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Quarterly Review and Outlook

First Quarter 2005

THE CONTINUING BOND RALLY

The Federal Reserve raised the overnight lending rate twice in the first quarter for a total of 50 basis points, and various Fed comments telegraphed that further rate hikes were on the way. Treasury notes responded accordingly, with two, five and ten year notes rising 71, 56, and 27 basis points, respectively. Contrary to the short end, but in concert with the experience of 2004, interest rates in long-dated Treasuries fell slightly, with the longer-duration zero coupon securities falling the most. Therefore, while five and ten year Treasury note holders suffered -1.5% and -1.2% total returns, the long Treasury bond and the 2027 zero coupon bonds had positive returns of 2.2% and 4.7%, respectively.

Why long Treasury bonds continued to provide positive results in a higher short interest rate environment continues to puzzle many investors, particularly at a time when the economy was growing above trend, key measures of inflation were rising, and Fed policy was hawkish.

One rationale is that sponsors of defined benefit pension plans have noticed the Labor Department's recent proposal to Congress requiring a more precise matching of assets and liabilities. However, lack of Congressional action and the absence of accounting rule changes suggest that this justification for the bond rally is suspect. A second explanation for the long end out-performance last year and in the first quarter may be that investors had already shifted out of long maturity positions believing rates were going to rise, and thus the market was "sold out."

A third, more likely cause is that investors are looking beyond current, transitory business conditions. For the past few quarters the economy has performed above trend. The coincident indicators of economic activity are rising smartly, but the leading indicators of

economic growth are faltering. These forward looking indicators suggest that growth will be considerably weaker as the year progresses. In addition, inflation, which has been trending higher, will, as a lagging economic indicator, begin to reverse this abbreviated uptrend in response to softer economic conditions that lie ahead.

LEADING INDICATORS SUGGEST A SLUMP

Coincident and lagging indicators have been showing strength, although the leading economic indicators are clearly pointing downward. The most powerful, in a causative sense, are the anticipatory indicators in the monetary sector. The quantity of money, as measured by the growth rate in M2, has slumped to just 1.9% in the past three months. M2 is a component of both the Leading Economic Index (LEI), developed by the Conference Board, and the Economic Cycle Research Institute's (ECRI) leading index. In 2004, M2 grew by 4.5%, the slowest annual increase in nine years, and far below the long-term trend rate of increase of 6.7%. M3, which also rose by the smallest percent in nine years in 2004, has likewise moderated to a slim 2.6% pace in the past three months. The pronounced weakness in money aggregates should not be surprising. Economic theory suggests that the demand for money and credit will slow when market rates of interest rise.

Applications for the purpose of refinancing mortgages, although not used by either the Conference Board or the ECRI, is also a leading monetary indicator, and one that indicates that Fed policy is already biting into the economy's future growth (Chart 1). Five sustained periods of declining applications on a year over year basis have occurred since 1990. As of March, the monthly applications have fallen below each year earlier level for 20 consecutive months,

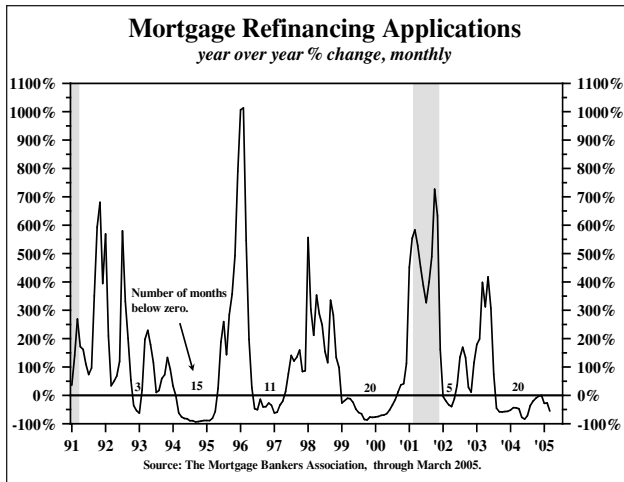


Chart 1

equaling an identical period of extended contraction prior to the recession of 2000-2001. The latest drop exceeds by five and nine months, respectively, the string of declines prior to the slowdown of 1995 and 1997-98. Refinancing activity has been an important source of funds to support consumer spending. The rising rates have now stemmed this source of income, creating the environment for a slowdown in consumer expenditures .

