

Hoisington

INVESTMENT MANAGEMENT COMPANY

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Quarterly Review and Outlook

First Quarter 2006

Economic Weakness Ahead

The fourteenth and fifteenth consecutive increases in the Federal funds rate to 4 ¾% had a definite negative impact on the entire yield curve in the first quarter. Five, ten, and thirty year Treasury securities recorded negative returns of -1.2%, -2.8%, and -4.4% over the past three months. Long-dated zero coupon bonds suffered the most, falling about 7.8% for the quarter following their 17% gain in 2005. Long-dated portfolios such as HIMCO's registered a -5.9% rate of return compared with a .6% loss for the shorter-dated Lehman Index. Short term volatility in the Treasury market is not unusual. In each of the five years prior to 2006, long Treasuries have registered a quarterly decline of 3% to 6%, yet the compounded five year return is 7% versus the shorter-dated Lehman Index return of 5%. The economic evidence in early 2006 reveals a distinct weakening in the forward looking economic indicators. This presages a noticeable slowing in economic growth as the year progresses. The cumulative impact of tighter Federal Reserve policy is taking its toll on domestic economic conditions, and international competition continues to place downward pressure on the prices of manufactured goods and services. With inflation quiescent, and economic growth slowing, a substantial decline in long rates will occur over the remainder of 2006.

First Quarter Vigor

The Federal Reserve Open Market Committee noted the economy "rebounded sharply" in the first quarter. This surge, which could register a 4%-5% real annualized growth rate, is at least partly a rebound from the extremely weak fourth quarter when final sales declined at the fastest rate since the previous recession. The spring-like conditions of the first quarter have created havoc with the seasonally-adjusted statistics. For instance, a 20% annualized surge in retail sales

in Q4 was converted to only a 1% adjusted rate of gain. The weather influenced first quarter had a non-seasonally adjusted 35% rate of contraction in sales, which then converted to a seasonally adjusted 13% rate of increase. Seasonal adjustment procedures are important in smoothing out economic data, but they can also be distorted by transitory factors. Averaging the two quarters can eliminate some distortions and doing so reveals a 3% gain in consumer spending, below the 3.5% and 3.9% increases registered for all of 2005 and 2004 respectively. Thus, the trend in consumer spending continues to wane despite a first quarter lift.

Stress in the Household Sector

Real disposable income (DPI) expanded by 1.5% in 2005, compared with a spending increase of 3.5% in the same period. The difference, of course, has to be additional borrowing or money taken out of savings. The primary source of funding in 2005 appears to have been the withdrawal of home equity (Chart 1), as, according to Freddie Mac, nearly \$250 billion was added to consumer pocketbooks with the cashing in of home values. That process will be less

