

Hoisington

INVESTMENT MANAGEMENT COMPANY

1250 S. Capital of Texas Hwy. #3-600, Austin, TX 78746 (512) 327-7200
www.HoisingtonMgt.com

Quarterly Review and Outlook

Fourth Quarter 2003

Risk Rewarded in 2003

High risk assets were the clear winners in 2003. The more speculative NASDAQ composite was up nearly 50%, while the higher quality Dow Industrial Average returned about 25%. Similarly, in the bond market long BAA corporates returned nearly 15%, while the returns on high quality Treasuries were closer to 1%, regardless of maturity. Thirty year bonds and cash equivalent results were essentially equal. Commodities, gold, and currencies of less financially sound countries outperformed the dollar, reflecting the enormous flight from quality that existed last year. Despite their rally, stocks are now basically unchanged for the two years combined, and, in fact, are no higher than they were five years ago. Similarly, the dollar index averaged the same in the fourth quarter of 2003 as it did in fourth quarter of 1999, despite its pummeling over the past 24 months. Long Treasury securities, often considered to be the highest quality investment asset, compiled a 9% compounded return for the past two years, and 6.5% for the last five, well exceeding the high risk categories mentioned above (Table 1). The structural problems of the world have not disappeared. Thus, the past may be prologue. The

next five years could easily be similar to the past five, with high quality assets outperforming the high risk categories.

It is possible to be constructive on the economy and bearish on interest rates for 2004 as 48 of 50 economists have suggested in a Wall Street Journal survey. However, our views are more in line with those expressed by the Federal Reserve. In its latest published minutes the Fed expects inflation to remain low and short rates to be stable for the foreseeable future, and they note that "above trend growth for an extended period of time will be necessary before the U.S. economy begins to absorb its excess labor and capital capacity." Long term rates generally follow the inflation rate movement, so if inflation remains low while the economy works off its excesses, long term interest rates will remain low as well.

With \$100 billion (annual rate) in additional tax cuts coming in the first half of 2004, the consensus 4.5% anticipated GDP growth rate is not surprising. The problem is that, beyond this near-term stimulus, the structural difficulties that had helped to precipitate the 2000 recession and the jobless recovery remain an issue. These structural problems include exhausted monetary and fiscal stimulus, and vast excess capacity in labor and capital resources.

Is Monetary Policy Expansionary?

Monetary policy, from both cyclical and structural perspectives, may be restrictive rather than accommodative, as is widely assumed. The general view is that the forty year low, 1% Federal Funds rate, is prima facie evidence that monetary policy is working hard to boost the economy. Some key market interest rates, such as mortgage rates, rose sharply in the second half of 2003, implying a policy tightening. In real terms, for the year as a whole the Fed Funds rate actually rose from -.5% to +.2% as the core inflation

Stock and Bond Returns
 30 Year Treasury Bonds vs. S&P 500 Index
 Period Ending 2003

	Annual Return		Compounded Return		
	30 Year Treasury Bond	S&P 500 Index	1 Year	30 Year Treasury Bond	S&P 500 Index
2003	1.0%	28.7%	1 Year	0.1%	28.7%
2002	16.7%	-22.1%	2 Year	8.6%	0.1%
2001	3.5%	-11.9%	3 Year	6.9%	-4.0%
2000	20.8%	-9.2%	4 Year	10.2%	-5.4%
1999	-15.3%	21.1%	5 Year	4.5%	-0.6%

Table 1

rate dropped more than the 25 basis point decline in the nominal Fed Funds rate. The more critical ten year Treasury note yield, in real terms, rose from 2.3% at the end of 2002 to 3.5% at the end of last year, which will have the delayed impact of slowing future economic growth. Another sign that monetary policy may not be in reverse is the current highly negative trend in the money and credit measures.

