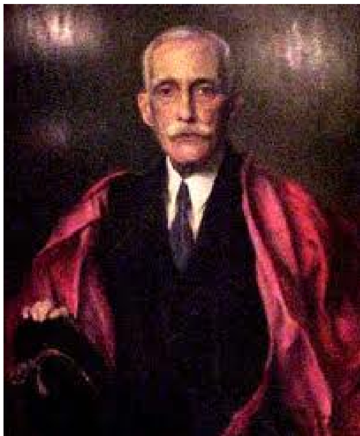
Knightsbridge Asset Management, LLC

July 21, 2012

Summary Quarterly Commentary



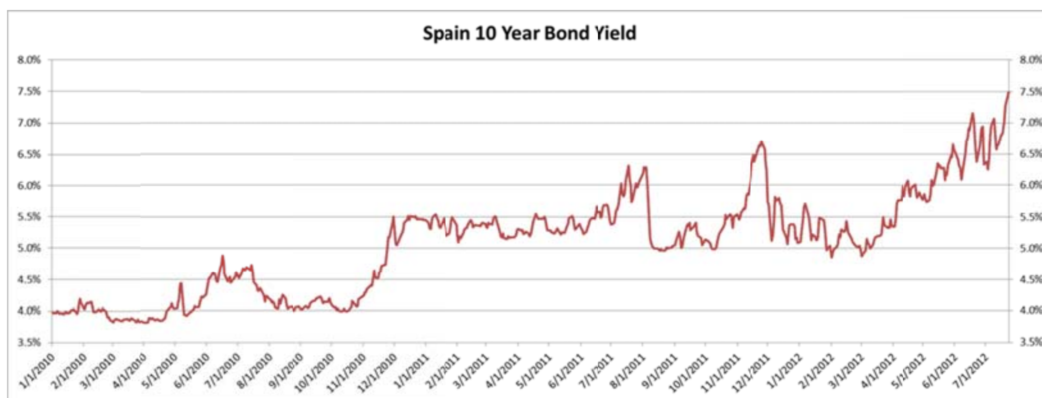
"Liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate... it will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people."

Andrew W. Mellon, 1855-1937
Secretary of the Treasury, 1921-1932
Banker, businessman and philanthropist

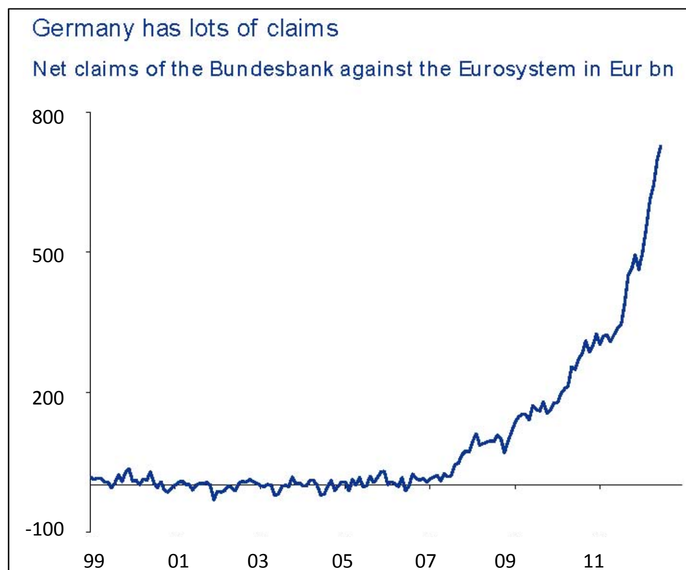
Such was the advice of third-longest serving US Treasury Secretary Andrew Mellon on the subject of how to deal with the Great Depression, as it was later recounted by President Hoover. Though we might note the Great Depression went on almost another decade while Mellon's successors implemented drastically different policies, his "come-what-may" approach is conventionally considered to have resulted in disaster. Since the onset of our more recent financial crisis, the exact opposite approach has been taken across the globe: almost nothing has been allowed to be liquidated or completely fail.