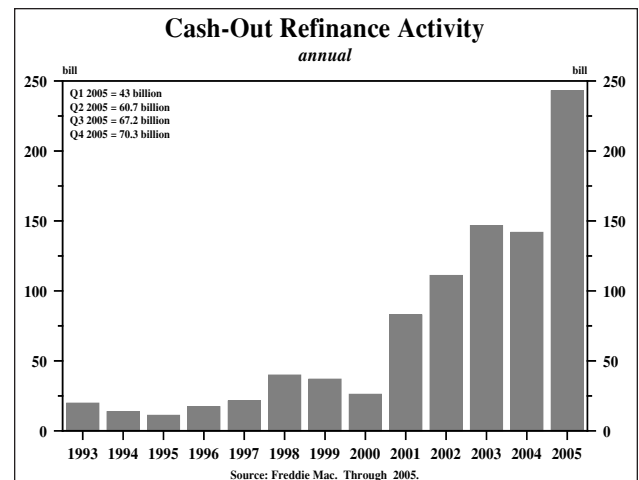


Chart 1

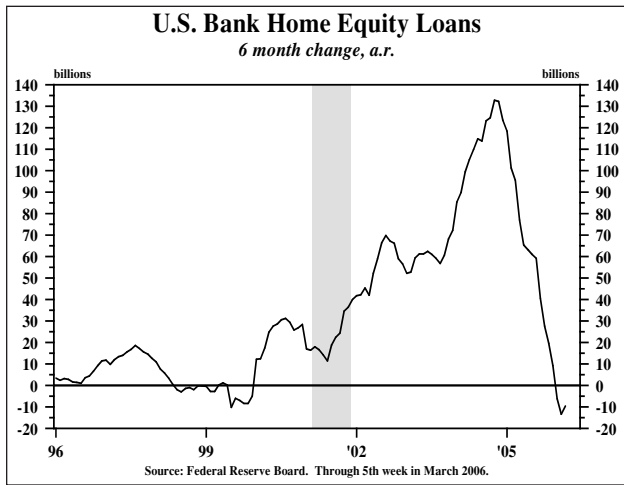


Chart 2

easily repeated in 2006. First, federal regulators have finally begun to scrutinize the quality of zero interest and other non-traditional loans. While the specific guidelines are scheduled to be issued this month, the impact of regulatory changes can be dramatic. In May of last year, regulators issued guidelines regarding home equity loans. Consequently, the six month change fell from over \$130 billion to minus \$10 billion currently (Chart 2).

Second, home values are now beginning to fall (down about 5% since October 2005), and new home sales are 21% off last year's peak levels. Since the new regulations are targeting zero down loans which represented 43% of new homes sales last year, further declines appear to be in store. With home sales down, inventories of unsold homes are up 23% from a year ago. Mortgage purchase applications are down 12% from a year ago, and refinancings are down about 20%. The National Association of Realtors said that nearly 40% of all home purchases last year were for second homes, and nearly 2/3 of those were for "investment purposes." It would appear that speculation was an important component of the housing buoyancy of 2005. New regulations, combined with the higher interest rates, have stopped that speculation, and will make home equitization exceedingly difficult in 2006, suggesting that consumers will be able to spend only what they make. This is quite a change since in eight of the last ten years income has trailed spending.

The increase in net worth may appear to have benefited spending increases, but a report recently released by the Federal Reserve in its tri-annual survey of consumer finances revealed that the average family only moderately participated in higher home and stock

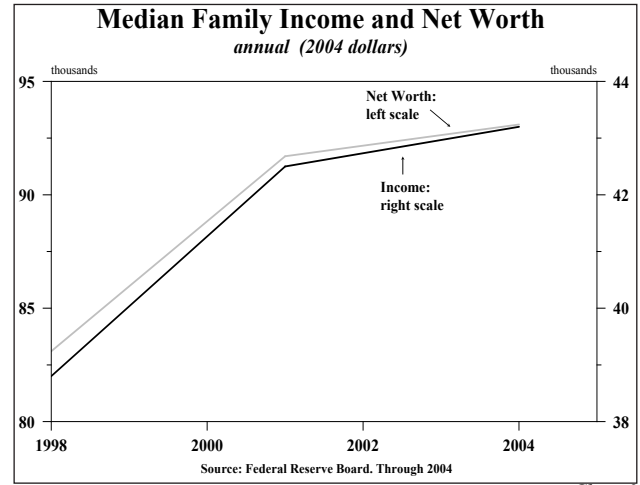


Chart 3

prices (Chart 3). In fact, the median family's real net worth rose only 1.5% from 2001 to 2004. Equally important, as of 2004 one half of the families in the United States live on an annual income of \$43,200 or less, up just 1.6% since 2001. Amazingly, the wage component fell 6.2% during that time period. Despite employment gains, wage growth fell as high paying jobs moved to low wage countries, only to be replaced with lower paying jobs in the United States. This is hard evidence of that dynamic. It also portends less ebullient consumption going forward, particularly if the borrowing spigot has been turned off by the higher rates and new federal regulations for lenders.

