

# Hoisington

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## Quarterly Review and Outlook

### *Fourth Quarter 2005*

#### INTEREST RATES

Long term Treasury rates fell last year despite the 200 basis point increase in the federal funds rate. One of the star performers in the bond market was the zero coupon Treasury bond (P) dated 11/2027, returning 17%. By comparison, shorter maturities returned approximately 1% for investors who were positioned in two, five or ten year notes. Fortunately, HIMCO accounts owned some of those 11/27 Ps, along with other long-dated Treasuries, creating an 11.6% return compared with the 2.4% return for the Lehman Aggregate Bond Index. The Lehman Long Term Government Corporate Bond Index returned 5.3%. In 2004 those same 11/27 zero coupon bonds returned 16%, meaning that over the past two years it was possible to make 36% in a long dated Treasury security while the Federal Reserve was raising the Fed funds rate from 1% to 4 1/4%-- counter intuitive and amazing!

Interpreting Federal Reserve policy is important in bond management, but in recent years this has been superseded by proper understanding of the yield curve, for it was, in fact, the dramatic flattening in the Treasury yield curve that produced the stellar results in the long end of the Treasury market. As 2006 begins, there are signs that the Fed process of rate increases is nearing an end. Does that mean that the outsized returns of the long end of the Treasury market are also about to end? Historically, the answer has been no. Since 1954, the long end of the Treasury market has always rallied before and after the switch from Fed tightening to a neutral or easing position, with only two exceptions. History supports the premise that the out-performance of the long end of the bond market can continue.

One attribute of the 2005 rally in the long end of the Treasury market is a continued downward shift in inflationary expectations. The current

Federal Reserve has been vigilant in shutting off any inflationary impulses derived from commodities or other exogenous factors. Second, structural shifts in the global competitive environment have contributed to a secular reduction in labor costs, allowing for the increased production of goods and services to be enacted with lower prices. Provided these two key developments are sustained, investors positioned in the long end of the bond market should continue to be rewarded.

#### FEDERAL RESERVE

Much has been written regarding the "forecasting ability" of the yield curve and what that circumstance means for future economic developments. Our interpretation is that the current flat yield curve reflects the actions of the Federal Reserve and investors, while simultaneously causing a slowdown in economic activity. The process by which economic stagnation sets in is as follows. The central bank influences the supply and demand for money when it raises the federal funds rate since it boosts money market yields. To boost the federal funds rate the Fed has to cut total reserves, which, in turn, reduces funds that can be supplied for borrowing and investing. Banks' profits, meanwhile, are crimped because they are unable to make easy money by borrowing at low, shorter-term rates and lending at higher, longer-term rates—the well known "carry trade." Thus, higher short rates can cause the borrowing and lending process to grind to a halt, or even put it into reverse. This process siphons funds from the spending stream as loans are repaid, and economic growth is stunted.

A flattening yield curve is a sign that Fed policy is working. It is not a surprise that a higher federal funds rate is followed by slowing growth in money and narrowing in the spread between short and long term Treasury yields. For example, in our present circumstance, total reserves fell in 2005 because of the

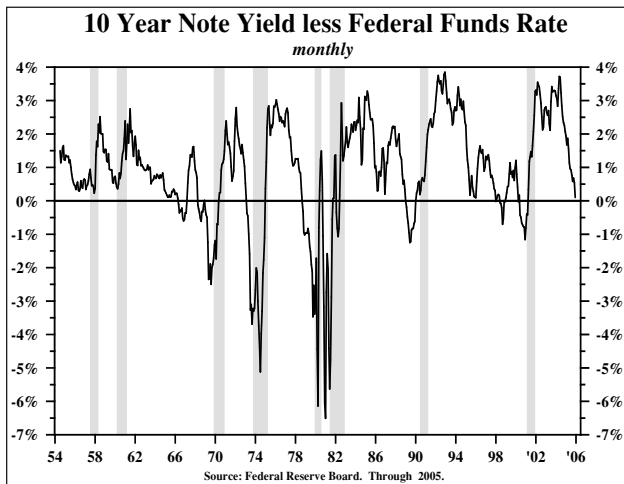


Chart 1

cumulative impact of the thirteen Fed rate increases. The M2 money stock has increased a paltry 4% in the last 12 months, compared with a 6.7% long-term average growth rate.