Balance Sheet Contraction at the Depository Institutions

In the fourth quarter of 2003 a startling aberration occurred as both the asset (loans, leases, etc.) and liability (monetary aggregates) sides of the balance sheet of the depository institutions contracted at the fastest rate since the end of World War II. In the three months ended December, M2 decreased at a 5.3% annual rate, while M3 dropped at an even faster 6.8% pace, both the steepest declines since the current monthly series were originated in 1959. As Chart 1 indicates, declines have rarely occurred. Since 1959, M2 and M3 averaged growth rates of 6.9% and 7.7% respectively. Since long stagnation in the aggregates foreshadow slower economic growth, more alarming is the near zero six month change for M3 and the slightly negative M2.

This plunge in the money aggregates has received little attention, in part because the FOMC no longer targets M2 and M3, and many have concluded that these swings convey little information, with some believing that money is largely shipped to other assets—an untested theory.

Three considerations suggest that money and

credit growth does matter to future economic activity. First, the last times that both M2 and M3 had negative growth rates were 1992 and 1993, occasions when the economy clearly underperformed. Indeed, the pace of job creation was so feeble that many did not feel the economic improvement, and Clinton defeated Bush on the theme “it’s the economy, stupid.”

Second, sharp contractions in the money supply in a low inflationary environment can be hazardous to economic health. After all, disinflation is too little money chasing too many goods. The last time money growth contracted (1992 and 1993), inflation rates slowed markedly. Coincidentally, today, with sluggish money growth, the core personal consumption expenditures (PCE deflator) has shown a yearly gain of only .8%. This is the lowest inflation rate in the history of the monthly data series that began in 1959, down sharply from the 1.8% increase in 2002. Using quarterly data, the core PCE deflator rose by the smallest rate since the year ending in the fall quarter of 1955. A prominent member of the Federal Reserve Board, Ben Bernanke, has said that 1% inflation is needed to provide a buffer against deflation. At present, that buffer does not exist. A drop in inflation, induced by a monetary contraction, would be a highly unwelcome development since it could easily push the economy into deflation.

Third, a sharp drop in total bank loans and leases and nonfinancial commercial paper reinforces the significance of the declines in M2 and M3. In the three months ended December, this key credit aggregate contracted at a 5.8% annual rate, the sharpest since 1948 (Chart 2). This is despite a one time upward adjustment to the series due to a recent

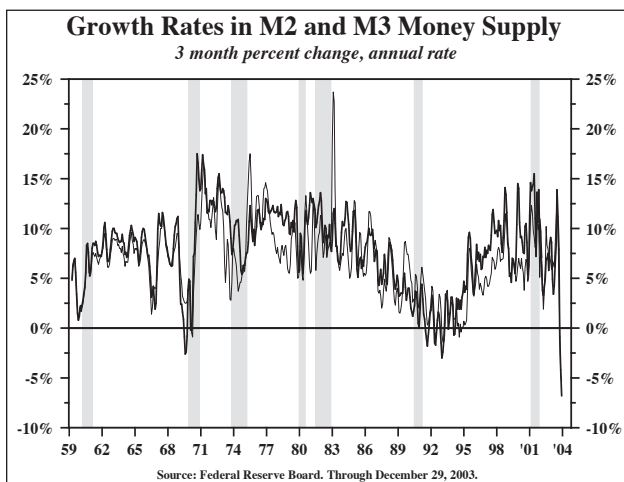


Chart 1

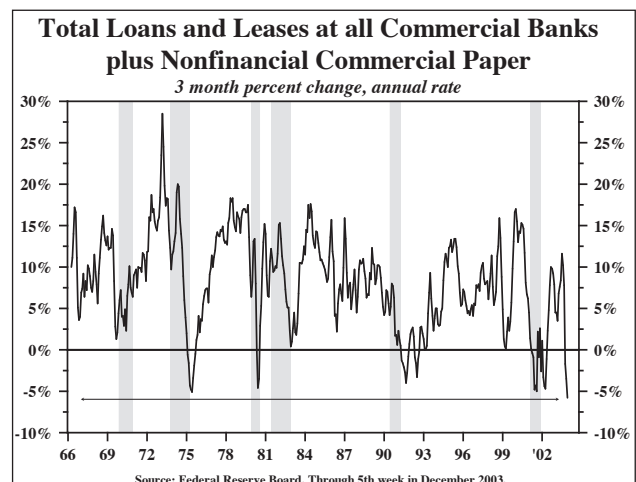


Chart 2

FASB ruling. As chart 2 indicates, the rate of growth of this key credit aggregate decelerated prior to all of the recessions since 1948, with a very noticeable slowdown prior to the declines in real GDP in 2000 and 2001. Additionally, even with the FASB distortion, this key credit aggregate, on a six month rate of change basis, was growing at just a 0.9% annual rate. This was dramatically lower than the long run average 8.4% growth rate.

