice it to say it is a complete mess: stay tuned.

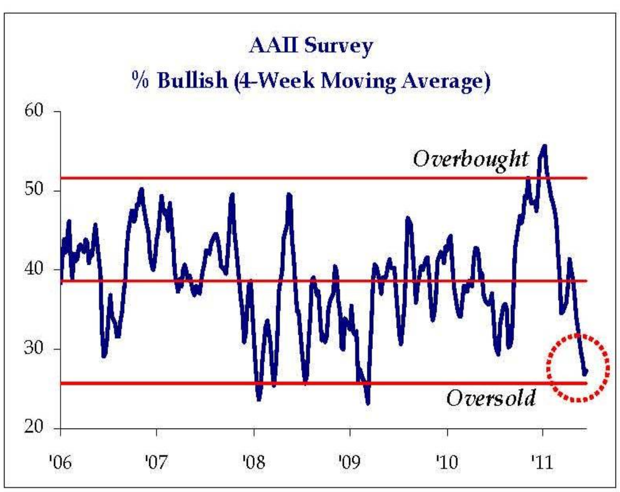
With the federal debt ceiling crisis looming and sovereign credit risks still to be solved, small wonder domestic equity investors have been spooked. Several surveys show this in dramatic fashion. In a recent Wall Street Journal/NBC News poll, 62% of respondents said the U. S. is on the wrong track and 44% said the U. S. is headed for another recession.

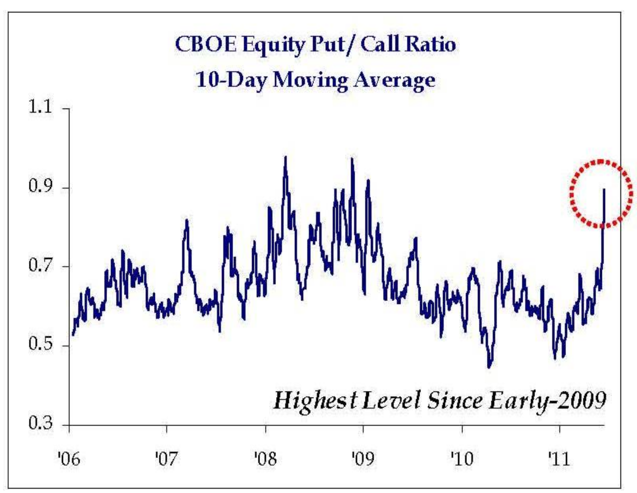


*Source: Bespoke Investment Group, LLC

A recent CNN poll found 48% of Americans seeing an "economic depression" as somewhat likely. Even though the last recession ended two years ago, pessimism is running high.

As if the above were not negative enough, the AAII (American Association of Individual Investors) Survey shows the lowest percentage of bullishness since March 2009, the market bottom.





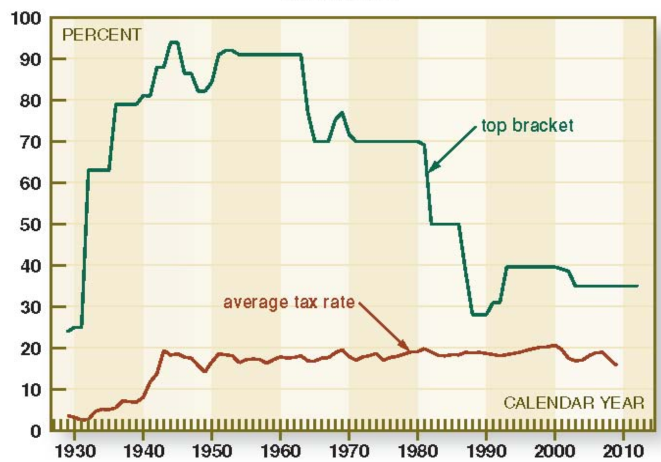
*Source: Strategas Research Partners

This negative intensity is confirmed by record readings in the put/call ratio for stocks with options traded on the CBOE. As contrarians, now would seem to be no time to pull the plug, and, in fact, quite the opposite, an excellent time to deploy liquid (mostly near-zero return) funds.

Much has been made of "millionaires and billionaires" and whether the most productive – some would say most fortunate – citizens are paying their fair share. This chart shows that since about 1944, average tax rate collections have been 19% or so irrespective of the top bracket rate which has been all over the map.

