

# Capital Visions

## The Dead Sea

We were on a small bus, traveling together with 17 family members on what turned out to be an adventure of a lifetime. Heading south on Highway 90, we knew we were riding on the world's lowest road, more than 1,000 feet below sea level. Starting the day in Bet Shemesh, an Israeli city (with a number of American transplants) located about halfway between Jerusalem and Tel Aviv, it was 3:00 p.m. before we neared our destination. As the area we were in gets less than 4 inches of rain *per year*, we left our umbrellas behind. Then, just as the biblical aura of the area began to permeate our thinking, a force of nature erupted as ominous as the thought of the Almighty him(her?)self.

It began to rain. No, not rain, but pour. NO, not a downpour, but a deluge ensued so violent that we wondered if we were to witness the "end of days." The desert mountain to our right lit up with lightning as the dense parched dirt instantly repelled the falling water that then came streaming towards our bus. "Look out!" yelled one of our group to the driver, as what may have been mistaken as a mirage just moments earlier was now a two-foot deep puddle on one side of the highway. We had no choice but to keep going.

As we drove up a small incline, we wondered if we would ever see our destination. The trip to Israel had been planned for more than a year. We were only four days into the journey and had so much more to see. This one-day side trip was to be one of the highlights. We hit a small bump at the top of the incline, and three of the seven children aboard began to cry. Then . . . it stopped. We turned around and saw what appeared to be a wall of water almost magically end like a cliff at the pinnacle of the road. The sun reappeared overhead and the road was bone dry. We knew we were in a very different part of the world.

After our brief scare, it was only another twenty minutes to our destination. We could see it ahead to the east, on our left. It did look "dead," like a black hole opening from the center of the earth. Why is it so famous? What makes its characteristics unique? Where did all that rain come from? We arrived, and without waiting for the bus to come to a complete halt, we (children first) jumped out of the coach and ran towards the Dead Sea.

As described on Wikipedia, "*The sea is called 'Dead' because its high salinity means no macroscopic aquatic organisms such as fish or water plants can live in it.*" The weather is warm year round and desert-like hot in the summer. We were there off season and so the sand beach was relatively empty. We changed into bathing suits and went running into the sea. Nothing too unusual yet. But what was that nasty smell? We looked around for an oil refinery but found no industry at all. "Enjoying the sulphur fumes?" yelled a fellow swimmer. The Sea (actually a giant lake) sits in the middle of the

Syrian-African rift, two land masses, one moving northward and the other south. It is fed by the Jordan River but has no outlet streams. Due to its unusual topography, and the many earth movements over the millennia, large and concentrated mineral deposits formed. We took another few steps and looked down.

"Wait, we thought these were sea shells we're walking on," we said, "*but they are pebble-sized pieces of rock salt.*" Typical ocean water is about 3½% salt. The Dead Sea is more than 30% salt. So, similar to the Great Salt Lake in Utah, a person can easily float due to natural buoyancy. More than that, it is nearly impossible to fully submerge. "*Hey, we can't sink even if we try!*"

We spent another day at the Dead Sea (there's only so much "bobbing" around one can handle) and continued our journey of a lifetime in different parts of the country. Far too soon, our memorable trip to Israel came to an end. We will definitely return. Back in our Newport Beach offices, toward the end of 2007, we reflected on our visit to the Dead Sea and remembered how we just couldn't sink. It struck us that we couldn't be dragged down, much like the U.S. stock market.

## Just Can't Drown

Much to the chagrin of our fixed income-oriented Newport Beach neighbor, try as the world might to force the U.S. stock market down, it just won't sink. With some, mostly brief, respites, stocks have powered higher since the summer of 1982. "Thrown" at it were a myriad of events including, in the past ten years, a tech bubble, the year 2000 (Y2K), a tech bubble burst, 9/11, a stronger dollar followed by a weaker dollar, dramatically declining interest rates, then three years of "measured rate increases," a housing bubble, now a housing bubble burst, Iraq, Iran, North Korea, and, now, a crisis in credit confidence.

*The Bank Credit Analyst* sums up the current situation as follows:

*"It is an ugly picture: the U.S. is in the midst of the worst housing downturn since the 1930s; the sub-prime mortgage crisis has spread through the credit markets like a virus, causing spiraling losses for lenders and borrowers; leading indicators for the developed economies are looking increasingly sick . . ."*

Yet all major U.S. stock market indices **rose** for the year 2007.

