

Hoisington

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Quarterly Review and Outlook

Fourth Quarter 2004

THE CONSENSUS DISAPPOINTED

Throughout 2004, most economists, as well as most consumers, expected both short and long-term interest rates to rise. Prestigious surveys of prominent economists at the end of 2003, and again at mid-year 2004, showed virtually unanimous predictions of higher interest rates. The respected University of Michigan survey placed the net percentage of consumers anticipating higher interest rates consistently above 70% last year. In line with the consensus, and satisfying to many economists, the Fed funds rate rose from 1% to 2.25%. The higher funds rate lifted the 2 and 5-year note yields to 3.1% and 3.6%, providing total returns of .9% and 2.4% respectively. The rest of the yield curve, however, behaved quite differently. Essentially, no net changes occurred for maturities from 7-10 years, although dramatic fluctuations occurred during the year. Significantly, however, the on-the-run 30 year Treasury bond actually declined in yield by 25 basis points to 4.82%, resulting in an 8.9% total return, confounding the consensus.

Another noteworthy nuance in 2004 bond investing was the shift in the yield curve. The basis point spread between the 10 year note and the 30 year bond narrowed by 20 basis points to stand at roughly 60 basis points at the end of 2004. This yield curve shift, coupled with the decline in the bond yield of 25 basis points, meant that long dated zero coupon bonds provided a remarkable 16% total return to the investor, nearly four times the return of the Lehman Aggregate Index. Therefore, both the reduction in long Treasury yields and the composition of the portfolio gave HIMCO accounts an 11.3% composite return versus the 4.3% return of the Lehman Aggregate Index.

A critical requirement for most institutional investors is for their investment returns to exceed their actuarial rate. With three and five year returns of 6.2% and 7.7%, respectively, the Lehman Aggregate Index

has fallen well below most actuarial assumptions. Over this same time frame, the long end of the yield curve has had the distinct advantage of substantially higher coupon flows. Thanks to this steep yield curve, portfolios such as HIMCO's have been able to achieve in excess of 10% and 11% returns over the past three and five years respectively, higher than most actuarial rates. With 55 of 56 prominent economists surveyed by the Wall Street Journal expecting long term rates to rise again this year, there is no change to the negative consensus outlook for bonds. Portfolios aligned with this bearish interest rate stance may well realize another actuarial shortfall. Our judgment is that long term yields will move irregularly lower during the year, and that the yield curve will continue to flatten with the 30 year bond moving closer to its historical average yield of only 10-20 basis points above the 10 year note. Therefore, the profit potential will again lie in the long end of the market. This view is importantly related to the inflation and economic growth trends in 2005.

MODERATING CONSUMER SPENDING AHEAD

The U.S. consumer represents slightly more than two thirds of final sales to domestic purchasers, and nearly 22% of the world's GDP. We expect consumer spending in 2005 to expand by about 2 ½%, matching the slimmest rise in more than a decade. This would represent a sharp slowing from the 3.8% growth rate in the year ending the third quarter versus the prior year. Our thesis of moderating consumer spending is a reflection of existing data regarding real income and job growth, saving and borrowing levels, and current fiscal and monetary stimuli.

The 3.4% increase in real disposable income in the latest statistical year was outstripped by the 3.8% growth in consumer spending. This was nothing new as expenditures have outpaced income in nine of the past