Here in the US we bailed out our banks, the auto industry, and many a homeowner (one can infer that Lehman was allowed to fail only in order to scare lawmakers into granting the much more important AIG/backdoor bank bailout). In Europe, various countries bailed out their banks, leaving their government finances strained. Said governments then needed a dizzying array of bailouts from other European countries, international institutions like the IMF, and circularly from their own bailed-out banks who received backdoor assistance from the European Central Bank and are basically forced by capital rules to purchase government debt. Between mounting US debt and the still evolving European situation, it will be years before the full consequences of this "bail out everything" approach can be known. Only then will we know whether we have avoided taking Mr. Mellon's bitter medicine, or if we have only simply postponed it.

In June, a nineteenth European summit produced the usual pattern of a short-lived swing toward hope followed by a relapse to reality. In this iteration, the encouraging notion was that European bailout funds could be directly lent to Spanish banks (once a Euro-zone banking supervisor is put in place), as opposed to lending the funds to Spain which would then lend to its banks. It would be a positive if this link in the negative feedback chain between the European banking system and sovereign debt could be broken. However, agreement in principle is not the same as execution. European Union officials have indicated the prerequisite bank supervision may be a year away and that countries may still be on the hook for funds their banks receive. Other recently celebrated plans inching Europe towards mutualizing both risk and fiscal control across the Euro zone have already proven complicated and are far from implementation. In the meantime, the current Euro bail-out fund faces further draw-downs by Ireland, Portugal, Greece and now Cyprus. Given that yields in the considerably larger Spanish bond market have entered unsustainable territory (over seven percent), market forces may not allow the time required to implement the hoped-for fiscal compact and permanent bailout fund.



Some in the financial media have portrayed the Euro crisis as a stand-off between Germany and the PIIGS (Portugal, Italy, Ireland, Greece, and Spain). This imagined standoff pits the debtor PIIGS, who demand money and resist change, against Germany, who demands big changes in the form of austerity and centralized oversight in exchange for money. Some have gone further and postulated that because Germany has a vested self-interest in keeping the Euro together, it will ultimately blink and the crisis will be solved. We think this doesn't paint the full picture.



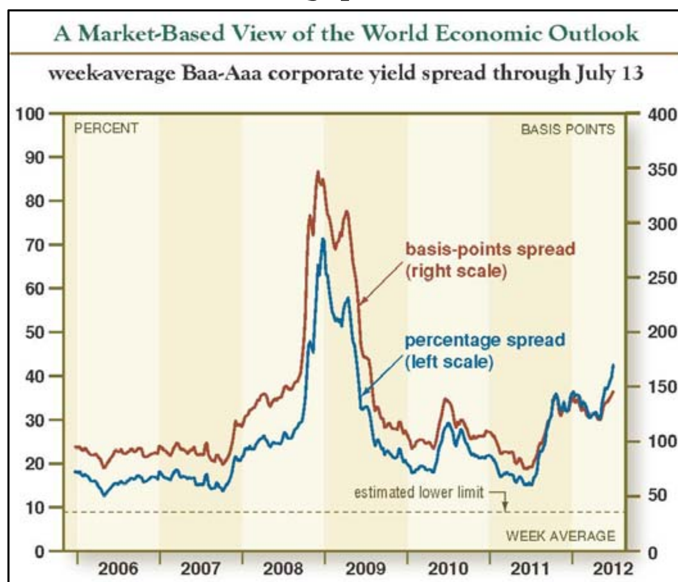
Source: Goldman Sachs

The first part is correct, Germany does indeed have a vested interest in keeping the Euro-block largely intact. Even aside from the substantial indirect disruptions to trade and the potential chain reaction of bank defaults that would result from a breakup, Germans are directly on the hook via the European Central Bank system which facilitates normal daily cross-country fund flows. This system, known as Target2, nets out but does not settle imbalances. As shown on the right, through this system, the German Central Bank (Bundesbank) currently has a €728 billion (~$900 billion) claim against the European Central Bank, which then has a claim against the central banks of the various debtor nations. If debtor countries leave the Euro, their central banks might repay these balances in vastly depreciated local currency... and basically if the ECB doesn't get paid, Germany doesn't get paid.