We offer two possible explanations: Either U.S. stocks are a disaster just waiting to happen, or something extremely powerful underlies the continued strength. While the former explanation is plausible, we prefer the latter. Long-term sustainable growth in global economic output, coupled with reduced volatility of this

growth is, we believe, the primary driver of rising stock prices. Following is a partial list of long-term trends that may have contributed to our “Dead Sea” market:

- Productivity improves almost continually worldwide.
- Globalization is an undoubtable and important intractable theme of which we’ve spoken many times.
- Availability of jobs. This feeds a cycle as more and better employment leads to higher incomes, which fuel greater spending, resulting in more demand for goods and services and, thus, demand for people to provide such.
- The decline of centrally controlled economies, which frees up capital and labor. This is just beginning to take hold in some huge economies, including Russia, China and India.
- Reduced constraints on the free movement of labor, capital and (most importantly due primarily to better communication), *ideas*.
- Significant FREE cash flow generation by corporations.
- Significant FREE cash flow generation by individuals (partly fueled by favorable demographics).
- Living standards continue to improve. While this has come at a “cost” of longer working hours, it has added fuel to the world economy.
- Financial disintermediation. With this have come ever more *exotic* forms of financial assets, including hedging vehicles, many of which are being tested for the very first time.
- A somewhat controversial driver of economic growth is the long-term rise in debt levels. While all would agree that “too much” debt must eventually be reconciled, there is no concrete evidence of how much is too much. Yes, U.S. household debt-to-income ratios have risen, almost in a straight line, since the 1950s. But this may be tempered by the fact that debt-to-asset ratios have not risen much. Even excluding the value of residential real estate, U.S. households have the highest level of assets and the highest ratio of assets to liabilities ever. This enhances consumer *confidence*, which drives spending.
- As a corollary to the last point, while U.S. household debt has risen sharply over the past decade, U.S. government and corporate debt are no higher (as a percent of GDP) than they’ve been for most of the past thirty years. So taken in aggregate, U.S. total debt levels may be sustainable or may even move higher.

All of the above have exceptions, and there will most assuredly be setbacks. We are also not certain which of the above may hold greater importance than the others. If one or two of these factors reverse, what may be the consequences for the long-term health of the financial markets? There are many unanswerable questions such as these. The clients of MetWest Capital may take comfort in the fact that (i) we’re asking about such issues and (ii) we will diligently study these topics with a goal of being out in front of any important long-term trends we uncover. As always, this will be done as a part of our individual company analysis.

Now, let’s provide greater detail on the financial markets, the results for 2007 and some more thoughts about the future.