The Average Federal Tax Rate and the Top Income Tax Bracket

from 1929



*Source: H.C. Wainwright & Co. Economics

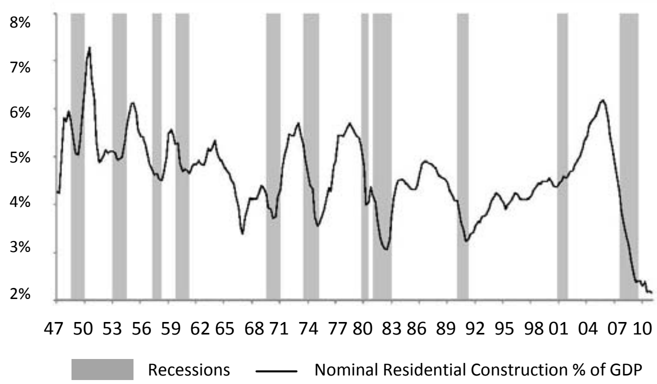
This is because loopholes and deductions have varied widely, and importantly, the percent of one's income subject to the highest rate is rarely discussed. Nevertheless, the rich are getting richer and the poor, poorer on a relative basis, mostly as a function of the shrinkage of the middle class. For these and other reasons, it is disturbing to see unemployment fail to budge from the 9.2% level and much higher levels if part-time and underemployed are included.

Clearly capital is king and business has enabled itself to grow revenues and earnings in the face of perniciously high unemployment.

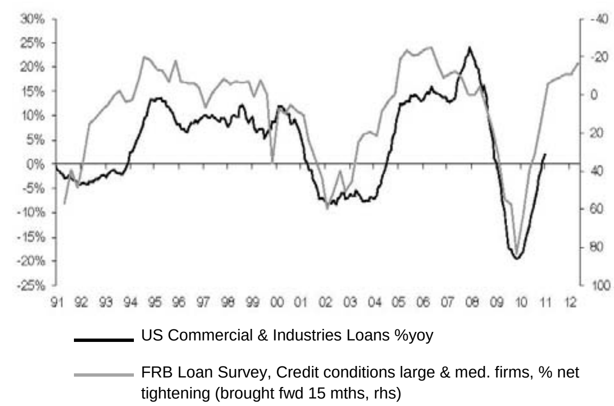
There is some evidence to suggest the sticky unemployment is due to a lack of recovery in construction spend, and further that

this construction spend, always enabled or compromised by bank lending abilities, is just around the corner. As seen in these charts, "Bank lending standards" and "Loan growth" are related such that the trend in the former leads the latter by a few quarters.

