

# Hoisington

INVESTMENT MANAGEMENT COMPANY

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

## Quarterly Review and Outlook

### Second Quarter 2004

#### Much Fury, Signifying Little

The long end of the Treasury market showed little change for the first half of 2004, ending at 5.29%, only 21 basis points above the closing 2003 yield of 5.08%. In view of the pervasive bearish sentiment, this was a very modest change. Rates fell unexpectedly in the first quarter, and then rose sharply in the second quarter, with the return from the coupon almost equalizing the slight decline in market price. Putting this in perspective, the mid-year closing yield was similar to the average 5.4% yield for the first 4 1/2 years of this decade, a striking reminder of the lengthy amount of time bond market yields have remained around the current levels. The benefits of investing in the long end of the yield curve are significant. Over the past 4 1/2 years, the average yields of two year notes and five year notes have been 3.4% and 4.3% respectively. Investors in the long end of the yield curve have been rewarded with an additional \$11,000 per \$1 million invested per annum versus the five year note.

#### Misplaced Optimism

The year end consensus was for a 4.5% growth rate in the first half of 2004 due to the low interest rates and tax cuts. This optimism seems inappropriate today, however, since early data suggest that consumer spending in the second quarter was only around 2%. Furthermore, no tax cut looms this July, and past tax cuts have not been saved. The household saving rate stood at 2.2% in May, only marginally higher than the 1.5% level of December 2000. With no further reduction in taxes, after-tax and pre-tax incomes will now rise around the mere 1.7% growth rate in pre-tax income registered since 2000. Additionally, consumer fuel expenditures averaged 7.8% of wage and salary income in April and May, up 1.5% in the last 2 1/2 years. This was comparable to the jump prior to the recession of 2001. Finally, mortgage refinancing in

June was almost 84% lower than a year earlier. Since mortgage rates have fluctuated around current levels this decade, few consumers can profitably refinance mortgages to bolster family resources. Going forward, real consumer spending will remain mired in the 2% or lower range, near the growth rate in real pre-tax income.

A consumer slowdown at this time has broad economic implications. First, the best growth rate for the overall economy has passed. Second, robust consumer spending, a reduction in the tax rate, and the weakening dollar in 2003 were the main causes of the rise in corporate profits in 2003 and earlier 2004 (Chart 1). Without the consumer, profits are vulnerable as pricing power disappears due to lower final demand. The reaction time from business, in cutting spending, is likely to be very short, especially since substantial corporate tax breaks expire at the end of this year. Third, capital spending should also lose momentum due to the high level of excess resources. This can be seen in the current 17% office vacancy rate, the highest level in ten years. Industrial vacancy rates are above 11%, close to the highest level since 1981. Also, factory use in May was 75.7%, six percentage points below the post 1949 average. Finally, the