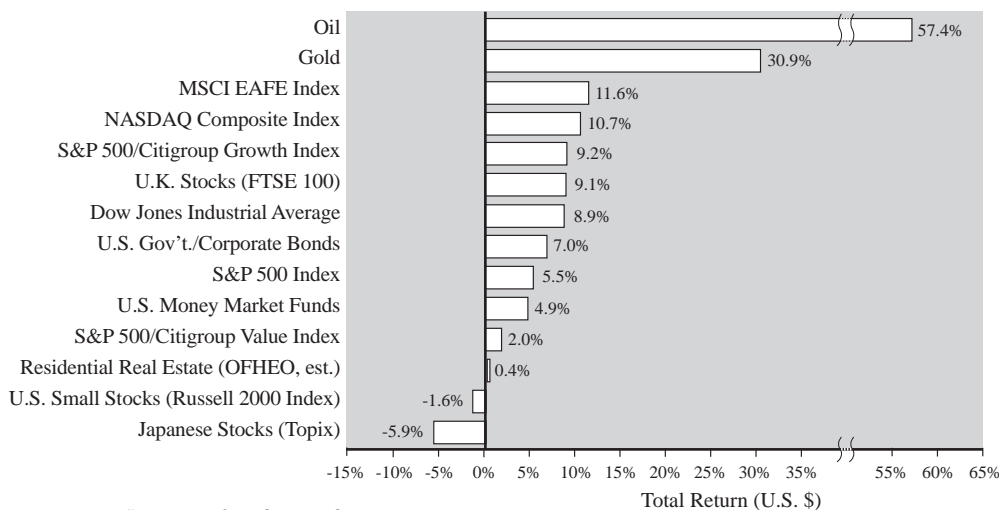
## VALUE EQUITIES STRATEGY

As discussed above, the financial markets finished yet another good year in 2007, their fifth in a row. Notwithstanding a year-end rally, the U.S. dollar was weak against all major currencies. Thus, most foreign stock markets rallied (as the rising foreign currencies added to their local currency performance). Developed market equities (as measured by MSCI EAFE) rose +11.6% including income. Some individual country markets did much better, as the German market gained more than +30.0%, while others lagged, as Japan declined for the first time in the past five years. Most commodities rose, led by oil (+57.4%). High-quality fixed income securities gained in price as the Federal Reserve Board (Fed) reacted to credit troubles by lowering interest rates.

As for U.S. stocks, the S&P 500 Index approached its long-term average by adding +5.5% including income for 2007. After mostly the opposite for this decade thus far, “growth” stocks outperformed “value,” while larger company stock prices significantly outpaced the decline of smaller companies. The NASDAQ, with its heavy technology exposure, did best. By industry, there was a very large dispersion of returns for the year. Consistent with the move in the underlying commodities, oil and gas and most other natural resource-related industries gained +20% to +50%. At the opposite end, most anything financial dropped—losing more than 20% for most financial industries.

Risks to the health of financial markets are always present. But, as discussed above, we remain sanguine in our long-term outlook for equities. At the same time, we are worrywarts, always concerned about what may go wrong. Sometimes the risks seem moderate and manageable. Other times the downside of those risks is substantial. The last time we thought we were in the “substantial” area was at the beginning of this decade, when we believed we were at risk of deflation taking hold in this country. We thought the chances of such were slim and believed that policymakers were keen on its avoidance. But the consequences of allowing deflation to take hold were material. Examples were the Great Depression of the 1930s and the Japanese malaise of the 1990s. Deflation in the 2000s has thus far been avoided and the global economy and financial markets have moved forward.

### 2007 Asset Performance



Sources: Bloomberg and Various

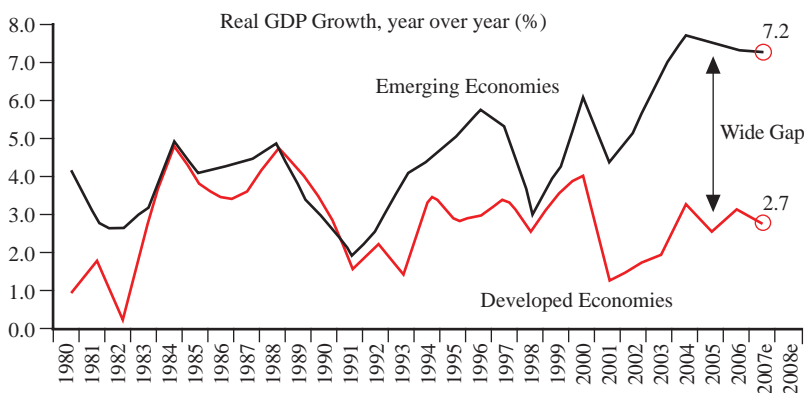
Today we see the risk of financial market “contagion” beyond housing and housing-related securities and their derivatives. Again, we believe the chances of a downward spiral are small, as one can’t help but read all the reports of awareness throughout the world’s financial system. We think the most likely progression is for U.S. housing to follow its “normal” path of correction after exuberance—this lasting a few years, and we are already more than a year into it. Lending may remain constrained during this period, but as residential investment is only 5% of GDP (and commercial development only another 2½%), the fallout in other economic sectors, while real, could be manageable and, possibly, short-lived.

We thus see global economic growth as continuing. This would pave the way for corporate profit increases, and equities should follow the path of company earnings. We will continue to reassess our judgments as new information becomes available.

## INTERNATIONAL/GLOBAL STRATEGIES

Last quarter in our *Capital Visions* entitled “Peter and the Wolf,” we highlighted “a new economic reality” whereby the emerging economies of Brazil, Russia, India and China would, over the coming thirty years, eclipse in size the developed economies. This quarter, while repeating such an opinion, we wish to introduce a caveat: the developed economies, themselves, must remain healthy. The following chart illustrates our point.