The point we'd like to make is that even though Germany has a huge incentive to agree to policies preventing a breakup, it may not be able to effectively implement those policies and a violent, chaotic breakup is still a very real possibility. For example, suppose Germany (read: Angela Merkel) decides that Euro bonds are necessary to save Spain. Well, Germany's Constitutional Court has indicated it would consider such Euro bonds unconstitutional. Could Merkel steamroll the court just because she thinks it necessary? We doubt it. Similarly, suppose debtor government leaders agree to give up their fiscal sovereignty in exchange for money. Would they legally be able to do so without popular referendums or legislative actions? What if some country (say, Finland) held out? A grand agreement might be in every country's best interests, but each

country isn't a single actor, able to immediately do what it wants. The real world is much more complicated and slow moving, and the speed of events could well overwhelm policy makers, even if they were in agreement. It is too early to tell what the ultimate outcome will be.

The European debt crisis continues to weigh on the European economy and this weakness has begun to spread to the US economy as indicated by recently disappointing US economic data. For example, June saw the largest one-month decline since 9/11 in the widely watched Institute of Supply Management Manufacturing New Order Index. This leading indicator is now disturbingly at its lowest level since 2009. Corporate credit spreads, as measured by Aaa relative to Baa yields, are one of the most reliable indicators of economic health. These spreads are more elevated than at any point during 2010 or 2011 (meaning that debt investors are more worried about default). While no one has been happy with the economy over the last three years, it is useful to remember that we have not been in an official recession since 2009. Is the bond market telling us that we could be headed for another recession? We see the risk and have attempted to select new portfolio positions that can perform well even in depressed economic conditions.



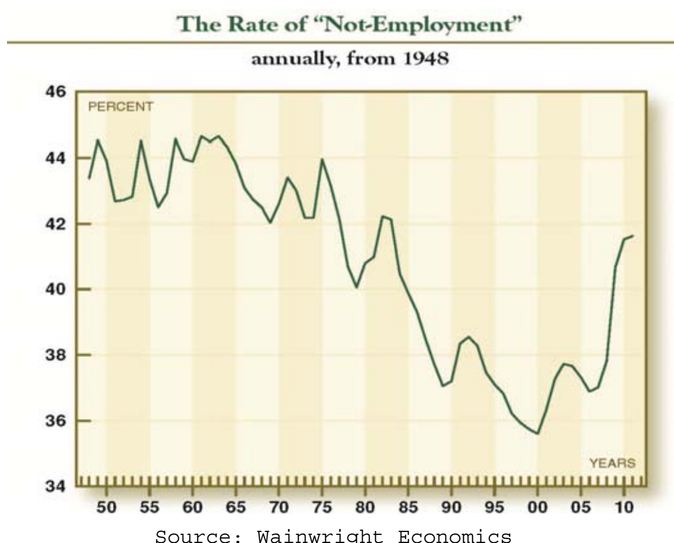
Source: Wainwright Economics

Adding to the uncertainty is the coming "fiscal cliff" which in essence is a drastic synchronized increase in taxation and decrease in government spending. While it is generally acknowledged that the US needs to reduce its budget deficit in the long-run, there is widespread concern that a sudden and drastic adjustment such as embodied in the fiscal cliff could throw the economy into a tailspin. Neither political party wants to be seen as ruining the economy or wholly failing to address budget concerns. Can they come together to enact more moderate longer-term deficit reductions which must include entitlement reform? The best thing for the economy would be to get a believable plan on the books right away to reduce business uncertainty. Unfortunately, political tendency is to wait until the last hour and always after elections. As Jean-Claude Juncker, Prime Minister of Luxembourg and the longest standing head of a democratic government once said, "We all know what to do, we just don't know how to get re-elected after we've done it." Expect uncertainty and fear until

the fiscal cliff is resolved (and kicking the can a few months down the road doesn't count).