US Residential Construction Share of GDP

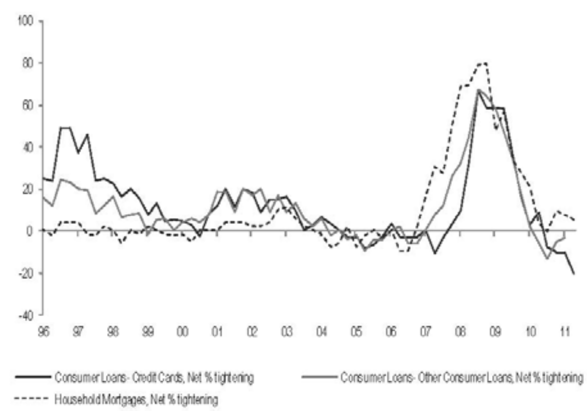


US Bank Lending Standards vs. Loan Growth

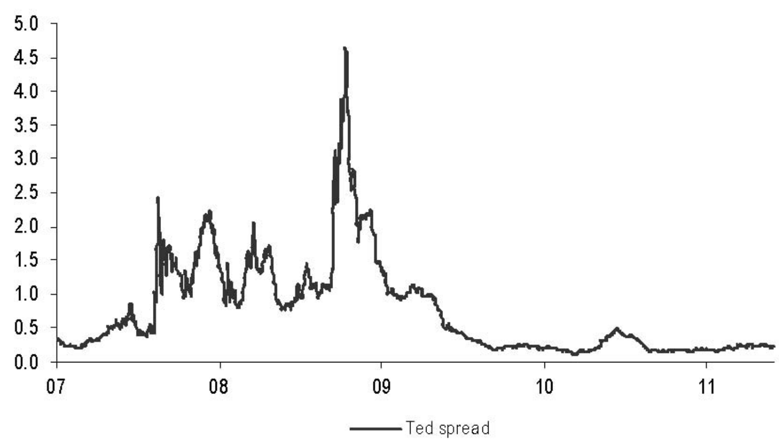


US Bank Lending Standards for Large & Small Corporates

US Banks Lending Standards for Consumer Loans



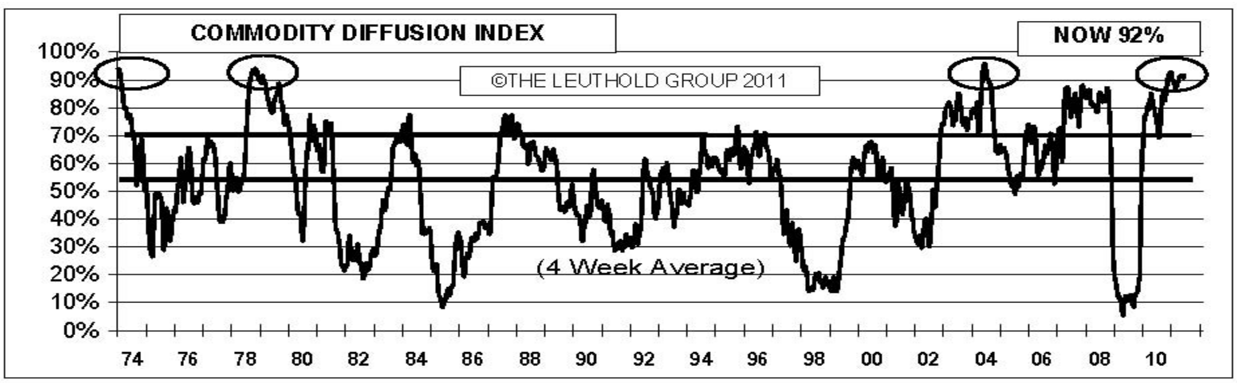
TED spread 2007-to-date



*Source: JP Morgan

This spread as seen here, implies that we have gotten the "Bank lending standards" improvement already, and are now waiting for the lagging "Loan growth" to catch up. Also, lending tightness has completely evaporated for "Corporate" and "Consumer" loans. This data bodes well for further economic recovery. Lastly, the "TED Spread", the difference between 3-mo T-Bills and 3-mo LIBOR, shows very little credit stress in the system at this point.

It could be that rising inflation expectations are restraining the market from advancing, as if other factors were insufficient. We consider what is known as the "Commodity Diffusion Index". This index, a measure of price increase from one year ago for all commodities, stands at 92%. This is to say that 92% of all commodities are higher in price than one year ago, a high plurality indeed.



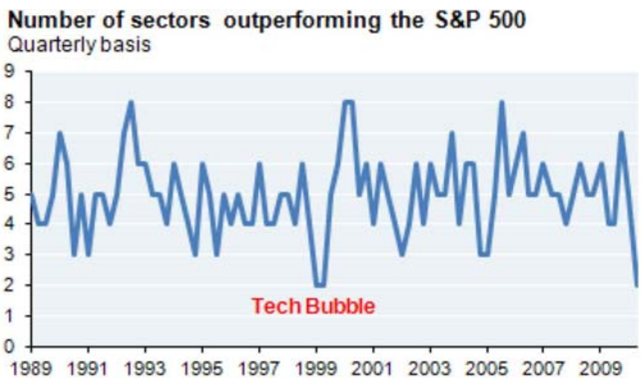
*Source: The Leuthold Group, LLC

In fact, going back almost 40 years, there were only three other episodes of readings above 90%, and each time inflation increased substantially in the months following:

1) **Late 1973, CPI y-o-y went from 7% in Q3-1973 to 11% by mid-1974**
2) **Mid 1978, CPI y-o-y went from 7% to 9% in six months**
3) **Early 2004, CPI y-o-y went from 2% in early 2004 to 5% by the fall of 2005**

Therefore, it might not be "out of the question" to expect 4% to 5% inflation at some point within the next year. Although this might not be enough to compress market P/E's from the currently

expected 13X forward earnings, it will certainly cause investor consternation.

