

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 Third Quarter 2005

Remarkable Variability In Returns

Over the first nine months of this year, the yield on the two year note increased from 3.1% to 4.2% as the monetary authorities hiked the Federal funds rate six times, each by 25 basis points. Thus, 2005 has been a continuation from 2004's final quarter when the Fed funds and two year note yield each moved ahead by 50 basis points. During the last twelve months other maturities rose in yield with the singular exception of the thirty year sector. Despite the eight Fed rate increases in this span, the yield on the long Treasury bond declined from 4.9% to 4.6% --the famous conundrum! This yield curve anomaly created remarkable variability in returns for investors. Those in the long end of the yield curve, such as HIMCO accounts, received 12.8% and 9.9% returns for the past year and year to date, compared with 2.8% and 1.8% returns of the widely quoted Shearson Lehman Aggregate Bond Index. This is a 1000 basis point difference over the past year.

Influenced by natural disasters, all interest rates moved higher in the third quarter. Long yields gained 35 basis points, creating a negative return of 4.2% for HIMCO accounts compared with a negative return of 0.7% for the Index. This late summer/early fall backup in long term rates should be viewed as a transitory up-shift in inflationary expectations that will be quickly reversed in the ensuing quarters. Although energy prices have entered uncharted waters, Fed authorities have left no doubt that the price increases will not translate into a generalized inflationary environment. Accordingly, additional Fed funds rate hikes should boost short term interest rates even as bond yields fall. Such a policy mix will expose the highly leveraged U.S. consumer to a tightening vice of lower discretionary income, higher interest payments, and reduced money and credit availability. Such basic considerations, of far broader significance than catastrophic weather events, ensure that the present slowdown in economic activity will persist and undoubtedly worsen in the quarters ahead.

Before the Hurricanes

Prior to this summer's natural disasters, the economic fundamentals were clearly pointing to more subdued growth:

- 1) Monetary and fiscal policies were becoming more restrictive.
- 2) Leading business indicators here and overseas were softening and barometers of coincident economic activity were downshifting.
- 3) Housing - the main U.S. economic driver for more than a year - was easing;
- 4) Consumer real income was lagging spending, and escalating energy bills were limiting discretionary expenditures.

Of the pre hurricane conditions, only fiscal policy has shifted. The budget indicators were on track for a 2005 deficit of about \$317 billion, or 2.6% of GDP. As recently as 2004 the deficit had reached \$415 billion, or 3.6% of GDP. While large in dollar terms, it was less than the 4.6% and 5.1% of GDP recorded in 1992 and 1983 respectively. For fiscal year 2006, no firm estimates are possible, but it appears that the deficit may widen to about 3.1% of GDP (Chart 1). This deterioration is only a small shift relative to total economic activity, but

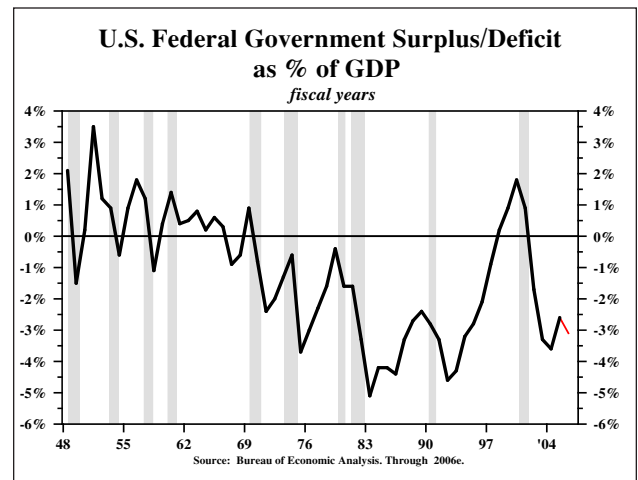


Chart 1

currently is a psychological negative for the financial markets. Increasing deficits conjure visions of faster commerce and inflation. However, deficits are neither expansionary nor inflationary if they are not validated by an expansion in the money supply. The Federal Reserve for the past 25 years has shown no tolerance for such a development.

History is interesting in this regard. During the Vietnam War and the Nixon and Carter presidencies, the deficits were large in nominal dollars by the standards of that time, but small relative to GDP. What made them inflationary was Fed policies which allowed them to be underwritten by a sharp lift in the money supply. From 1964 through 1968, M2 jumped by 7.5% per annum, or above the 105 year average of 6.7%. From 1971 through 1973, M2 swelled an even faster 11.4% per annum. In the five year span ending in 1980, M2 grew at a near 10% per annum pace, and the only faster time spans were during the Spanish American War and World Wars I and II.