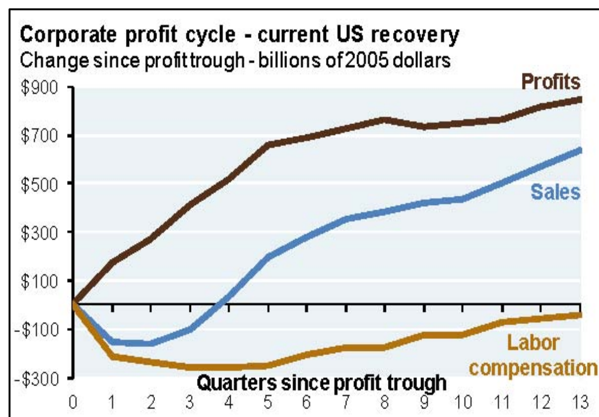
The weight of European fall-out and budgetary uncertainty is reflected in the recent Pew Research Center's annual Global Attitudes Project which reveals dire American views toward our economy: only 31% of respondents believe the US is experiencing a "good national economic situation". Only 14% of those polled believe it is "easy for a young person to get a better job / become wealthier than their parents".

Another striking measure of employment conditions is to simply consider the percentage of the civilian working-age population that is *not* currently employed, as the following chart illustrates. This measure of unemployment is the highest since the early 1980s.

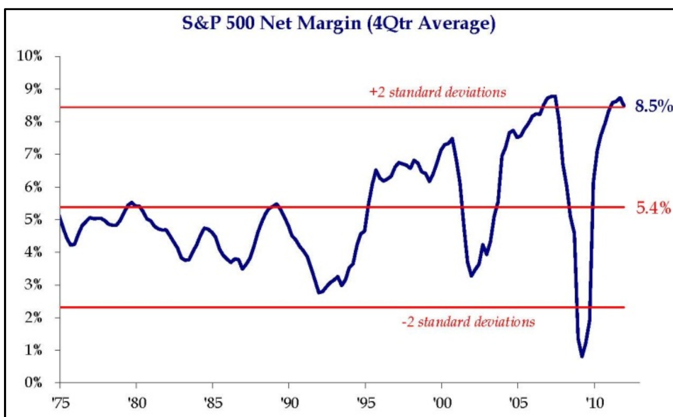


Source: Wainwright Economics

However, what has been bad for labor has been good for corporate profits, resulting in net margins for the S&P 500 Index currently two standard deviations above the historical average. Likely reversion of margins toward norms presents a headwind for earnings.