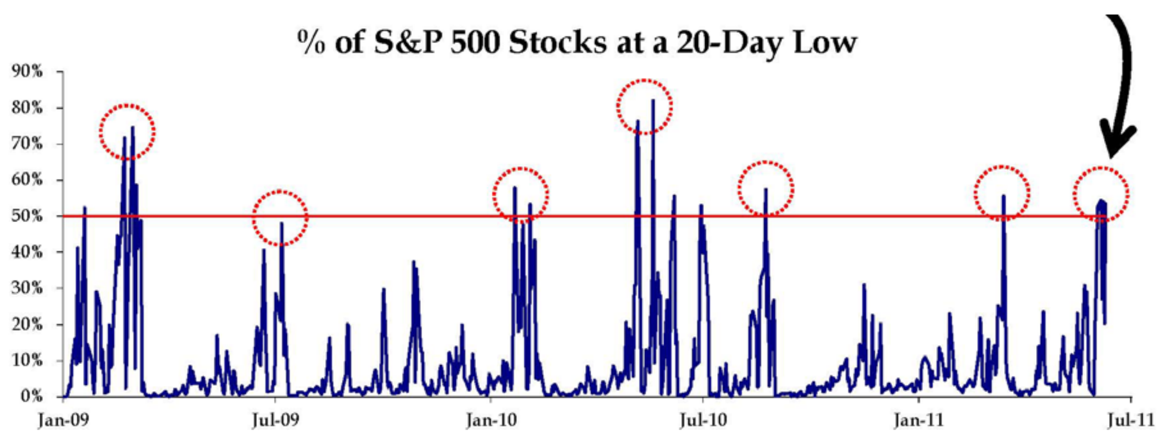


*Source: JP Morgan

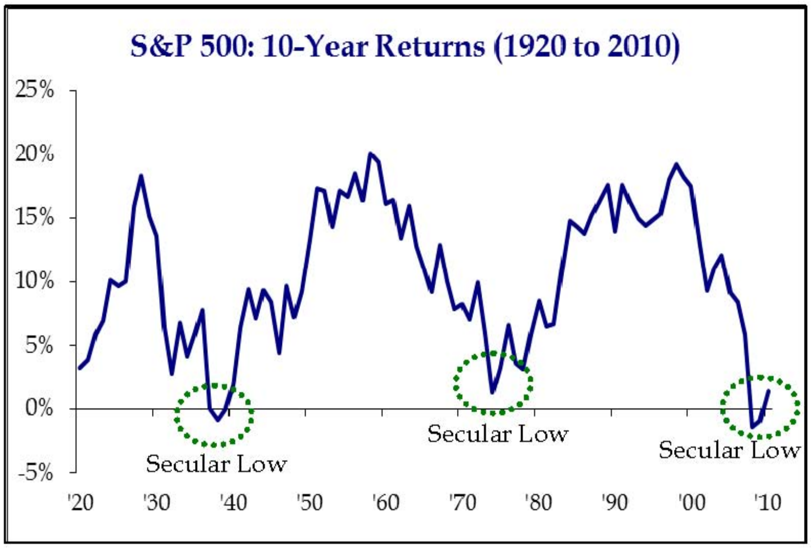
Yet another cautionary alert is being given by narrow sector breadth. This chart highlights episodes of breadth narrowness over the past 12 years. Only two sectors out of ten, energy and industrials, outperformed the S&P 500 index in the 1st quarter this year. This is the narrowest sector breadth since 1999, just before the bursting of the tech-bubble market top in March of 2000.

This begs the question of whether or not we could be within, say, 6 to 12 months of a market top characterized by energy stocks leading the parade. Such a bold conclusion need be tempered with the knowledge that a handful of data points cannot a certainty make. Nevertheless, forewarned is forearmed.

One of the shorter-term indicators pointing in a bullish direction is the percentage of stocks at 20-day lows. This is a contrary opinion indicator that postulates that when 50% or more of stocks have reached 20-day lows, exhaustion in selling has probably occurred. We are there as of June 24th. Historical forward returns since 1973 are 9.9% in 6-months and 16.7% in 12-months.



*Source: Strategas Research Partners



*Source: Strategas Research Partners

Once again we will beat the drum with our chart showing rolling 10-year equity returns. This 100-year chart shows why we might all be best served by just sitting back and letting what come what may, exceedingly difficult though that might be, and even though we have all become "so weary with disasters".

Sometimes a single word or two is never enough, though we know no other way to express it. We thank our investors for their calm and patience, and their confidence in us.

Very truly yours,

Alan T. Beimfohr | **John G. Prichard, CFA**

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