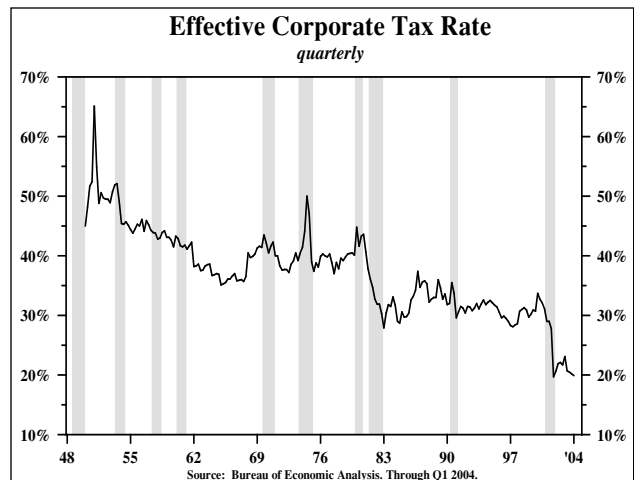


Chart 1

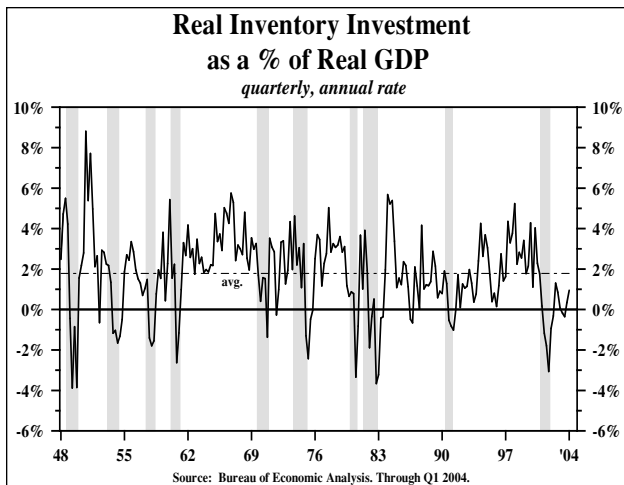


Chart 2

initial consequence of a consumer slowdown is rising inventories. However, inventory positions may already be almost as high as desired. In the first quarter, real inventory investment accounted for 1% of real GDP (Chart 2). Since 1948, inventory investment accounted for 1.8% of real GDP. With the switch to “just in time” manufacturing and other inventory control procedures, it is hard to believe business will not react quickly to a consumer slowdown.

State and local governments have moved into surpluses from deficits of a year ago, and the Federal deficit is currently running about 1% less stimulative relative to GDP than a year ago. By late in the year the economy will reflect considerable weakness.

### The Fed - Ahead of the Curve

From our perspective, another problem looms. Contrary to the widely held opinion that the Fed is “behind the curve”, the data suggest that the Fed may have tightened too soon, and is actually “ahead of the curve”. The most compelling argument for this is derived from the broadest measure of performance in the labor markets. Based on the index of aggregate hours worked, (if the June 30th hike in the Federal Funds rate was the start of a series of Fed rate increases), the move by the Fed was unprecedented in its modern history. Since the beginning of this index in 1965, the cyclical low in the Federal Funds rate did not occur until the aggregate hours worked (payroll employment multiplied by the average workweek) had recovered from the prior recession-related drop (Chart 3). The cyclical “turning points” in the Funds rate are represented by the circles in the chart. The “turning points” in the Federal Funds rate in 1973 and 1977 only were reached after aggregate hours returned to the range of the previous cyclical highs. The cyclical

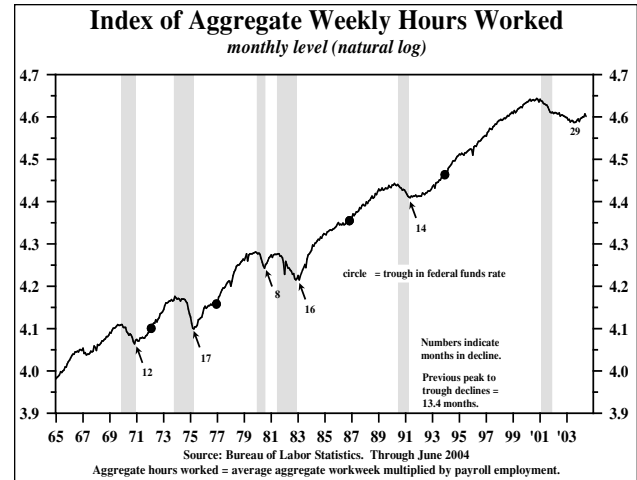


Chart 3

low in the Federal Funds rate in the 1980s and the 1990s only occurred when the index of aggregated hours worked was well above the cyclical peaks reached prior to the recessions of the early 1980s and 1990-91.

In June, the index of aggregate hours worked was 4.1% below the peak reached in November 2000. This drop reflects substantial unused labor resources, measured by both the number of people working and the number of hours worked. In June, private payroll employment was 1.88 million lower than the peak reached in late 2000. The average nonfarm workweek last month was 33.6 hours, down from the late 2000 peak of 34.3 hours. As indicated on the chart, the peak to trough drop in aggregate hours worked persisted for 29 months, far exceeding the prior record 17 month decline associated with the 1973-75 recession. Although some recovery has unfolded, the gain has paled in comparison to the extended previous decline. Chart 3, expressed on a natural log scale, shows that all moves on the line chart have remained proportionate.

The relationship captured by Chart 3 has two additional interpretations. First, since the index of aggregate hours worked suggests the Fed tightening is premature, the Fed hike in the Funds rate may be only one of a limited number of moves that may ultimately have to be reversed in their entirety. This possibility stands in stark contrast with the consensus view that a cyclical and multi-year low in the Federal funds rate has now passed. Second, the Fed may have improperly guided the markets. Late last year the Fed talked of being accommodative for “an extended period of time.” They might have better served the markets, the economy, and monetary policy by linking the need for accommodation to the index of hours worked. Specifically, they could have indicated to the markets that policy would remain accommodative until aggregate hours worked moved into the range of its old cyclical high. At the very least, the Fed would have

established a more objective standard than simply the passage of time.