Source: J.P. Morgan Asset Management

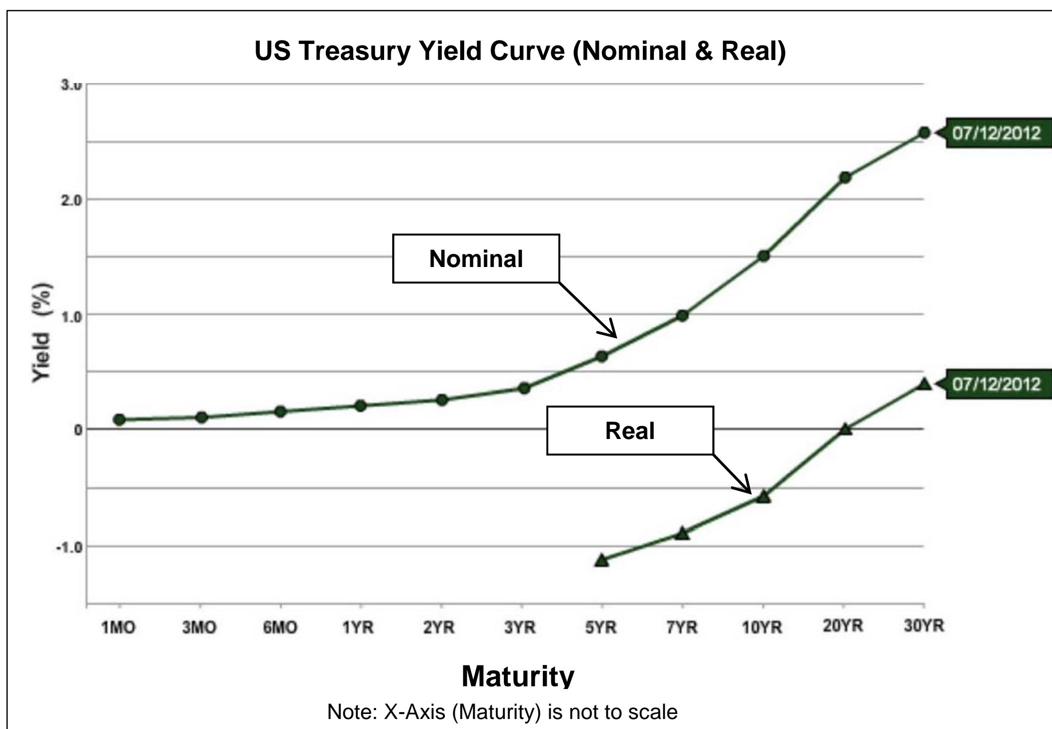


Source: Strategas Research Partners

Given all these fears, should one seek safety in bonds? We suggest this is a very crowded trade. Some bond investors these days willingly *pay* for the privilege of having someone else hold their money. Flight to safety has driven two-year sovereign yields into negative territory in Switzerland, Denmark, Austria, Germany, Finland and the Netherlands. To be clear, this means investors buy these bonds knowing two years later they will not receive all their money back. Why not leave their money in a bank and receive 100% back in two years? Could it be because they expect even less of their money back if they leave it in a European bank?

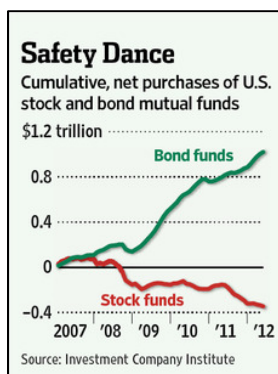
Are holders of shorter-term Treasuries also looking for yields to go negative? We see asymmetric risk assuming US yields can only go to zero. Two-year Treasury notes yield 0.22%; a one percent increase in two-year rates would produce a roughly two percent price loss, wiping out nine years of interest payments. Five-year Treasury notes yield 0.58%; a one percent increase in five-year rates would produce a roughly five percent loss in price, erasing more than eight years of interest payments. It appears these bonds offer much greater potential for loss than gain.