One of the most important propositions of monetary economics is that a rise in market interest rates will reduce the demand for money credit. This would mean then that the nearly unanimous consensus projection for a rise in interest rates would further depress the growth in money and credit. In fact, one reason money and credit collapsed in late 2003 is that many key market interest rates rose sharply in real terms, depressing the demand for money and credit. The Fed, apparently content with the current readings on the economy, then acquiesced to the contraction in the Ms and bank lending. Prior to the 1980s, money and credit contraction was a sign that the Fed was setting the Federal Funds rate above the level consistent with stable future economic growth. In addition, within six to nine months, a sharp deceleration in nominal GDP could be expected to follow. Only time will tell whether that historical pattern is being restored.

There is an additional reason why the monetary and credit contraction is negative for the economy. While the drop in the Ms may be a reflection of the rise in real interest rates in the second half of 2003, it may also be an early sign that the Fed is now “pushing on a string”, a phrase coined by the great British economist J. M. Keynes. In other words, demand for credit is falling because there is already too much debt, and the degree of leverage is uncomfortable to the typical borrower. The only way to resolve this conundrum is for interest rates to fall. If they decrease, and money and credit growth recover, then the pushing on a string point has not yet arrived. But, if rates drop and money and credit growth continue to contract, then the Fed would be pushing on a string, or a condition Irving Fisher, Keynes great adversary, called debt deflation.

Fiscal policy has been highly stimulative over the past three years, swinging from a 2% surplus in 1999 to an expected 4.5% deficit as a percent of GDP in 2004. However, fiscal policy becomes more neutral after the middle of 2004. The estimates of the impact of

the tax legislation enacted last year suggest that a \$100 billion cash stimulus on an annualized basis will be transmitted from the public to the private sector in the first half of 2004. Additional stimulus would require further tax legislation in the face of a \$400-\$500 billion deficit, which seems unlikely. Thus, with monetary stimulus in reverse and fiscal policy turning neutral, job growth becomes critical to sustaining forward economic momentum.

Jobs Hard To Find

In 2003 the U.S. economy failed to create new jobs for the third consecutive year (Chart 3). This has not happened since the end of World War II. To be sure, the 74,000 job loss for the calendar year was much less than the 463,000 and 1.78 million job losses of the previous two years; nevertheless, it is very discouraging news. The lack of payroll gains means that wage and salary growth is stagnating near 1%, which will serve to dampen consumer spending. The strength of consumer spending in 2003 was sustained by temporary factors that will not be in place going forward. These included: a) lower monthly payments for automobiles as incentives were increased; b) lower monthly payments for homes as mortgages were refinanced, c) lower taxes in the form of tax refunds and diminished withholding, and d) the assumption of additional debt. The uptick in mortgage rates since July, however, has reduced remarkably the amount of funds people have been able to take out of their homes due to refinancings. The Mortgage Bankers Association’s Refinancing Index has declined nearly 80% from its June peak. The effects of the federal tax stimulus will continue to boost consumption in the first half of 2004, but, as noted, diminishes in the latter