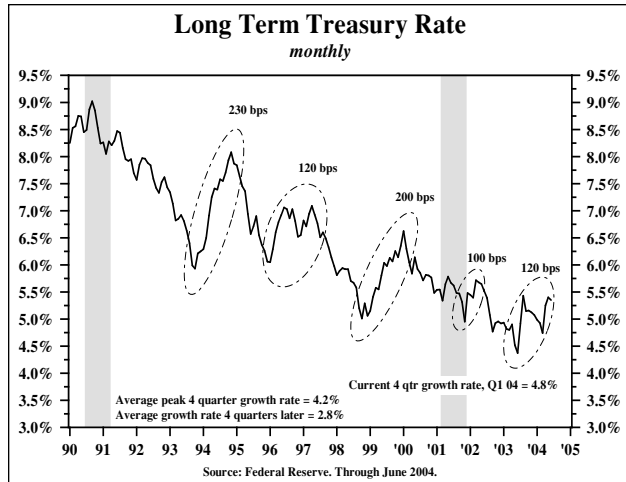


Chart 4

### Strong Support for The Secular Bull Market in Bonds

From the June 2003 lows to the May peak, the long Treasury bond yield increased by 120 basis points. This was the fifth significant interim rise in this yield since 1990 (Chart 4). The magnitude of the latest upturn was very comparable to the ones from 1996-1997 and 2001-2002, and less than the ones in 1994 and 1998-99. The prior four interludes did not interrupt the secular bull market in bonds, and neither will the one just concluded. Four considerations support this conclusion:

1) the economy's underlying fundamentals are so frail that material interest rate increases slow economic growth (i.e., rates can go up but can't stay up);

2) capital spending is still such an extremely elevated percent of GDP that the capacity to produce goods and services will continue to increase rapidly and place downward pressure on inflation;

3) the velocity of money is in the midst of a multi-year decline, and as such nominal GDP will, on average, rise by less than M2 growth; and

4) the real long-term Treasury bond yield remains above its long term historical average (from 1870 to the present), and is consistent with a continuing secular bull market.

### (1) Frail Fundamentals

Prior to each of the four long rate backups from 1994 to 2002, real GDP increased by an average of 4.2% over the year. On average, real GDP then slowed to 2.8% in the next four quarters. In other words, when rates rose, the economy faltered. This time should be similar because the underlying fundamentals are just as weak, if not weaker. The economy is more leveraged than at any of these earlier periods. Private sector debt was recently at a near record 162.7% of GDP, up from 142.5% at the end of 1999. The household debt component recently stood at a record 111.7% of personal disposable income, up from 94.1% at the end of 1999. Moreover, it has recently taken more than \$2 of new household debt to generate \$1 of new consumer spending on goods and services. In other words, the economy is getting less and less bang for each dollar of new debt, which may be an unfortunate sign that consumers are borrowing in order to make interest payments on existing debt or leveraging into problematic financial markets.

### (2) The Elevated Capital Spending to GDP Ratio

Historically, real capital spending has comprised 7.6% of real GDP. Over the last four quarters, real nonresidential fixed investment comprised 10.9% of real GDP, matching the average level from 1994 to 2003. This slightly exceeds the 10.7% level that prevailed from 1919-1928, which was the only other investment led expansion since 1900 (Chart 5). Quite simply, a much greater than normal amount of the country's output is being allocated to developing future production of goods and services.

The high capital spending ratio means that productivity gains will increase faster than the long-term trend. As such, the output gap is even larger than officially indicated. If productivity is assumed to have a long-run potential of 2.8%, instead of the 2.1% incorporated into the official calculation, then the output gap is closer to 6%. The official measure places it at just 1.4%. The high capital spending ratio also means that the employment gap will remain large. In June, we calculate the employment gap was almost 7.1 million people, or about 5.4% of current payroll employment. Thus, the employment gap and the

