

Hoisington

INVESTMENT MANAGEMENT COMPANY

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Quarterly Review and Outlook *Second Quarter 2002*

Investment Parameters Turned Upside Down

The Dow, S&P, Nasdaq and Wilshire 5000 stock indices are lower by 25%, 41%, 74% and 41% respectively in early July 2002 from their Y2000 peak price levels. Treasury bonds have gained over 30% for the same time period. Over the past five years our Treasury-only bond portfolio has eclipsed the S&P 500's 3.7% compounded return by about 5 1/2%. An analysis of asset class performance indicates that long-dated Treasury securities may become an even more desired vehicle of total return and safety of principal.

Two sectors possibly in need of risk-free, long duration assets are private, state and local government pension plans and life insurance companies. As recently as 1996, these entities held as much as \$582 billion in Treasuries. The siren song of high returns from riskier investments siphoned enough funds from Treasuries that by the end of 2001 their holdings totaled a mere \$374 billion, a reduction of \$208 billion from 1996. Making these statistics even more significant, only \$246 billion Treasuries with maturities longer than 20 years are outstanding. A dramatic re-pricing would occur if these investors restored their government guaranteed, non-callable, non-risk portfolio.

To further illuminate the paucity of risk-free securities consider that according to the Treasury Bulletin treasuries with maturities of five or more years totaled only \$750 billion at June 30. At the same time, the Wilshire 5000 Stock Index (reflecting the overall value of stocks) stood at \$8.742 trillion, almost twelve times greater than Treasuries with maturities of five years and over. From its peak levels, the loss in this stock index of some \$6.2 trillion has, of course, serious economic implications, but from an investment perspective, boring Treasury bonds seem a wonderful alternative.

Outlook

The massive destruction of wealth mentioned above carries ominous implications for businesses and consumers. When corporate pension plans are underfunded and experience continuous shortfalls, a charge to retained earnings is required by FASB. With debt ratios near all-time highs, this prospect is most unpleasant. Businesses have been on a tear to bolster the stability of their funding by reducing bank and other short-term debt. This more conservative balance sheet approach has sharply slowed corporate share buybacks, a major source of liquidity for the equity markets. Investment theorists, including the famed Graham and Dodd, have long argued that corporations should reduce debt and build equity when stock prices are strong. Instead, for the past six years non-financial corporations reduced equity capital to the tune of \$852 billion, or \$142 billion per annum. These balance sheet weakening stock buybacks were so great that they actually exceeded foreign purchases of stocks, that totaled only \$542 billion, or \$90 billion per annum. Now, with a weak equity market, more conservative accounting practices, and balance sheets badly in need of deleveraging, these corporations issued net equities at a modest \$20 billion annual rate—only the second positive quarter in the past eight years.

If the stock wealth loss in pension plans persists, corporate earnings will have further charges to retained earnings, which in turn could further reduce share prices. This would leave debt-laden companies with little incentive to hire, expand or invest. In other words, business conservatism would reign supreme. Restructuring will be difficult in a world with no pricing power, weak top line growth, increased governmental oversight, more restrictive accounting standards, fierce foreign competition, and massive excess capacity. A renewed investment cycle will not unfold until balance sheets are repaired, pension funds

are stabilized, legal remedies are analyzed, excess capacity is rationalized, and final demand is improved. Those circumstances are several quarters, if not years, in the future.

Negatives

The main input for business output is, of course, labor. A shift toward financial conservatism in business would point toward severe restraints on hiring, or precisely what the so-called “recovery” is witnessing. Thus far into the “recovery of 2002”, 250,000 private payroll jobs have been lost, rather than the average job gain in postwar recoveries of about 1,200,000 in today’s terms.

Over the long run, consumer behavior is heavily influenced by conditions in the labor market. Normally, people spend about what they earn. Since 1959, wage and salary income has gained 7.2% per annum, while consumer spending has risen 7.6% per annum (Chart 1). Some deviation between the two is to be expected since other components of income have increased, saving has declined, and wealth has increased. But, even with these other considerations, spending and wage and salary income are closely tied. Over the past five years, average wage and salary income, which includes exercised stock options, expanded 5.9%, while spending rose 5.7%. However, for the first five months of this year spending jumped at a 3.1% rate, while the wage and salary growth rate was a mere 1.3%. Spending outpaced income during and immediately after the recession due to the well timed tax cuts that added 2.7% to the real disposable

income growth rate. “Corporate conservation” will likely cause weak labor markets to persist, meaning modest growth in wage and salary income which, if held to a 1.3% increase for the entire year, would be the smallest rise since 1960.