Leading Indicators

The Federal Reserve appears content to raise rates until GDP slows. This approach is equivalent to driving while looking in a rear view mirror since GDP is a coincident indicator of economic activity. Monetary policy and interest rates work on the economy with long and variable lags, and it is apparent that a two year time span and 375 basis points of tightening have already tilted the economy toward a negative trajectory. How do we know that? We don't for certain, but great efforts by statisticians have been made over the years to arrive at a set of impartial, non judgmental economic statistics which forecast future economic developments. These are known as leading economic indicators. The Conference Board and the Economic Cycle Research Institute have developed thirteen different leading indicators which provide a glimpse of future economic developments. At the present time, despite Federal Reserve opinions to the contrary, all but two are signaling a noticeable slowdown, if not a recession, in the quarters ahead.

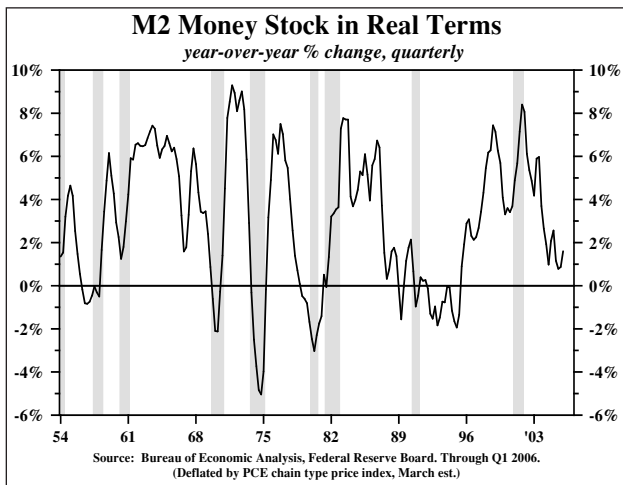


Chart 4

The first and most reliable indicators are changes in the real money stock (M2) and the yield curve (Fed funds to ten year notes). These two are heavily influenced by the Fed, and are presently weak. Real M2 (year over year) has declined from an 8% growth rate in 2001 to less than a 2% growth rate currently (Chart 4). This indicator has a 100% batting average since it has turned down prior to all recessions since 1954. The Fed funds rate increases have flattened the yield curve from 370 to 10 basis points. This second leading indicator has a couple of missed calls, but still bats around 80% when calling recessions (Chart 5).

Three other indicators of future growth also reflect the tightened monetary conditions, including mortgage purchase applications, the BAA bond spread, and the difference in yield between corporate and Treasury notes. As noted above, mortgage purchase

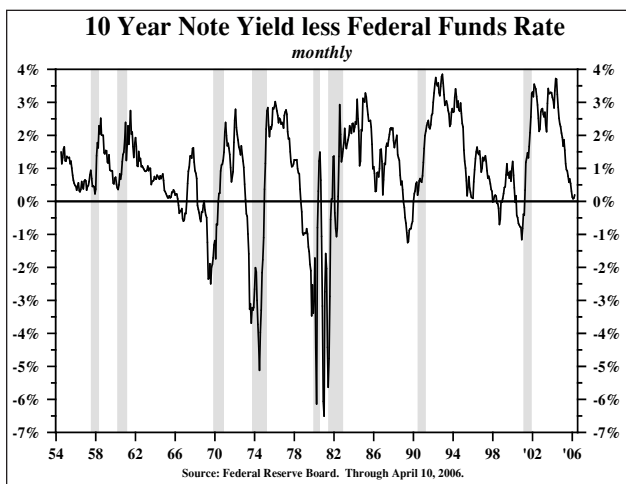


Chart 5

applications are 12% below a year ago, BAA yields are up 60 basis points from the February 2005 lows, and the spread between corporate and ten year notes has widened about 13 basis points from their narrow of one year ago. These are less emphatic regarding the slowdown, yet they too point in the same direction.