Still another leading monetary indicator is the shape of the yield curve. One of the ten components of the LEI compiled by the Conference Board, the curve is captured by the spread between the ten year Treasury yield and the Federal funds rate. The sharply rising short rate has narrowed the yield differential between short and long term rates, which has the impact of reducing the profit potential for banks and other financial intermediaries and depressing monetary and credit growth. Further, when short rates rise but long rates decline, investors expect economic activity and/or inflation to slow. In addition to the flatter curve, the yield spread between Treasury and corporate, or other lower quality debt instruments has been widening. This is a component of the ECRI's leading index. Not only is this a sign of increased angst among investors over the long-term economic outlook, it also raises the cost of funds to lower credit quality borrowers, a negative for investment and future economic growth.

Our research indicates that the spread on the yields of the thirty year Treasury bond and the ten year Treasury note is actually a slightly better indicator than the ten year spread against the Federal funds rate, though both are excellent leading indicators (Chart 2). More importantly, the flattening of both spreads points

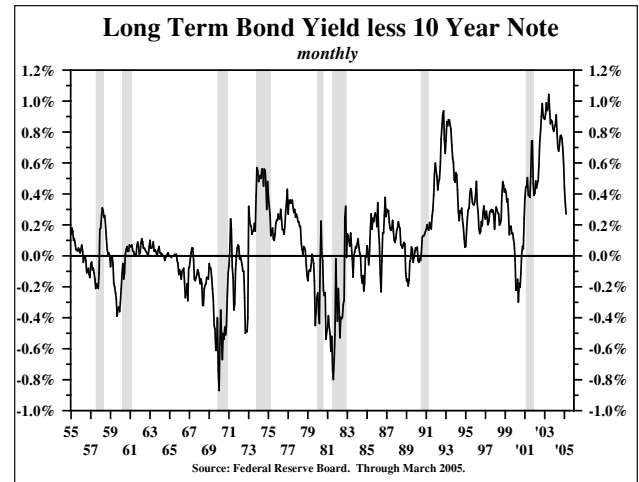


Chart 2

to softer economic growth ahead, and is consistent with the sharp contraction in money and reserve growth.

REAL SECTOR LEADING INDICATORS ALSO TURN DOWN

The Conference Board's LEI contains the following seven non-financial indicators: 1) average weekly hours, manufacturing; 2) average weekly initial unemployment insurance claims; 3) real manufacturers' new orders, consumer goods and materials; 4) vendor performance, slower deliveries diffusion index; 5) real manufacturers' new orders, nondefense capital goods; 6) building permits, new private housing starts; and 7) consumer expectations.

Five of these seven indicators have been in a decline for at least seven months, and have registered significant decreases since their peaks of 2004. Consumer expectations and the manufacturing work week crested in January 2004, falling by 17.3% and 1.2%, respectively (Chart 3). Real manufacturers' new orders for consumer goods and materials topped out in March 2004, with the latest reading 2.2% lower. Vendor performance in March stood at 52.5, down very sharply from the 67.6 high reached in May 2004. Real manufacturers' new orders for nondefense capital goods in February of this year were .7% below the zenith reached in July 2004. This was a minor, but meaningful, decline since a 50% bonus on depreciation expired at the end of 2004.