### Soft Decoupling?



Sources: Federal Reserve, IMF, Haver, Thomson Financial and Morgan Stanley

This graph shows economic growth for both developed economies (red line) and emerging ones (blue line). Note the strong correlation of the two. Thus when, for example, the U.S. and Europe slow, so, too, do China and India. This is because a meaningful share of the latter’s success has come from both investments by the former into their economies and growing exports from developing to developed countries. The gap in growth comes from the increasing domestic consumption by the newer economies that may be added to their exports. But the growth gap is unlikely to remain as wide as it has been in recent years, and it may even narrow. This would occur especially should the U.S. or Europe enter into outright economic recessions. The dramatic fall off of investments in and exports from the developing nations may not be overcome by their local growth.

We must remain mindful of this correlation and seek diversification in our international investments, not becoming overly reliant on the

developing market themes that have worked out so well of late.

Let us now highlight a few opportunities we are taking advantage of around the globe.

## INVESTMENT ACTIVITY

In this section, we highlight several of the newer investments from any or all of MetWest Capital’s equity strategies: *Intrinsic* (Large Cap) Value, Small Cap Value, International Core Value and Global *Intrinsic* Equity. Fixed Income is covered in the section that follows. The following new investments were selected as representative and do not necessarily reflect our “best” or “highest-conviction” ideas:

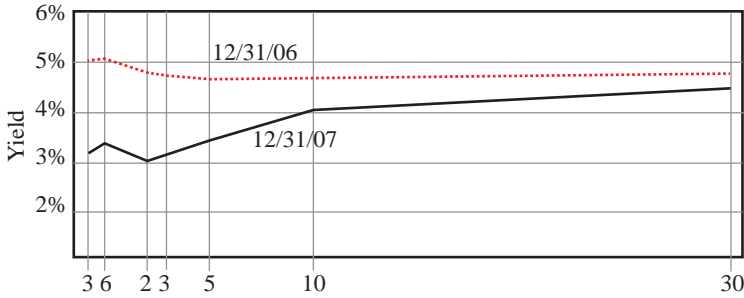
- **Safeway** operates 1,750 supermarkets throughout North America, with its largest concentration in California, Texas and Illinois. It also owns one of the largest food chains in Canada. The retail food industry, and Safeway in particular, has transitioned from a focus on building new stores to one of better serving its customers by upgrading existing stores. Safeway (also operating as Vons, Pavilions, Dominick’s, Genuardi’s, Tom Thumb and Randall’s) is halfway through rolling out “Lifestyle” formats, which feature organic meats, nut bars, wine cellars and sandwich shops tailored to each location. These investments take time to mature, and thus current earnings are understated. The company also owns 100% of a start-up company called Blackhawk, the world’s largest gift card distributor and processor. We believe this business is not properly valued within Safeway’s stock and thus represents a nearly “free option” for shareholders.

- **European Aeronautic Defence and Space Company (EADS)** is Europe’s equivalent to the U.S.’s **Boeing**. Two-thirds of its sales come from Airbus commercial aircraft, with the remainder from aerospace and defense. Similar to our earlier discussion of the stock market, almost everything imaginable has been “thrown” at EADS. Its high-profile double-decker A380 faced significant delays and cost overruns. The rising euro currency made it more difficult to compete with dollar-based Boeing. Major defense programs were late. The company faced pressure from its government shareholders. Yet EADS continued to sell and produce aircraft (the first A380 is now flying for Singapore Airlines) and work through its many issues. Over time, we find no reason why Airbus cannot be as profitable as Boeing, leading to a much higher EADS stock price.

## FIXED INCOME STRATEGY

As changes in interest rate policy are not needed to combat inflation, the Fed has felt comfortable focusing its policies on keeping the economy growing. While many central banks around the world are still *raising* rates, the U.S. Federal Reserve Board lowered the Fed funds target rate three times during the last four months of 2007. The rate currently stands at 4¼%, one full percent lower than where it began the year. The graph on the next page shows the U.S. Treasury yield curve at the beginning (dashed red line) and end (solid blue line) of 2007.