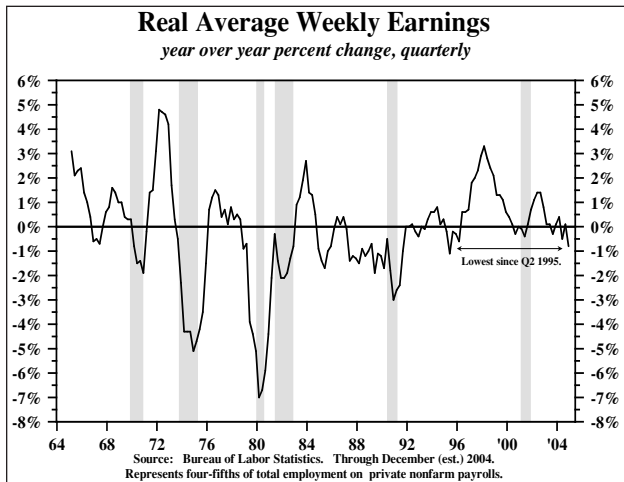


Chart 1

15 years. The income increase for 2004 was boosted by a tax cut that resulted in higher than normal income tax refunds during the first half of the year. No new tax cuts are planned for 2005. Late in 2004 important leading indicators of consumer income eroded. In the fourth quarter, real average weekly earnings, which reflect the income of four-fifths of total non-farm payrolls, stood 0.8% below the year earlier level. This important income measure was considerably weaker late last year than before the start of the 2001 recession, and the lowest since Q2 of 1995 (Chart 1).

DEBT PROBLEMS

Household debt levels imply that the financial condition of the typical American household is stretched. Household debt was a record 115.3% of disposable personal income in the third quarter, an all time high for the series. The financial condition is only slightly better when household debt is viewed in terms of assets or net worth. This is surprising since the value of homes has increased sharply in recent years, and stock values have somewhat recovered. In the third quarter, household debt was 18.1% and 21.3% of total assets and net worth, respectively, mere fractions below their all time peaks reached two years earlier (Chart 2). Many critical consumer borrowing rates became more costly in 2004. Reflecting last year's 125 basis point rise in the Federal funds rate, the prime commercial bank lending rate also increased 125 basis points, reaching 5.25%. With most consumer credit card and home equity loan rates tied to the prime, consumers were directly and adversely affected. Additionally, adjustable rate mortgage yields moved upward last year, with the November average of 5.4% the highest since July 2002. Not surprisingly, the household debt

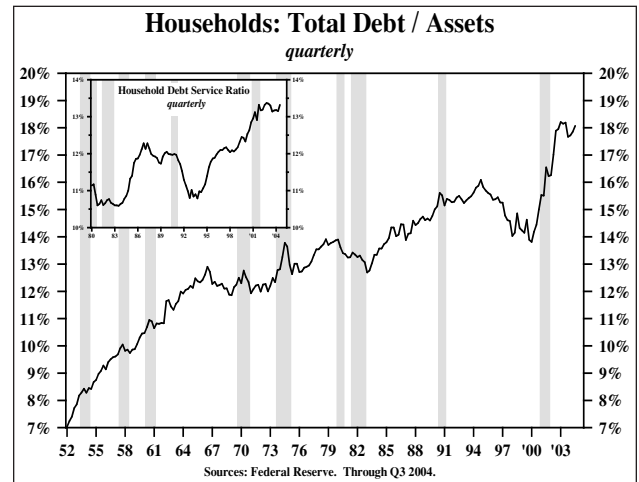


Chart 2

service ratio rose to 13.3% in third quarter of 2004, up from 13.1% a year earlier (Chart 2 insert). Since short term rates increased 50 basis points in the fourth quarter, the household debt service ratio probably set a new peak, eclipsing the old record of 13.4% in the fourth quarter of 2002.

Through the first eleven months of this year, the personal saving rate averaged 0.8%. This was the lowest since 1933, and dramatically below the long-term average of 7.7%. Based on the life cycle hypothesis, an aging population should have increased saving in preparation for retirement. Huge numbers of baby boomers approaching retirement appear to be unprepared. Any increase in saving for retirement will reduce spending levels and slow the economy. The elevated debt levels to net worth and low saving rate are signs that the consumer has increased debt and reduced saving to push spending growth beyond income growth. Repairing the consumer's extended balance sheets will serve to stunt spending.

OIL SHOCK

In the first two months of the fourth quarter, total consumer fuel expenditures jumped to 8.3% of wage and salary income, the highest energy burden since 1990 (Chart 3). Fuel expenditures now require an additional 2.1% of total wage and salary income from the lows in 2001. The current oil shock now stands as the third largest of the five events that have occurred since the early 1970s. Each of the preceding oil shocks were associated with recessions.