While the flattening yield curve (measured by the difference between the ten year Treasury note yield and the federal funds rate) is part of a broader process, its historical implications shouldn't be taken lightly. Such flattenings have preceded all the recessions since 1954 (Chart 1). There were no technical recessions following the severe flattening in 1966 and 1994, but there were major slowdowns in economic activity in each of those years. In the middle of those slowdowns the economy grew at annual rates of 1.6% and 0.9%, respectively. Only a quick and decisive Fed reversal toward easing prevented worse economic conditions. Since 1954, growth in M2, when adjusted for inflation, slowed dramatically in the four quarters right before recessions, reflecting the Fed's tighter policy (Chart 2). This occurred also in the slowdowns of 1967 and 1995.

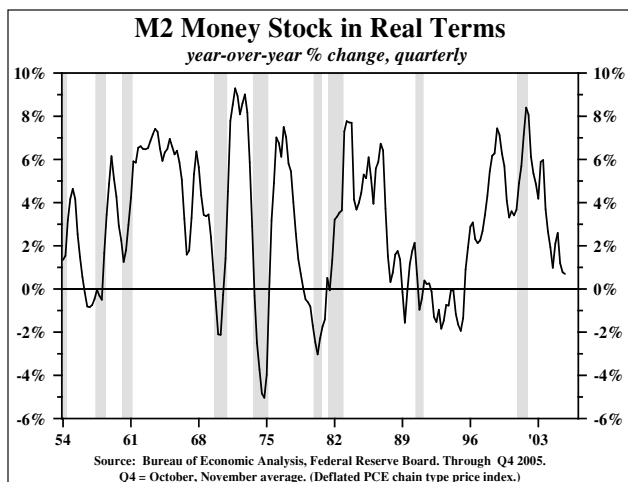


Chart 2

Both the yield curve and M2 are widely considered excellent leading indicators.

Growth of less than 1% in real M2 in the past four quarters, combined with a sharp contraction in total bank reserves, reinforces what the yield curve is telling us--the economy is headed for a slowdown. That means either less inflation, less real growth, or some combination of the two.

## CONUNDRUM

While the Federal Reserve moved the federal funds rate and influenced other short term rates higher last year, the reason for the long end rates moving lower is a matter of some debate. The best answer is lowered inflationary expectations. A restrictive Fed and downward movement in core inflation rates influenced investors in the long end of the market. Despite higher energy prices, on a fourth quarter to fourth quarter basis, the core PCE (personal consumption expenditure) deflator decelerated from 2.2% in 2004 to 1.9% in 2005. The latter figure was based on reported October and November numbers, and an estimate for December similar to the rise of the two prior months. In other words, investors, domestic and foreign, assessed the underlying inflation picture, determined that it was decreasing, and bought bonds. Since 1959, when quarterly data came into existence, the bond yield has moved in the same direction as the core PCE deflator 74% of the time.

Some speculate that it was totally foreign demand that drove down Treasury bond yields in the face of higher short term rates. The objective evidence is entirely to the contrary. Foreign buying was heavy

### Maturity Structure of Foreign Holdings of U.S. Treasury Debt Securities

	5 years and less	5 - 10 years	over 10 years
2004	75.5%	16.4%	8.1%
2003	72.4%	16.3%	11.2%
2002	71.6%	16.3%	12.2%

Source: U.S. Treasury Department

Table 1

for Treasury securities of five year maturities or less. As indicated in Table 1, foreign holdings of these shorter maturities increased to 75.5% of their total portfolio in 2004, up from 72.4% in 2003 and 71.6% in 2002. Over this same time span, foreign holdings in maturities over ten years dropped to 8.1% in 2004, down from 12.2% in 2002. Thus, in the area of the curve where foreign buyers are active, interest rates rose because the short-term rates are heavily influenced by the central bank controlled federal funds rate. In the area of the curve where foreign interest was diminishing, yields declined.