## U.S. Treasury Yield Curve 12/31/06 versus 12/31/07



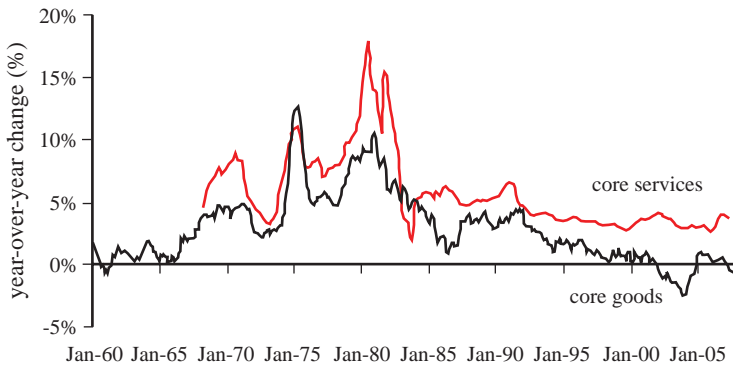
Source: Bloomberg

Note the significant decline in short-term rates due to both the Fed actions and a flight to quality. But also note that longer-term interest rates have moved less. Ten-year yields have declined by only 68 basis points (0.68%), while the longest rates are down even less. This could be due to expectations for higher inflation once the current credit market uncertainties subside.

Inflation is, to us, an inverted “Dead Sea.” It just won’t go up. Thus far in the decade, the U.S. economy has experienced strong growth (even considering the recent housing weakness). The value of the dollar has weakened—it took only 84¢ to purchase one euro in 2001 compared to a peak of \$1.48 per euro this past quarter, pushing up the cost of imported products. Labor has been tight, with the unemployment rate consistently below 5%. Commodity costs have skyrocketed. Yet throughout this period, inflation has hovered between 2% and 3%. As of yet, this is not consistent with our expectations of gradually rising inflation.

### Inflation

(Core Goods and Services CPI – last observation September 2007)



Sources: Bear, Stearns & Co. Inc. and Haver

This chart shows a potentially worrisome trend. Earlier we said that the Fed had conquered the threat of deflation and so this concern has subsided. But note how, for some parts of

our economy, not only has inflation **not** ticked up, but we may be back in a deflation. The solid blue line depicts core goods inflation (excluding volatile food and energy prices) as negative. A major factor in the deflation is the decline in the price of new automobiles. But other manufactured goods have seen declining prices as well. Services inflation has remained steadier at around 3% but has not risen much, even with a tight labor supply.

The question one must ask is, if inflationary pressures have not mounted with so many external forces pushing it higher, is the threat of **de**flation going to be an issue in the future? Clearly this is a question we must factor into our longer-term analyses.

*Not all securities mentioned herein are necessarily owned in all MetWest Capital portfolios. Differences due to restrictions, tax considerations, cash flows and other factors may have impacted the decision to buy and/or sell certain securities at specific times. Inclusion does not imply that investments in these securities have been profitable. A list of all recommendations made in the prior one-year period is available upon request.*

## CONCLUSION

Murphy’s Law would suggest that as soon as we write a *Capital Visions* describing the never-ending bull market, stocks will decline. That may well be, and we offer no view for the near term (meaning less than five years). We recounted our trip to the Dead Sea this quarter as, similar to one trying to submerge in a lake that is 30% salt, the U.S. stock market remains “afloat” even after all that has been thrown at it. We offered many long-term positive factors keeping global economic activity moving forward and thus carrying stock markets along with them. We pointed out our belief that the economy and stock market, while always subject to interim volatility, may continue on their upward trajectory. But we also noted that we do not know if the recent strength was influenced more by certain forces than others (such as demographics). What may happen when these trends reverse?

Just prior to the beginning of our story, our bus had stopped to see the Dead Sea Scrolls near where they were discovered in the settlement of Qumran, just north and west of the Dead Sea. Buried in caves for two thousand years, and found quite by accident by a Bedouin shepherd in 1947, these scrolls represent some of the oldest biblical texts known to man. This discovery highlights to us the unpredictable nature of such finds, similar to the seemingly random movement of financial markets.

Was the sudden downpour of rain we encountered “sent” to remind us of the greater forces of nature? Or was it just time to rain? These “higher” questions, as well as those less ethereal, will continue to be pondered by the investment team at MetWest Capital.

*We wish you a truly buoyant 2008!*



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