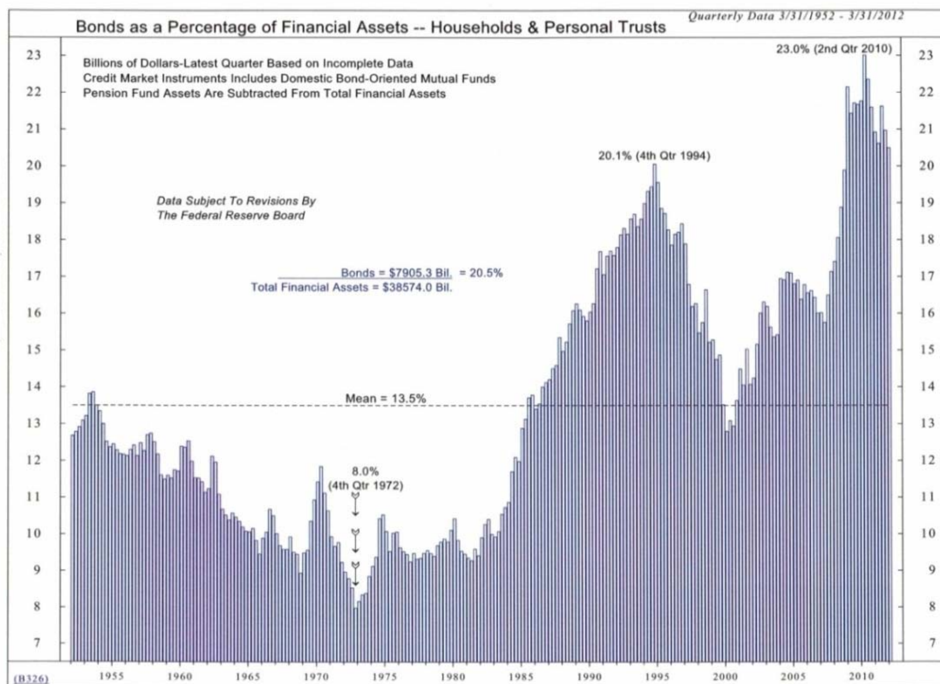
The chart below shows the nominal (before inflation – top curve) as well as the real (after current inflation – bottom curve) Treasury yield curves. All Treasury maturities as far out as 20 years offer *negative* real returns. The actual return experienced by investors could turn out to be substantially more negative than indicated should inflation rise above today's tepid rate.



Source: Department of Treasury

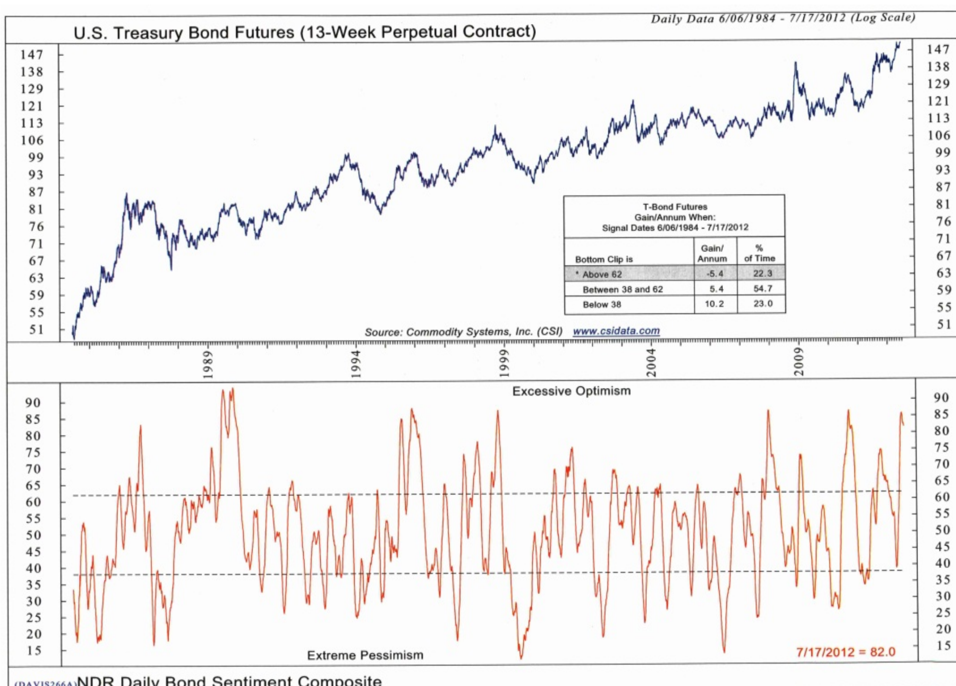
Investors, spurning equities, appear eager to accept multi-decade low bond yields despite limited potential for capital gains. Monsanto Co. recently issued a long-dated corporate bond at 3.6%, setting a 40-year low. Since 2007 US bond funds have received a staggering $1 trillion of net cash inflow. Bonds now represent 20% of household and personal trust financial assets (a near 65-year high). Clearly bonds are in vogue.