Two statistics from the real sector, however, continued improving into 2005, suggesting that an outright recession may be avoided. Although weekly unemployment claims jumped sharply in March,

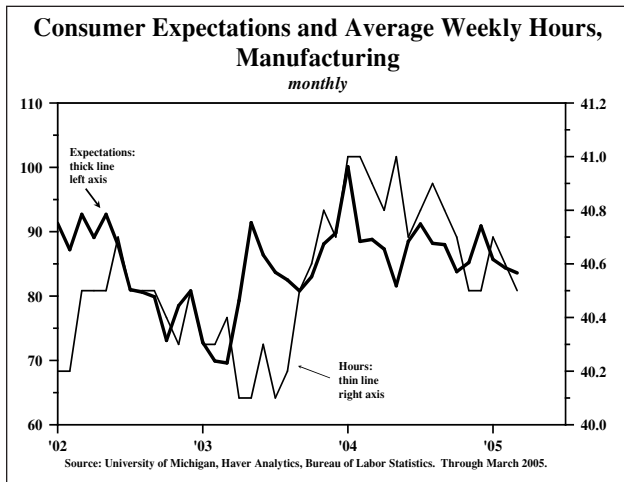


Chart 3

February's reading was the lowest in this series for this forty month expansion. Likewise, building permits are only one month away from their peak, with only a very marginal decline having occurred. However, it should be noted that mortgage home purchase applications -- the housing sector proxy in the ECRI -- shows a slight downturn. In March, these applications were 2.9% lower than November 2004's high water mark.

WHAT ABOUT STOCK PRICES?

Both the LEI and the ECRI use a stock price indicator, with the S&P 500 in the former and the NYSE Composite in the latter. Despite the recent softness, neither of these two indicators, using the standard business cycle tests, show meaningful deterioration since both were at cycle highs in February. This does not, however, preclude future economic weakness. Note, for example, that the S&P and the NYSE both failed to anticipate the contraction in economic activity that started in Q3, 2000 (Chart 4). The highest point in the S&P and the NYSE occurred in August and September of 2000, respectively. Hence, this provided no lead time against the .5% decline in GDP in the third quarter of 2000, the first of three contracting quarters over a five quarter span. Further, stocks also failed to signal an upturn in economic activity. Both the NYSE and the S&P indices bottomed in the first quarter of 2003, a full year after the first quarter of the economic recovery. Stock prices may have lost their heralded forecasting ability.

The preponderance of evidence suggests that economic growth is about to slow significantly. This softening in business activity should be viewed in a context of existing, long-term structural imbalances such

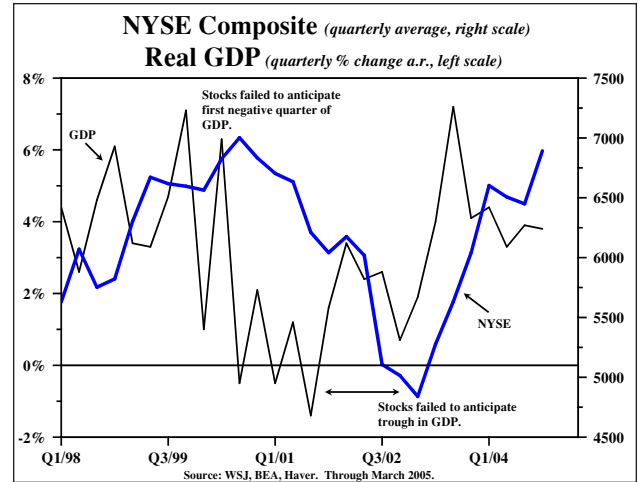


Chart 4

as high debt levels, low saving rates, underemployment, and a realignment of manufacturing and service jobs to low wage destinations. The risk of an economic accident, which could shift the U.S. from slow growth to an outright slump, is ever present.

GREENSPAN'S BOND MARKET CONUNDRUM

In recent Congressional testimony, Federal Reserve Chairman Alan Greenspan mentioned that the performance of the bond market was a conundrum, or mystery. He was referring to the noticeable decline in Treasury bond yields in the face of rising short and intermediate term interest rates. It is our view that this flattening of the yield curve appropriately reflects current monetary policy, as well as existing global realities.