Historically, the first response of consumers is to reduce saving to pay for higher interest expenses

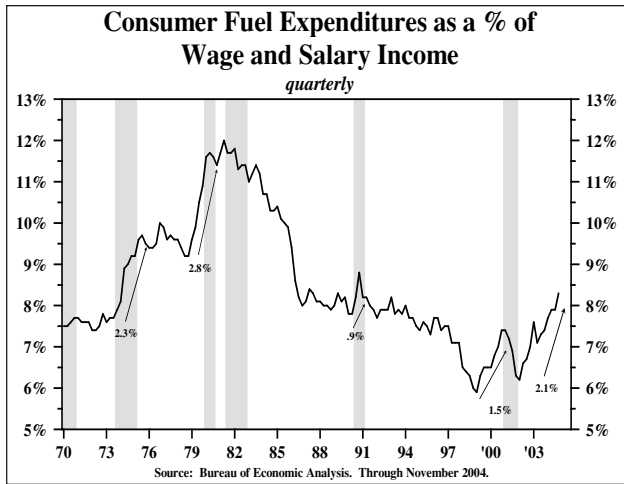


Chart 3

and energy bills, and only later do they decrease their purchases for discretionary spending. Thus, 2004's surge in energy prices and increase in interest costs could restrain consumer spending throughout 2005, even if oil prices and interest rates were to decline this year.

MODEST PROSPECTS FOR CAPITAL SPENDING AND HOUSING

The two best performing sectors of 2004, nonresidential fixed investment and residential investment, are now positioned for only modest growth. The hurdles for capital spending, which makes up 10% of real final sales to domestic purchasers are: a) the end of a substantial tax credit on December 31, 2004 and b) an uneven pattern for new orders for non-defense capital goods during a period of expiring tax breaks.

On the last day of 2004 a 50% bonus depreciation allowance expired. Temporary tax credits have been used since the 1960s, and frequently orders surged prior to expiration only to slump thereafter. Interestingly, in the current situation, new orders for non-defense capital goods actually peaked in July 2004, and moved irregularly lower, with the November level about 0.5% below the July peak. The tax expiration should result in a significant deceleration for the early part of this year. This sector, which expanded by over 10% in 2004, will halve its growth rate in 2005 as it reacts to a slowdown in consumer spending and the tax expiration.

The housing sector is 5% of real final sales to domestic purchasers. The problems in this sector

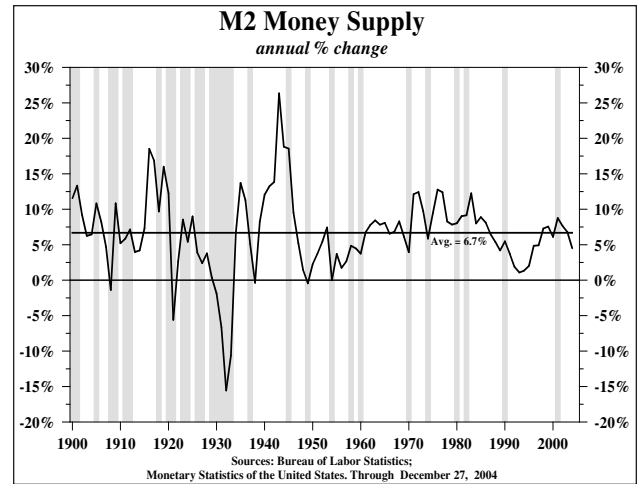


Chart 4

include more restrictive monetary conditions, over investment, and loss of momentum in key leading indicators. In addition to the previously mentioned rise in adjustable rate mortgages, housing should moderate from its 11% growth rate in 2004, partially in response to markedly contained monetary growth. For 2004 versus 2003, the M2 money stock increased by just 4.5%, the third consecutive yearly reduction in growth, and the slowest increase since 1995 (Chart 4). M2 growth in 2004 was far below the post 1900 average rate of 6.7%.