Source: Ned Davis Research

Ned Davis Research compiles a bond sentiment measure that incorporates newsletters and surveys as well as bond traders' short interest and option positions. Bond sentiment, wildly optimistic at an 82% bullish reading, has reached a level consistent with previous sentiment peaks. Such optimism has

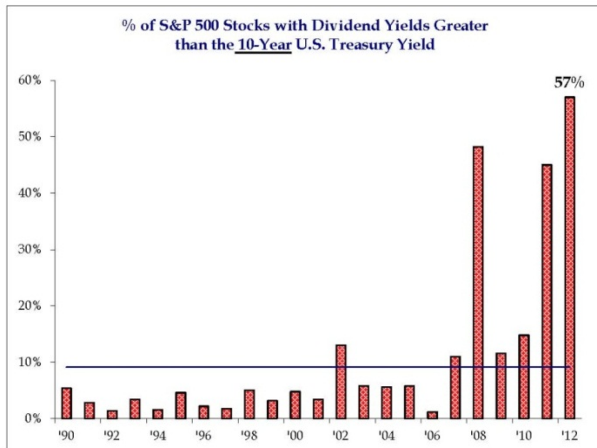


Bottom Clip is	Gain/ Annum	% of Time
* Above 62	-5.4	22.3
Between 38 and 62	5.4	54.7
Below 38	10.2	23.0

Source: Ned Davis Research

produced negative bond returns, as the box in the top half of the chart above illustrates.

Bonds are popular while stocks are contrarian. This has been the case for a few years and yet bonds have continued to beat equities. However, this should not be surprising. Almost by definition, contrarian plays initially disappoint... but only for a time. It's not until the contrarian becomes the new consensus that independent thinkers are handsomely rewarded.

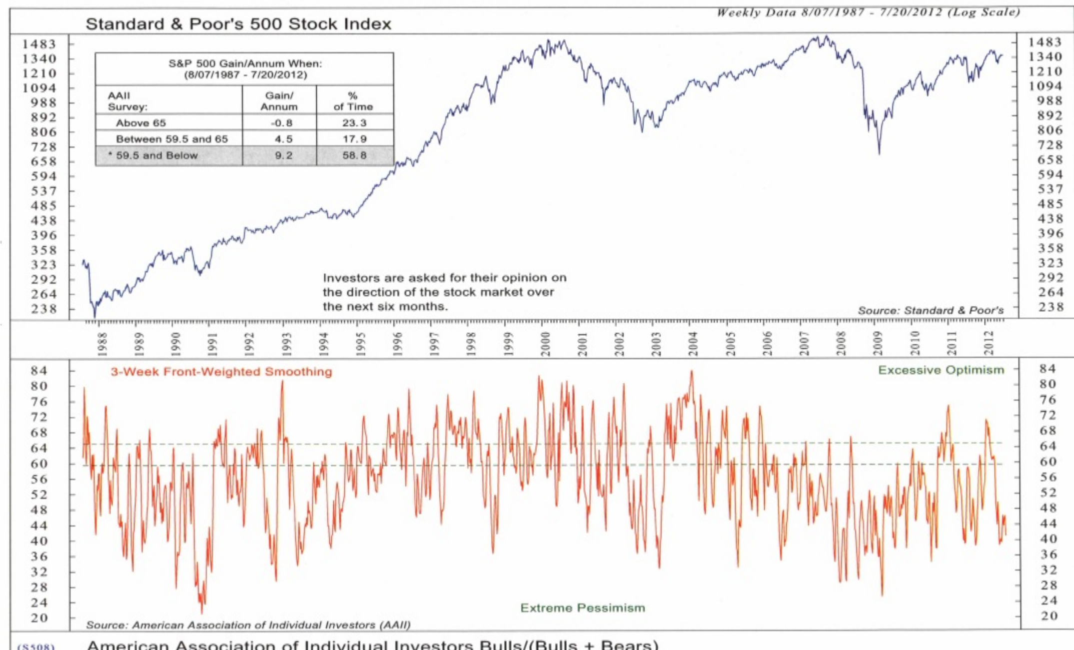


Source: Strategas Research Partners

How much more popular are bonds than stocks? Consider that 57% of the S&P 500 Index stocks offer dividend yields in excess of the yield on 10-Year US Treasuries. Investors may not realize it, but they are essentially saying they expect stocks to be lower in 10 years.