Two major alternative theories explain long-term interest rate movements: 1) That long rates are a function of short-term interest rates, and 2) That long rates are determined by rational expectations. Utilizing the former, a rise in short-term rates translates into higher bond yields. Under the rational expectations theory, decision makers take into account all available information in determining whether they will buy or sell Treasury bonds, including existing and future inflation. Accordingly, the rational investor considers the influence of short-term interest rates, but this is only one element of the entire universe of information that investors consider in determining whether they will buy or sell. This rational expectations view can be universally applied to any type of decision making, whether buying bonds, common stocks, big ticket items, or nondurable goods.

Investor information includes the speeches of the Federal Reserve Chairman, which can have broad or specific thrusts. An example of the former has been Chairman Greenspan's often-stated intention to control inflation, which has given us the confidence to hold bonds when at times transitory factors – like oil and commodity prices – boost inflation.

As an example of the specific type of data in those speeches, consider the following paragraph from Chairman Greenspan's Senate testimony on Feb. 16, 2004: "There is little doubt that, with the breakup of the Soviet Union and the integration of China and India into the global trading market, more of the world's productive capacity is being tapped to satisfy the global demands for goods and services. Concurrently, greater integration of financial markets has meant that a larger share of the world's pool of savings is being deployed in cross-border financing of investment. The favorable inflation performance across a broad range of countries resulting from enlarged global goods, services and financial capacity has doubtless contributed to expectations of lower inflation in the years ahead and lower inflation risk premiums."

When Treasury bond yields are viewed historically from 1870 to the present, the Chairman's words ring true. From 1870 until about 1950, with the exception of the years of worldwide war, a true global trading market was intact. During this period, as clearly indicated on the Chart, Treasury bond yields fluctuated around 3%. Rates began their secular rise in the late 1940's with the onset of the Iron and Bamboo Curtains, which cut the world's productive capacity in half, and which, along with other factors, contributed to the inflationary boom that crested in 1980 coincident with long term rates (Chart 5). The

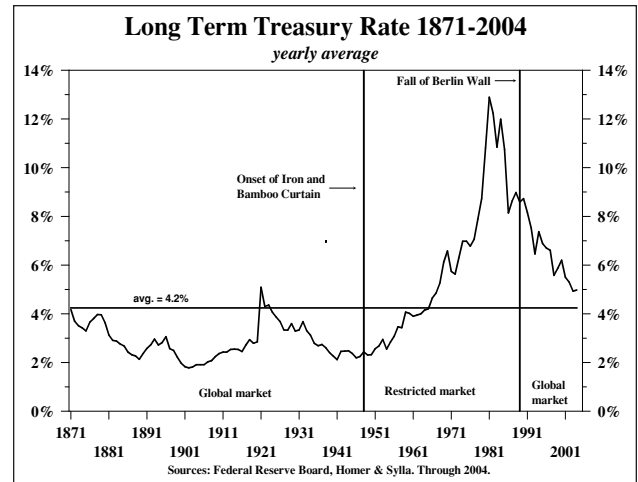


Chart 5

reversal in the upward trend occurred partially in response to increasing productive resources. These came into play after the fall of the Berlin Wall and the integration of more of the world's productive capacity that introduced larger amounts of lower priced goods, as Chairman Greenspan testified. The 135 year average of 4.2% was heavily influenced by the abnormal trading conditions that existed for the 60's, 70's, and 80's.

Why does a global versus a half global trading system matter? It matters for precisely the reasons articulated by the Fed Chairman. The greater the economies of scale and the degree of price competition, the lower will be the inflation rate and inflationary expectations. The fall of the Iron and Bamboo Curtains restored the model more closely associated with the one of freely competitive markets so well described in economic theory. But, since Treasury bond yields are ultimately determined by inflation, investors might be wise to assume that they, too, are returning to an environment that once prevailed, and will now prevail again.

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