If Fed policy dictates that the 2006 deficit be financed from existing money balances (i.e. without a boost in the money supply), short-term rates will climb further since the bulk of the Treasury financing will fall on that portion of the curve. Yield spreads between short- and long-term bonds would continue to level out, and in all likelihood invert. Raised short term borrowing costs, combined with such yield curve changes, would serve to transfer spending from the private to the public sector. As such, the enlarged budget deficit would do little to invigorate activity, and the inflation rate would not escalate.

Increasing Monetary Restraint

Even before the latest round of Fed tightening, substantial monetary discipline was in place. In the past twelve months, M2 grew just 3.5%, contrasted with a nine year low growth rate of 4.5% registered in 2004. Growth in zero maturity money, or MZM, has slumped to just 1.8%, a level associated with past recessions or meaningful decelerations. Covering all the monetary aggregates, the real Neo-Austrian money supply contracted over the past year.

The yield curve has continued to flatten significantly. The spread between the ten year Treasury and the Federal funds rate recently stood at 60 basis points, down from 372 basis points in May 2004. The spread between the long term and ten year Treasury yields has dropped from 104 basis points in June 2003 to 20 basis points recently. Like M2, the yield curve is an excellent leading indicator, with an outstanding

predictive history.

Flatter yield curves are signs that investors expect: (1) a less exuberant economic situation, or (2) reduced inflation or (3) a combination of both. Moreover, by reducing the profit making opportunities at the financial intermediaries and thereby reducing lending, a more horizontal yield curve works to help ensure that these expectations will materialize.

Weaker Coincident and Leading Indicators At Home and Abroad

In the last four quarters, a coincident indicator, real gross domestic demand (GDD)—which is GDP less net exports of goods and services—rose 3.5%, down from 5.1% for the second quarter of 2004 (Chart 2). Real GDD for the Euro 12, plus Canada, the U.K. and Japan, moderated to 1.8% in the last four quarters, measurably less than the 2.3% apex in the third quarter of 2004 (also Chart 2).

Leading domestic and foreign indicators exhibited an even greater loss of momentum. In the twelve months ending August (a time frame virtually unaffected by the hurricanes), the leading economic index was up just 1.9%, compared to the 10% reading logged in March 2004 (Chart 3). Not surprisingly, recent deterioration in numerous indicators – job market perceptions, consumer confidence, housing, and sales of chain stores and auto manufacturers – cannot be neatly explained away by Katrina and Rita. For example, the Conference Board notes that a huge September nose dive in attitudes about employment opportunities was a national, not a Gulf States phenomenon. Thus, the economy was downshifting prior to the hurricanes, and this process was just beginning.