### SLOWDOWN

Consumer spending in the last five years has accounted for 70% of the U.S. GDP, compared with a 64% share since World War II. The prospects for this key sector in 2006 are diminishing since consumer fundamentals worsened last year. With an estimate for December, real disposable income (DPI) grew 1.2% in 2005, significantly less than the 3.4% posted in 2004. Quite probably the gain in real DPI for 2005 could be the poorest since 1993 (Chart 3). Household debt surged to a record 122% of disposable personal income in the third quarter, as the personal saving for 2005 fell into negative territory—the worst reading since 1933. More importantly, the household debt service ratio jumped to a record 13.7%, indicating that higher short-term interest rates are forcing consumers to shift funds from discretionary spending to mandatory interest payments.

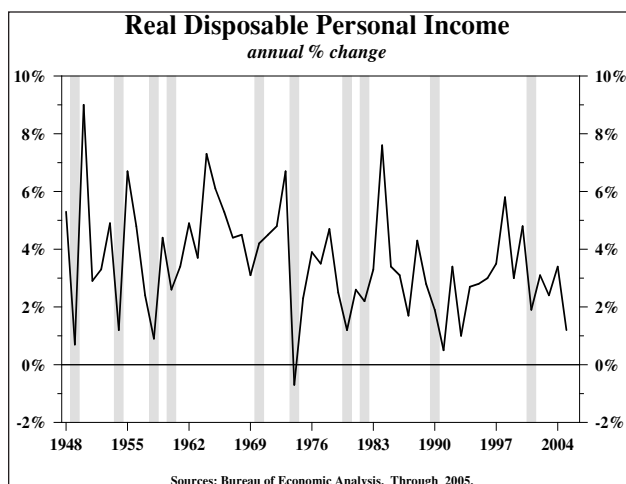
Future income growth has been stunted by fewer job opportunities as payroll employment expanded only by 114,000 per month in the last four

months of 2005 compared with 196,000 per month in the first eight months of the year. Aggregate hours worked expanded by 1.8% in the fourth quarter, 0.6% below the yearly average, and the work week in December is only 1/10 of an hour above the record low set in early 2003.

The consumer appetite for borrowing is seemingly satiated or constrained by increased regulatory activity. Consumer installment debt has fallen \$9 billion in the past two months—the first back to back decline in nearly a decade and a half. Home equity loans, which expanded 39% in 2004 and 8% in the first half of 2005, have experienced a net decline since July. Going forward, new lending guidelines issued by the office of the Comptroller of the Currency, the Federal Reserve, and other regulatory institutions regarding interest only and other marginal loans, has the potential to sharply curb lending in the new year. This will stymie the growth in the home building sector in 2006. Mortgage refinancing, which has been the primary source of consumer spending power, is now down 23 % from a year ago. In sum, the near zero rate of growth in consumer spending in the fourth quarter of 2005 is the harbinger of diminished economic activity in 2006.

### UPDATE TO HIMCO'S SECULAR STUDIES

In the 2002 winter issue of the Journal of Portfolio Management, HIMCO examined the long term economic and financial development beginning in 1871 regarding the stock/bond risk premium. In our Second Quarter 2005 quarterly letter we differentiated between the “open” global market that existed prior to the Iron Curtain in 1946 and the “closed” global market that existed until the impediments to free trade and capital flows ended in 1989 when another “open” period commenced. As we have continued to work on this data, important additional insights that bear directly on the risk of inflation during an “open” economic era have emerged. In our previous study the original “open” economy era lasting from 1871 to 1945 included World Wars I and II, and the GDP price deflator increased by .7% per annum. Obviously, however, during these wars the global trading system was “closed.” Excluding the ten years of global conflicts in that earlier period, we discovered that outright deflation existed as the GDP deflator declined by 0.4% per annum (Chart 4). The longest prevailing



Sources: Bureau of Economic Analysis. Through 2005.