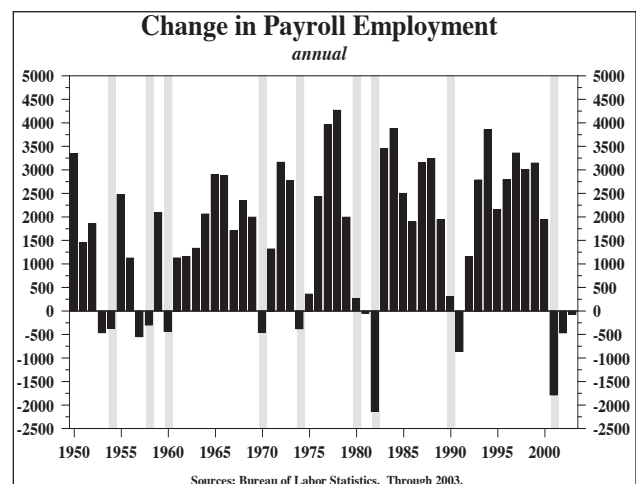


Chart 3

half of the year. Without payroll gains going forward, further indebtedness will be necessary to sustain consumer spending. Unfortunately, debt is reaching burdensome proportions. For instance, in the third quarter, with GDP surging, business and non-business bankruptcy filings soared to \$1.66 million, 7.4% above year earlier levels and the highest in modern times. Simultaneously an unsurpassed 4.09% of consumers fell behind on their credit card payments. Record levels of debt, which now burden the consumer, are increasingly difficult to service and repay as job growth continues to be meager.

Despite the lack of job growth, the headline making unemployment rate fell during 2003 from 6.0% to 5.7%. The primary reason for this decline had less to do with new job creation than it did with people leaving the labor force. If the labor force participation rate maintained its February 2001 level of 67.2%, the unemployment rate would be 7.4%, not the 5.7% recorded in December (Chart 4.) However, this slack labor market has caused downward pressure on wages. In fact, the growth rate over the past twelve months in average hourly earnings of 2% is the lowest annual change since 1987. The average rise in the fourth quarter was just .9%, the smallest increase for any quarter since the series began in 1966.

Excess labor is accompanied by excess capital. The factory use rate of 73.8% in November of 2003 was up a meager 1% from the end of 2002. The Federal Open Market Committee probably had this low rate in mind when it stated that, “an economic performance in line with their expectations would not eliminate current large margins of unemployed labor and other

resources until perhaps the latter part of 2005, or even later.” If productivity growth averages 3% per annum and the labor force grows at 1%, it would take at least 3 years of 5% gains in GDP to eliminate the current output gap, or the difference between potential and existing levels of GDP.

High Quality Debt Still Attractive

Reflecting the momentum of late 2003 and the boost from large tax refunds, the economy could start off 2004 expanding close to the pace projected by the consensus view found in recent surveys by Business Week and the Wall Street Journal. Structural imbalances and a continuing monetary and credit contraction could detract from growth in the first half of the year. The greater risks are in the second half of the year, after the fiscal stimulus fades, when the growth rate could drop to 2.5%. By late in the year, the economy might possess little, if any, forward motion.

In view of the large amount of idle resources and the monetary contraction, inflation should continue to work irregularly lower in the years ahead. In this environment, the boost in consumer spending from larger than normal income tax returns will be no more inflationary than the child-care tax rebates of July and August. While the financial markets may be slow to recognize the continuing drop in inflation, investors will be handsomely rewarded with high real income on long-Treasury bonds. With long Treasuries yielding 5% or better, and the core inflation rate less than 1%, the real yield is over 4%, double the average real yield over the last 133 years.

Van R. Hoisington
Lacy H. Hunt, Ph.D.

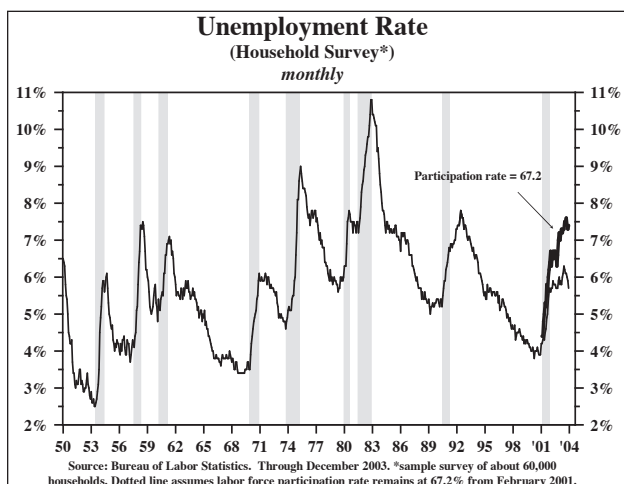


Chart 4