So far this year the consumer has spent at a rate three times faster than income. Thus, the risk for the U.S. economy is that the consumer will adjust spending downward to align with income. Five considerations suggest that this is not an unreasonable assumption. First, a \$100 billion tax cut similar to last year’s will not be repeated. Second, without a tax cut the debt service burden, which recently stood at a near record 14% of disposable personal income, will move higher. Third, the unemployment rate will rise for the rest of the year. Fourth, consumer sentiment is already slipping due to rising unemployment. Fifth, the lagged impact of stock wealth loss will negatively influence spending for a considerable time. Fed Chairman Greenspan noted in his April testimony that fully 1/5—yes 20%—of personal outlays could be explained by changes in wealth.

Positives

There are some positives. First, things are pretty cheap. After all, 0% financing will surely encourage some automobile buying for the 94% of the labor force still working. Second, for some the price of credit is falling, allowing apartment dwellers to purchase houses at bargain basement rates. Thus, housing will remain ebullient for a time. Also, refinancing of existing mortgages will surge with the low interest rates, and possibly put billions of additional funds into the hands of homeowners. Third, the federal government is “priming the pump” with great zeal since a surplus of \$129 billion in 2001 has been quickly converted into a deficit of some \$160 to \$180 billion this fiscal year—the most massive reversal in fiscal policy on record. The rate of growth in federal spending surged at an 11% rate in just the past two quarters. Fourth, inventory levels are quite lean, resulting in higher factory shipments and new orders, while causing layoffs to diminish.

In spite of low inventory levels, an important statistical positive, the weight of the negatives in the coming quarters will overwhelm the positive factors resulting in minimal economic growth. The risk of a recession has not ended.

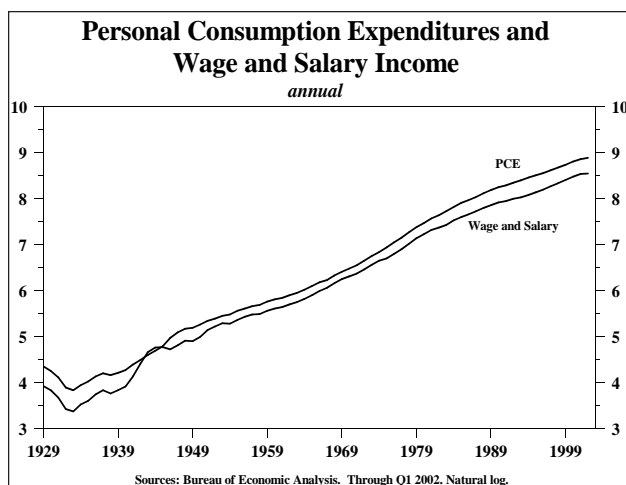


Chart 1

Fed Policy

The Federal Reserve was quick to realize the fragile condition of the U.S. financial system, and lowered rates to the current 1.75% level quickly in 2001. The major stimulative effect of that rate reduction has been felt, but an equal rate reduction encore is impossible. To be sure, the Fed funds rate, as we expect, could be cut further, but the stimulative impact of further easing will be less. Although interest rates are low, financial conditions are quite restrictive as illuminated in falling postings for bank loans and non-financial commercial paper. Further, rates are rising for many firms as default and fraud fears rise.

The Fed can pump additional reserves into the banking system in the form of high-powered money, i.e., increase the monetary base (comprised of currency in circulation and total reserves of the depository institutions). This high-powered money would be multiplied through the system, eventually creating greater income and spending. On the surface the Fed appears to be doing its job. The base expanded at a 6.9% annual rate in the latest three months and by 9.4% over the past year. Unfortunately, currency in circulation surged by 9.9% and 10.8% respectively over these time periods. Thus, total bank reserves actually fell for the last three months and gained a mere 1.5% in the last twelve months. Currency in the wallet, mattress, cash register or overseas does not support money and credit growth or income and spending expansion. Monetary policy has not been overly expansive, even with a low Fed funds rate. Hopefully the Fed will reverse this restraint in the future.

How About That Dollar?

In terms of the Fed's major currencies index, the dollar fell a sharp 8.8% in the first half of this year (Chart 2). This dollar series, which includes just seven currencies, is the one most widely followed. Presumably the reason for this is that it covers the currencies that are most directly involved in short-term investment flows. However, this series, valued in nominal terms, does very little to express how fluctuations in the dollar shift international trade. For example, the broad seven does not include Chinese yuan. At the margin, China now dominates U.S. imports.

Two Versions of the Trade Weighted Dollar
monthly

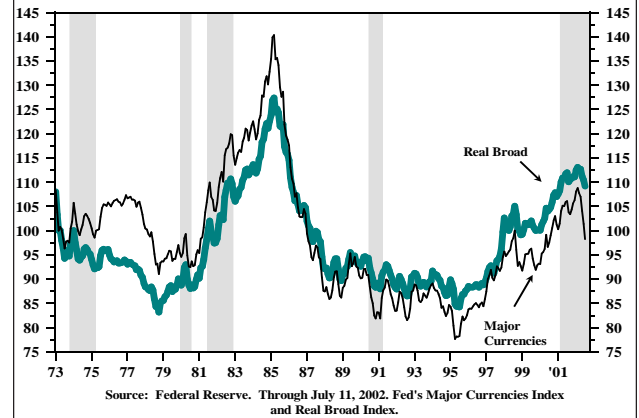


Chart 2

When the focus is international trade, the Fed's broad, real trade weighted dollar, calculated against 26 currencies, is the preferred measure. The broad dollar eased a miniscule 1.1% in the first half of this year (also Chart 2), and actually gained a significant 6.3% over the past twelve months. As such, nothing of any consequence has happened in the foreign exchange markets that will change the pattern of international trade.