Housing assets could be considered over-owned as nearly 70% of the population now own their home (Chart 5). Further, the ratio of the dollar value of individually owned real estate (as measured in the Flow of Funds Accounts) surged to a record 2.1 times that of disposable personal income in the third quarter of 2004. As recently as late 2000, this ratio was a far lower 1.7x (Chart 6). Since 1952, when the Flow of Funds came into existence, the ratio averaged

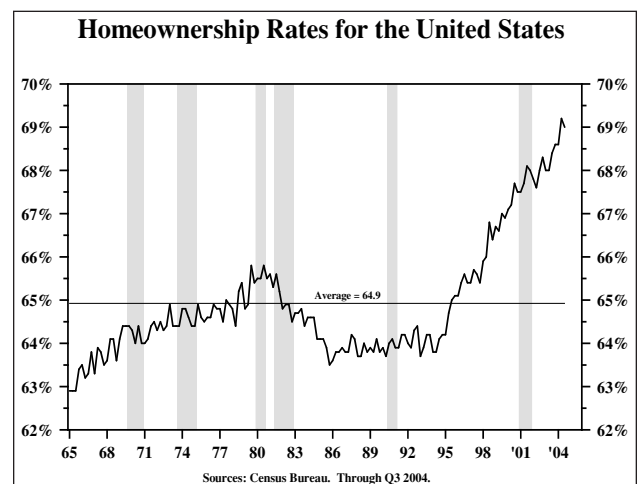


Chart 5

a dramatically lower 1.5x. If consumers were to realign their housing assets relative to the more normal relationships vis-à-vis income, housing could soften, perhaps for an extended period.

Some of the best leading indicators of the housing sector suggest that the beginning of that realignment process may be near. Single family building permits, which are a component of the Leading Economic Index (LEI), averaged a 1.55 million annual rate in October and November, almost 1% below the quarterly peaks reached in the second and third quarters. Single family housing starts, which were in the LEI for many years, were at a 1.54 million annual rate in the last two months, 6% below the peak level reached in the fourth quarter of 2003. As such, housing fundamentals do not seem capable of producing another double digit gain in real residential structure spending in 2005, and may be flat for the year. If interest rates drop in the first half of 2005, a small lift in mortgage activity may occur later in the year.

LESS FISCAL STIMULUS

Aggregate fiscal policy for Federal, state and local governments will be less stimulative in 2005. The federal budget deficit has already receded from 3.9% to 3.2% of GDP, and the Congressional Budget Office projects that the deficit for the full 2005 fiscal year will be 2.9%. This reflects the fact that there will be no additional cut in taxes, and the 50 % bonus depreciation has expired, plus high revenue growth from a healthy 2004.

The growth rate in the defense spending, which carries the highest multiplier effect on the rest

of the economy, has eased noticeably. Federal defense outlays, measured on 12 month sum of a year over year change, have decelerated from a peak 18.4% increase in March of last year to 12.1% in November. The current administration has proposed reducing the future growth in defense spending by another \$60 billion over time. The bottom line is that fiscal policy will no longer be as supportive for growth as it was in 2003 and 2004.

EXPORT PROSPECTS: NOT WHAT THEY SEEM

Most forecasters expect U.S. exports to improve this year because of the two year decline in the dollar, but this view may be too optimistic. Although the dollar fell last year, the price index of finished imported goods – including capital goods, automotive and all other consumer goods – was little changed (Chart 7). While economic textbooks indicate that a falling currency leads to higher prices for imports, this did not happen. We believe that global excess capacity and a fear of losing U.S. market share caused these importers to hold the line on prices despite the falling dollar.

Importantly, exports are far more sensitive to economic growth than to relative prices. The stagnant economies of our trading partners do not point to much, if any, improvement in U.S. exports. Indeed, two factors have pushed the global economy into a slump: (1) monetary conditions were tightened in many key economies in 2004 (the U.S., China, Canada, Australia, and Great Britain), and (2) rising oil prices have hurt many foreign economies heavily dependent on imported oil. Slowdowns are evident in Europe, Japan