In addition to the five so-called monetary indicators, there are six measures of real economic activity that give us a clue regarding future economic developments. First, vendor performance (the percentage of firms reporting slower deliveries) has recorded a sharp 15% decline since May of 2004. Second, real manufacturers' new orders for non-defense capital goods are 18.7% below the 2005 peak. Third, private building permits are about 2% lower than their September 2005 peak, and fourth, the Consumer Expectations Index about future economic conditions stood at 76 in March, down from 80.2 in December and the peak of 100.1 reached at the start of 2004—perhaps a reflection of the poor quality of the job market. Less convincing are the modest increases in initial claims for unemployment insurance and the insignificant decline in the work week from the peak set ten months ago. In sum, however, the real sector indicators confirm the monetary leaders.

Despite the weakening of the eleven mentioned above, two indicators are still rising, disputing the call for an outright recession. These widely viewed factors are stock prices and commodity prices. Here, however, the recent record of these key financial indicators has been poor in signaling economic turning points. The S&P 500 and the New York Stock Exchange Price Index peaked in August and September of 2000, providing no lead time to the decline in GDP in the third quarter of 2000, which was the kickoff to the last recession. Moreover, these stock price measures bottomed more than a year after the recovery had started in 2001. Similarly, industrial commodity prices, as measured by the *Journal of Commerce*, peaked in September of 2000, providing no advance warning for the impending recession. Those same commodity prices bottomed simultaneously with the last decline in real GDP in 2001. Commodity prices also failed to advertise the cyclical turning points in the 1990s. Thus, two of the so-called 13 leading indicators, which are pointed in a direction opposite from the other 11, have somehow lost their prescient abilities of late.

In assessing the movement of these important financial economic and monetary leading indicators, it is our conclusion that a significant slowdown will embrace the United States before 2006 is completed. Furthermore, if the year over year growth rate of real M2 turns negative and the yield curve inverts for more than three months, the probability of recession will rise to over 50% on a statistical basis. Judgmentally we are already over 50%.

The Bond Market

For nearly a decade the generalized economic environment in the United States has been characterized by a disinflationary condition, with an overabundance of goods and services relative to the demand for those items. Consequently, the broad measures of inflation continue to work lower. The year over year rise in the Core Personal Consumption Expenditure Deflator, which stood at 1.8% in February, is within the 1%-2% range that Federal Reserve Chairman Ben Bernanke has stated to be price stability (Chart 6). The present level is slightly lower than the 2% increase in 2005 and the 2.2% increase registered in 2004, despite soaring energy prices. It is no wonder that even with fifteen increases in the Fed funds rate the long term bond yield still remains nearly forty basis points below its peak when the Federal Reserve began to tighten policy. We have been long the bond market throughout the 2 ½ year firming of monetary conditions. The realization that the Federal Reserve has once again gone too far in ignoring the leading indicators while emphasizing the coincident indicators in a disinflationary environment causes us to remain fully invested bulls in the bond market.

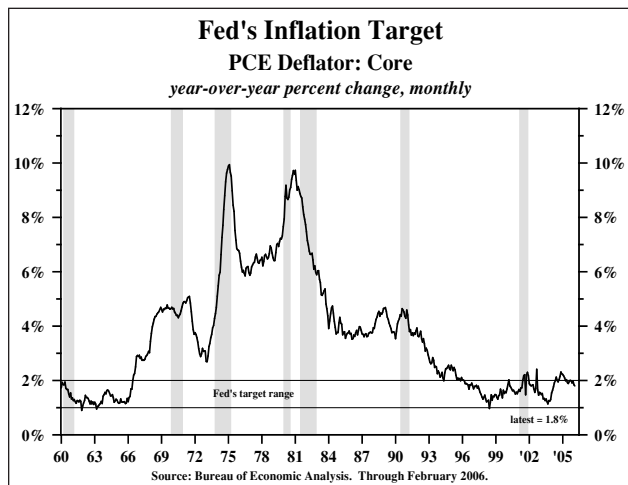


Chart 6

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