While the dollar fell against the Euro, yen, pound, Swiss franc and Canadian dollar, it made huge gains against the Mexican peso and many other Latin American currencies. Indeed, the Brazilian real fell to a record low against the dollar, losing more than a fifth of its value. Even the broad measure doesn't pick up the gains the dollar made against Argentina and other Latin American currencies.

Individual economic statistics suggest that the major foreign economies are performing better than the U.S. in the second quarter. These recent gains in foreign economies may be simply reflecting the 6.1% U.S. growth bounce in the first quarter. The major foreign economies have been lagging the U. S. economy by one to three quarters, and over time they have been growing consistently at rates lower than those in the United States.

In short, nothing of a fundamental nature on the global scene has changed. The dollar remains strong in terms of trade, the rest of the world is heavily dependent on the U.S. consumer, and a continued flow of increasingly lower price goods will be heading toward the United States importing deflation.

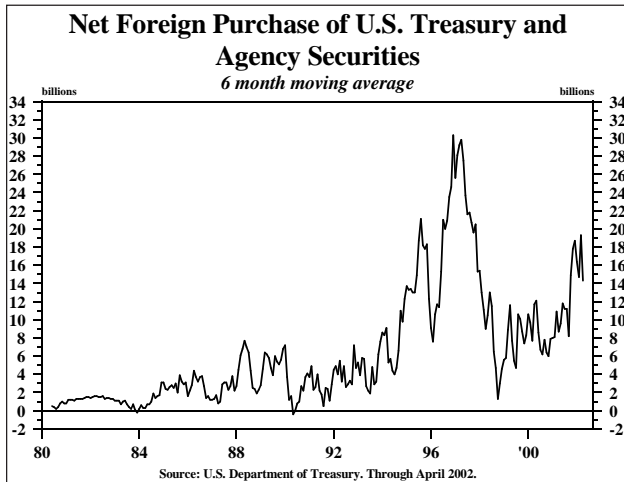


Chart 3

Moreover, in spite of rumors to the contrary, foreign purchases of U.S. Treasury and Agency securities have remained strong, gaining almost \$15 billion in the six months ending April (Chart 3).

Excellent Prospects for Treasury Bonds

Therefore, our analysis continues to indicate that the multi-year disinflationary trend is intact. Inflation is too much money and credit chasing too few goods. The over-riding theme of the global economy is one of restrained monetary conditions in the face of an ever-increasing global capacity to produce goods. This overall situation should be reinforced by a highly reliable cyclical pattern. During and after the nine previous post WWII recessions, the inflation rate fell by an average of about 3%. The risk remains that the overall economy will begin to

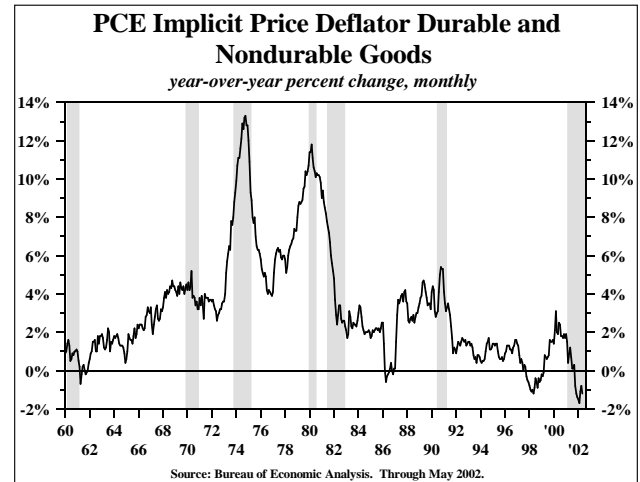


Chart 4

experience what the goods sector has known for the past year – deflation (Chart 4).

Since inflation is the main determinant of Treasury bond rates, the multi-year trend in yields remains downward. Admittedly, the Federal budget deficit will be large, but the deficits have historically worsened in this stage of the cycle and Treasury yields have still declined. We should emphasize that Treasury debt carries the full faith and credit of the U.S. government. In this time of unknown accounting irregularities, under-funded liabilities, and unprecedented leverage in corporate balance sheets, the risk-free appeal of Treasury securities should more than offset the greater financing needs of the government. We continue to favor investments in long-term Treasury bonds, including zero coupon Treasuries.

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