One can observe the low expectations for stocks manifested in various other forms, which we view as highly bullish:

- The American Association of Individual Investors Survey, which gauges equity market expectation among individual investors, is running decidedly pessimistic.

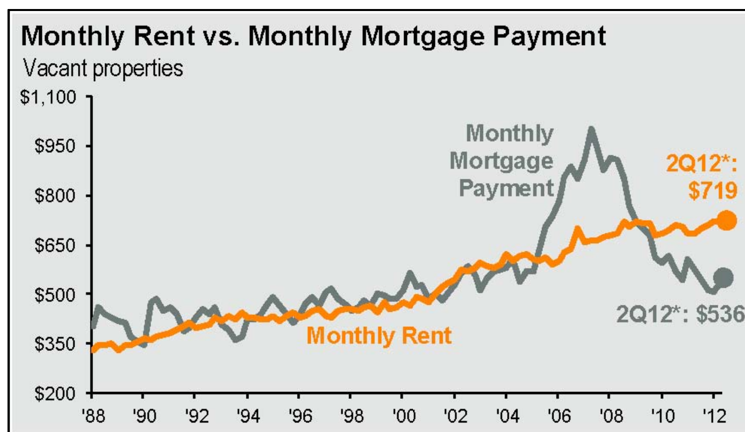


Source: Ned Davis Research

- The recommended equity allocation by Wall Street Strategists is at a five-year low.

- No S&P 500 company's pension plan assumes annual returns above nine percent. This is compared to 56% of plans assuming nine percent or higher in 1999 (not a good time to forego bonds to invest in relatively "riskier" stocks).

- On May 23, 2012, The Financial Times published an article entitled Markets: Out of Stock which, while noting that stocks have not been so cheap compared to bonds in half a century, ponders whether the "cult of equity" is dead. One is reminded of the August 13, 1979 BusinessWeek cover, Death of Equities, published near the end of a horrendous decade for stocks which preceded one of the great equity bull markets of all time.

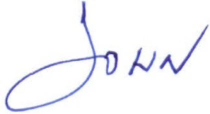


What might finally spark a turnaround in the economy and investor confidence? A housing recovery. US home builder confidence just made the largest monthly increase in nearly a decade and housing starts are at their highest level since 2008. Spending on home construction and home improvements have added to US GDP for four straight quarters. People are starting to wake up to the reality that in most markets it is cheaper to buy than rent. While not all can take advantage, we hear reports of savvy investors quitting the hedge fund business to buy and rent out single family homes on a scale never before seen. In certain markets houses have been selling below replacement cost... an environment that most certainly will not last. Given the totally collapsed state of the housing industry, any recovery would provide a substantial boost to employment and the economy.

As this letter hopefully makes clear, the current environment offers both challenges and opportunity. Much depends upon the course chosen in dealing with the legacy of a financial crisis and adjustment in the values referenced by Andrew Mellon. We have worked this year to position clients

more firmly for a tenuous environment. While cautious on the current big picture environment, we are strongly positive on the long-term direction of Knightsbridge portfolio holdings, especially the stocks purchased during 2012. We have purposefully purchased stocks that we believe can thrive based on their individual characteristics without being as dependent upon a highly cooperative investment environment. We thank our investors for their calm and patience, and their confidence in us.

Very Truly Yours,



John G. Prichard, CFA

Past performance is not indicative of future results. The above information is based on internal research derived from various sources and does not purport to be a statement of all material facts relating to the information and markets mentioned. It should not be construed that the information in this commentary is a recommendation to purchase or sell any securities. Opinions expressed herein are subject to change without notice.