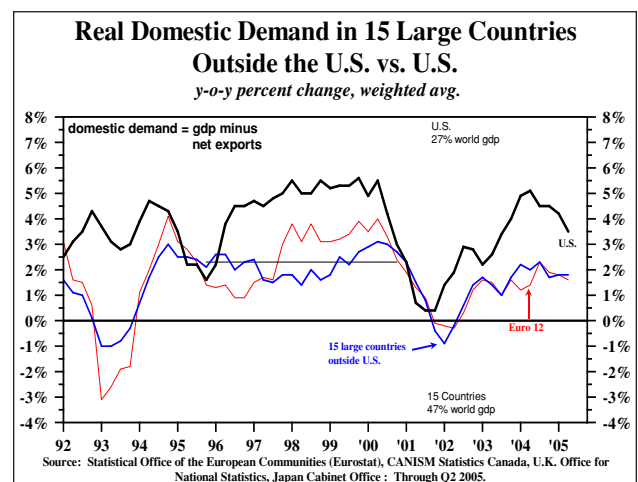


Chart 2

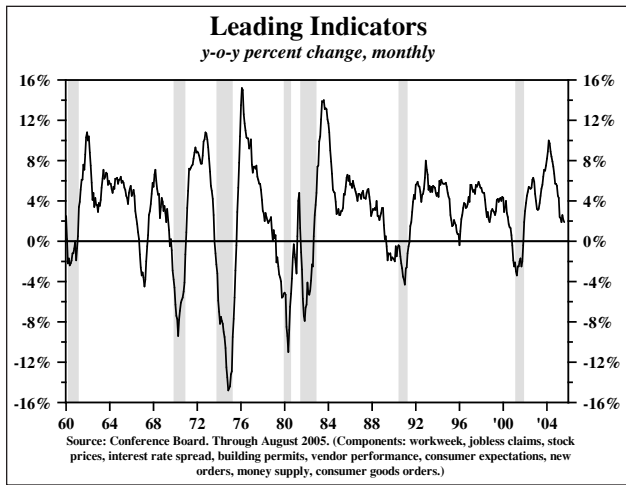


Chart 3

The Long Awaited Slowdown in Housing

Housing statistics were mixed at lofty levels through August. However, September information provides signs of a downturn. Consumer surveys detected a noticeable curtailment of home buying intentions in September. The Conference Board found that plans were at the lowest levels of the past ten months, while the University of Michigan survey dropped even more sharply. The Housing Market Index compiled by the National Association of Home Builders fell to 65 in September, down 9.7% from the June peak--the lowest reading since July 2003. In addition, net new home equity loans have virtually stopped (Chart 4).

Such signs, though tentative, are consistent with erosion in housing sector fundamentals, tighter credit standards and evidence that house prices are exceedingly inflated. The Housing Affordability Index of the National Association of Realtors – which takes into consideration family income, home prices and mortgage rates - recently stood at 117.6. This was the lowest reading since 1991,

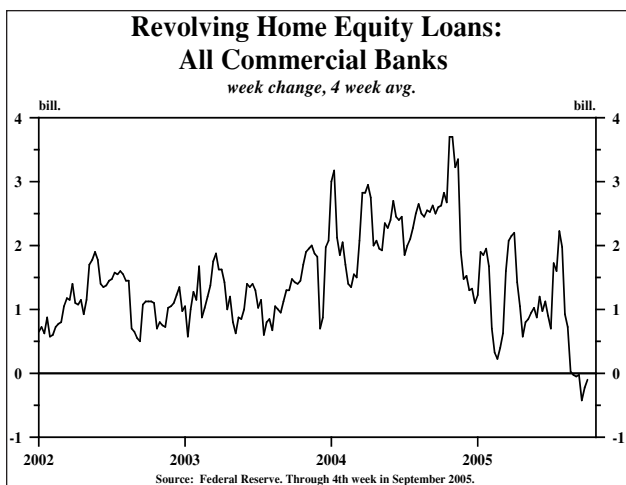


Chart 4

off nearly 18% from the 2003 high. In May, the Fed, the FDIC and the other federal regulatory agencies served notice that increased scrutiny of marginal loans would be forthcoming, in effect raising mortgage lending standards. This caution by regulatory officials is a bit late, however, as evidenced by the soaring home prices of the past few years (Chart 5).

By linking five different home price series since 1890 and deflating them by the CPI, Dr. Robert Shiller created a U.S. Real Housing Price Index. Based on an index of the year 1890 = 100, home prices in 2005 totaled an unprecedented 186.2, 84% above the mean of the past 115 years. Previously, there were four multi-year extremes – 1894, 1955, 1979 and 1989, with an average of a much lower 121.4. Real prices fell in all three, five and ten year periods after those pinnacles. Three of those extended declines entangled the banks and other financial intermediaries, aggravating the overall state of affairs.

A dip in the housing sector would have far ranging consequences since rapidly appreciating prices permitted consumers to extract equity that supplied substantial funds for consumer spending over most of this decade. Both the Federal Reserve and Freddie Mac have compiled estimates of this process, the former calling it “Gross Equity Extraction” and the latter “Total Home Equity Cashed Out.” The Freddie Mac series suggests that equity “takeouts” constituted 31.5% of personal consumption expenditures during this decade. Similarly, Chairman Greenspan, one of the authors of the Fed study, said that “a fourth to a third” of these “takeouts” financed personal consumption expenditures directly, with another portion flowing indirectly into consumer spending. Indisputably, the housing market has played a major role in permitting the consumer to spend much greater sums than generated by income. Accordingly, the practice of taking equity out of the family home goes a

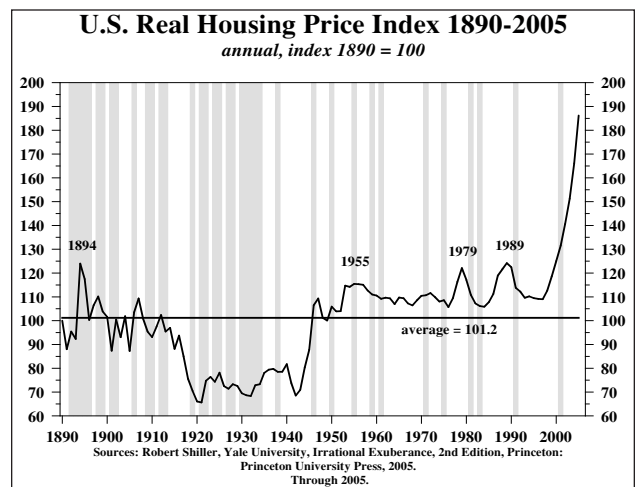


Chart 5

long way toward explaining a fall in the personal saving rate to a negative .9% in July and August. The third quarter saving rate could be the worst since the 1930s, an outcome that was likely before hurricanes Katrina and Rita. A downturn in housing, with extensive ripple effects, could be at hand.