Chart 3

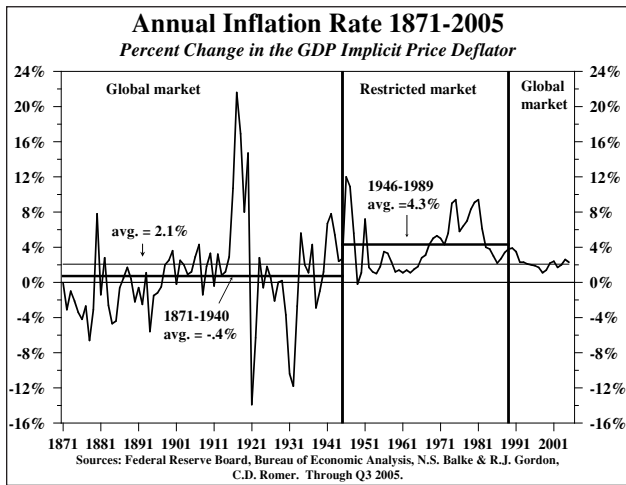


Chart 4

U.S. Treasury bond yield averaged 2.9%; thus the real long Treasury bond yield was 3.3%. This “open” economy provides an even more dramatic contrast with the “closed” economy that existed from 1946 to 1989 when the inflation rate was 4.3%, the Treasury bond yield was 5.8% and the real yield was 1.5%.

### ECONOMIES OF SCALE

These new calculations serve to reinforce our previous conclusions that “open” economies are vastly different from “closed” ones because of economies of scale to the manufacturing of goods as well as the factors of production—labor, natural resources, entrepreneurship and capital. The greater the economies of scale, the larger the number of units over which fixed costs can be distributed, which, in turn, lowers average production costs. Thus, when the Berlin Wall fell, the former Soviet Union and its satellites entered the world economy and China and India emerged. The conditions of the earlier global economy were now restored, creating massive economies of scale. In addition, the new globalization

### Global and Restricted Markets

		Open Economy	Closed Economy
		1.	2.
		1871-1940*	1946-1989
1.	Bond Yield	2.9%	5.8%
2.	Inflation Rate	-0.4%	4.3%
3.	Nominal GDP	3.2%	7.6%
4.	Real GDP	3.5%	3.2%
5.	Per Capita Real GDP	2.0%	1.8%
6.	M2	5.3%	6.7%

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, A Half Century of Returns on Stocks and Bonds by Fisher and Lorie, History of Interest Rates; Homer & Sylla, N.S. Balke & R.J. Gordon, C.D. Romer, Robert Shiller - Yale University, Peter L. Bernstein Inc., HIMCO. (\* excluding WWI and WWII years.)

Table 2

added huge numbers of producers of goods and services and suppliers of the factors of production, which enhanced competitive forces, also serving to place downward pressure on inflation.

Importantly, the adjusted data confirms that real economic growth was better in the “open” than the “closed” period. From 1871 to 1940 (ex World Wars I & II), real GDP grew 3.5% per annum, versus 3.2% from 1946 to 1989 and real per capita GDP increased 2% in the former period versus 1.8% in the latter period (Table 2). This finding has extremely important implications for investors since bond yields are ultimately determined by inflation and inflationary expectations, not real growth.

Therefore, with the disinflationary/deflationary impulse of lower labor costs around the world intersecting with tight U.S. monetary policies, inflationary expectations should continue to diminish, and we remain steadfastly bullish and committed to the long end of the Treasury market.

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