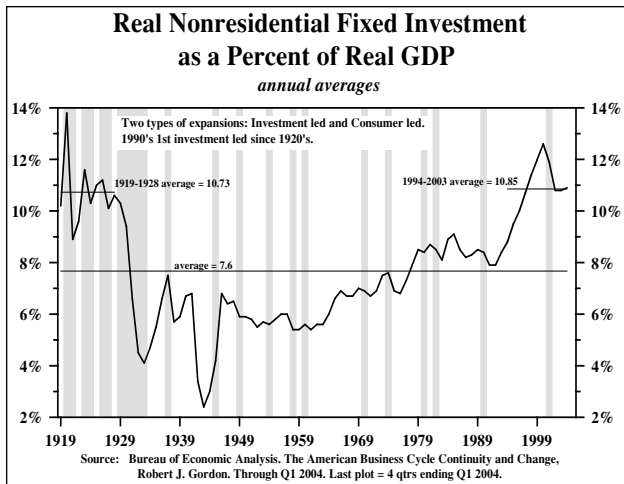


Chart 5

adjusted output gap are within .6%, an insignificant difference. The elevated capital spending ratio means that the current glut of office space and manufacturing capacity will remain in surplus. Together, these considerations mean that the capacity of the U.S. economy to produce goods and services will continue to increase rapidly, thereby placing downward pressure on inflation. Importantly, China is helping to reinforce this trend. China is our second largest import trading partner, and has invested nearly 40% of their GDP in fixed investment over the past few years. This excess capacity, coupled with low labor costs, will insure that the personal consumption expenditures deflator for durable goods will continue to deflate, as it has on a year over year basis since 1995.

### (3) A Multi-Year Decline in Money Velocity

Monetary conditions will also work to suppress inflation. After peaking at 2.12 in 1997, the velocity of the M2 money stock has declined steadily on an annual basis, reaching 1.83 in 2003. Velocity variation is a function of the rate of change in financial innovation. It is hard to see new innovation matching that of the late 1980s and 1990s, such as securitization of assets, increased use of derivatives, unbridled growth of FNMA and GNMA, the massive proliferation of the mutual funds and the emergence and rapid growth of the hedge funds. Therefore, velocity should continue to decline irregularly for years (the recent level was still above the post 1900 average of 1.67.) An ongoing decline in velocity would mean that the rate of increase in nominal GDP would be less than the growth in M2. This is not an encouraging prospect since M2 growth was just 4.3% in the past twelve months. Accordingly, nominal GDP growth could eventually fall to 4% or

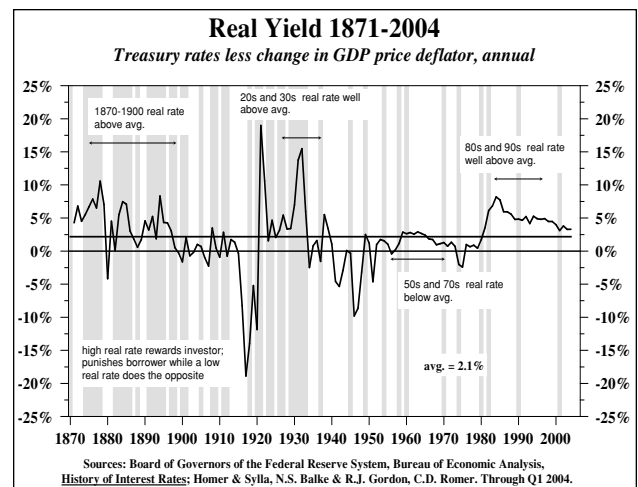


Chart 6

less. Even with a low inflation rate, this would leave such little room for growth in real GDP that the output and employment gaps would start rising again.

### (4) Real Long Treasury Rates Still Encouraging to Investors

Since 1870, the nominal long term Treasury bond yield has averaged 4.2%. The rate of increase in the GDP deflator over that period has been 2.1%, resulting in a real bond yield average of 2.1%. The historical record has indicated that investors should stay invested in long Treasuries when the prevailing real rates are above the historical average and be invested in Treasury bills when below the historical average. Using the April/May average for the long Treasury yield and the core personal consumption expenditures deflator, the real rate was 3.8%, 170 basis points above the historical average (Chart 6). We continue to believe that the secular bull market in bonds will be intact until the real rate moves below the historical average and holds there for an extended period of time, as was the case in the late 19th century and in the 1930s and 1940s. As the historical record indicates, the real rate may even need to fall below zero before the secular bull market in bonds is over. Such a prospect is a long way off.

Patient investors will continue to be rewarded by holding positions in long Treasury coupons and strips, just as they have been well served by such investments over the past two decades, as the secular bull market continues.

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