The Consumer Squeeze

The housing sector's critical role in sustaining consumer spending is also illustrated by contrasting the growth in real disposable personal income (DPI) with real Personal Consumption Expenditures. Over the last twelve months, real PCE gained 3.5% while real DPI was up a slim 1.4%. Housing equity cash "takeouts" played an important role in closing this gap. The main factor suppressing DPI has been a severe squeeze on wage earners. In the past twelve months, average real weekly earnings declined 1.1% as nominal wages trailed inflation. Without a continuing fresh supply of funds from the housing sector, consumer spending growth could slow precipitously.

Responding to Fed rate actions, the household debt service ratio was an unparalleled 13.6% in the second quarter, 1.3% greater than the old mark set three years ago. Short-term interest rates have increased since spring, so debt burdens are destined to climb, and the current record high readings of credit card delinquencies and bankruptcies may soon be broken.

The consumer must also confront bulging energy prices. In August, total consumer fuel expenditures were 9.1% of total wage and salary income, a level not seen in nineteen years. Total fuel expenditures now total \$527 billion versus \$298 billion in February of 2002. Relative to wage and salary income, consumer fuel expenditures have advanced 3.1% from the 6% low of 2002. This change is larger than all previous oil hikes including the Arab oil embargo of 1973-74 and the embargo of the late 1970s with the fall of the Shah of Iran and the Soviet Union invasion of Afghanistan. Prior to the Arab oil embargo, the U.S. imported about 33% of its oil, versus over 70% currently (Chart 6). Over time, the pattern of consumer energy purchases being recycled into the domestic economy has been dramatically curtailed, leaving higher energy prices today a dead weight on the economy.

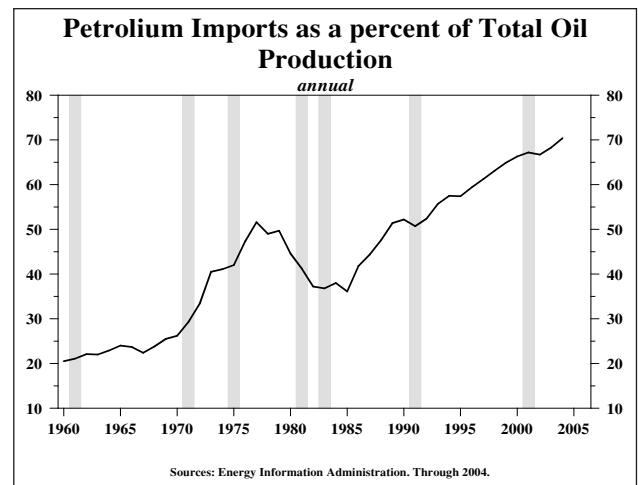


Chart 6

Core Inflation and Bond Market Prospects

In the past year, the price of crude oil ballooned 53% and the price for natural gas more than doubled, so the headline CPI inflation rate could soon exceed 4%. Yet, the more stable gauges of inflation have been flat in 2005. In the twelve months ended August, the core PCE deflator rose 2%, versus 2.2% for 2004. The figure for the market based core PCE was just 1.7%--identical to 2004.

Two of the persistent traits in the U.S. for more than a decade have been fast enhancement of worker productivity and cost containment in the corporate sector. Productivity in the nonfinancial sector - the only one where measurements are valid - bounded ahead at an unparalleled 6.4% in the past four quarters. Indeed, the 3.6% pace of the past five years is also without precedent, and considerably above the 2.1% long-term experience. With labor compensation modest, unit labor costs inched forward a mere 0.4% in the past four quarters, beneath 0.7% in 2004 and a mean 0.8% per annum over the past five years. This suggests that wage push inflation is unlikely.

Aided by global circumstances the Fed has done a very effective job of containing swollen energy prices. The more subdued economic climate likely in 2006, plus continued Fed resolve, indicate that core inflation will move lower over the next year. With the tendency for long term Treasury bond yields to be determined by multi year patterns in inflation, Treasury bonds should continue on their long term path to lower yields.

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