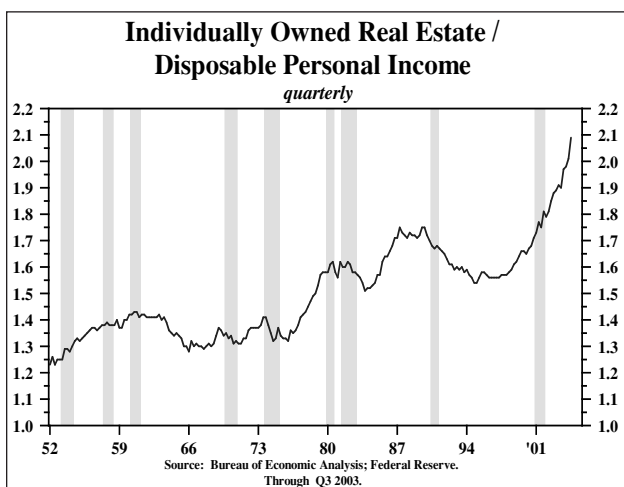


Chart 6

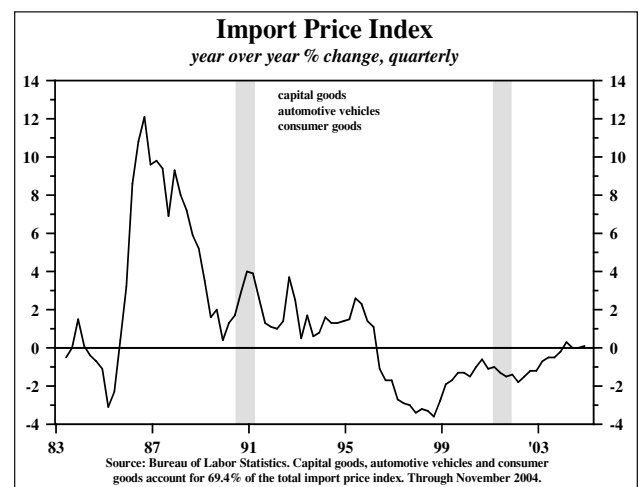


Chart 7

and even China and the Asian Tigers. The tepid pace in consumer spending that we anticipate will further debilitate major economies outside the United States, and this, in turn, will serve to undermine potential U.S. exports.

THE FED'S SUCCESSFUL WAR AGAINST INFLATION

In the minutes of the December 14th meeting, the FOMC wrote "the current level of the real funds rate target remained below the level it most likely would need to reach to keep inflation stable and output at its potential." This suggests that the Fed does not consider that it is being successful in the war on inflation, and that it will continue to raise the Federal funds rate. Many interpret this statement as justification for remaining invested in short term debt instruments.

But, when the Fed says that it wants low inflation, and that it is willing to further tighten monetary conditions, the record suggests that it should be taken at its word. Future tightenings by the Fed will dampen the already sluggish growth in the monetary aggregates, supporting our view that economic activity will soften in the year ahead. Thus, the macro economy will be characterized by too many goods chasing too little money, the condition that produces disinflation.

We have every reason to believe that the Fed will continue to win the war on inflation, even though it was higher in 2004 than 2003. In the past twelve months the CPI increased 3.5%. This advance reflected a 56% surge in oil prices from the end of 2003 to the

close of last year, as well as large increases in some key commodity price indexes to all time highs. In the present situation, such events are contractionary, not inflationary, even if they temporarily lift the core inflation rate. They are only permanent if the Fed monetizes them by accelerating monetary growth. The rate of increase in M3 like that of M2 dropped to a nine year low in 2004, effectively isolating the higher oil and other commodity prices. The CPI should reverse sharply to the downside this year, and the multi-year low in the core inflation rate lies ahead.

REAL YIELDS STILL ELEVATED

Since June the core personal consumption expenditures deflator rose by a very slim 1.1% annual rate, or less than the 1.5% rise of the past twelve months and below the 1.3% increase in 2003. Accordingly, the trend to lower inflation, though temporarily interrupted, has been re-established. Using the post-June core consumer inflation rate, the real yield on the long Treasury bond recently stood near 3.7%, well above the 135 year average of 2.1%. Therefore, in real terms, current long term rates remain attractive, particularly when coupled with the steep 10/30 yield curve. Accordingly, long-dated Treasury bonds should continue to be a safe and very rewarding investment.

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