

# Hoisington

INVESTMENT MANAGEMENT COMPANY

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## Quarterly Review and Outlook

Third Quarter 2006

### THIRD QUARTER RALLY

The U.S. Treasury bond market rallied sharply in the third quarter. Two, five and ten year notes returned 2%, 3.4%, and 5% respectively, while the longer-dated thirty year bond rose more than 8% for the quarter. This rally was generated by weaker economic data while the Fed funds rate remained at 5 1/4%. The equity market, as measured by the S&P 500 stock index, also moved upward registering a 5.7% rate of return for the quarter.

Presently, the five, ten, and thirty year interest rate levels, standing at 4.6%, 4.7% and 4.8% respectively, are noticeably below the 5 1/4% funds rate. This yield curve inversion, while unusual, is not unprecedented. Similar inversions occurred prior to six post WWII recessions. In the inversions prior to the 1990 and 2000 recessions, the yield curve became more inverted until the Federal Reserve lowered the Fed funds target rate. A similar outcome should prevail in this business cycle, with the inversion process only halting when the Fed reduces rates.

### THE "NO OPINION" INDICATORS

Judgments regarding the course of future economic activity are as plentiful as pages in a newspaper. Each forecast contains assumptions about future economic developments. As a result, current opinions range between a Fed pause and subsequent tightening to an early reduction in the Fed funds rate. Interestingly, a body of statistical indicators exist that carry no opinion, but which have proven over an extended period of time to do

a superior job of forecasting the level of economic activity. This statistical series, compiled by the Conference Board since 1960, and prior to that by the U.S. Department of Commerce, is known as the Leading Economic Index (LEI). The LEI, comprised of ten different economic indicators, has declined on a six month basis thirteen times since 1952. Nine recessions and four slowdowns followed each of these contractions. This 70% batting average is measurably better than the record of most economic pundits.

One of the LEI components--the spread between the ten year Treasury note yield and the Fed funds rate--has, by itself, an outstanding record of signaling recessionary periods since the late 1960s (Chart 1). It is possible to improve the statistical probabilities of these two prescient indicators by combining them into a third leading barometer. Since the end of WWII, a simultaneous yield curve inversion and a six month decline in the LEI have occurred only seven times. With the exception of an inversion forty years ago, this combination has been 100% accurate in calling

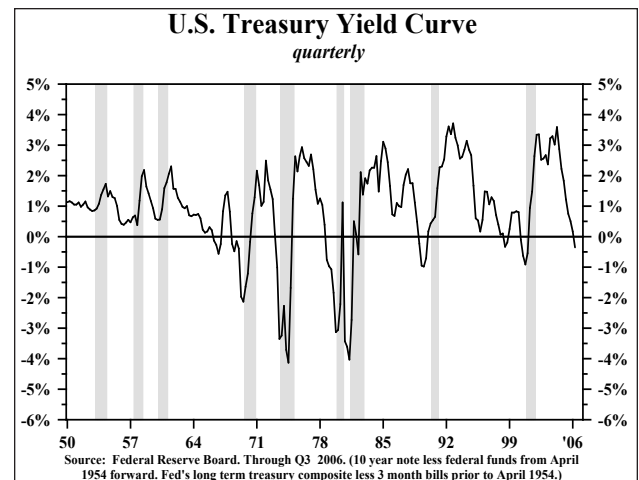


Chart 1

recessions. The average lead time between the meeting of these two conditions has been about nine months (but with significant variations from the average). The most recent episode occurred in June of this year, suggesting that the economy should register at least below trend growth rates in 2007. All "opinions" aside, cyclical financial history points to disinflationary, sub-par growth rates over the next several quarters. Augmenting this statistical view is the present collapse of various housing indicators.

### HOUSING

The housing sector has recently recorded the greatest boom in U.S. history. Speculation and a plethora of new financing alternatives had driven home prices to extreme levels. A significant increase in the Fed funds rate to 5 1/4% over the past couple of years has begun to impact this heretofore strongest sector of the U.S. economy. In fact, it is safe to say that housing is already in a recession. The National Association of Home Builders Market Index has fallen to a sixteen year low (Chart 2). New home sales are off 17% from a year ago, resales are down 13%, and importantly, prices in both categories are slightly negative on a year over year basis. Housing starts have slipped 20% below year ago levels. While ostensibly housing only represents about 6% of GDP, the multiplier impact on lumber, copper, steel, cement, household furnishings, and employment is significant. In light of the fact that housing related employment has contributed roughly 1/3 of the

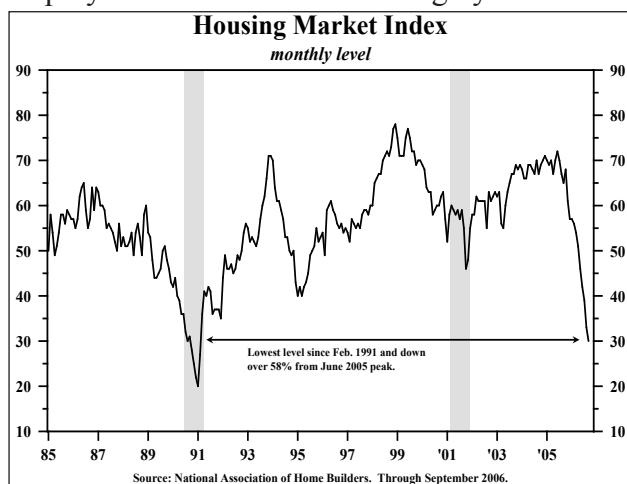


Chart 2

employment growth of this entire expansion, its reversal will significantly influence future growth rates. Presently, construction employment is still rising modestly, so it is clear that the U.S. economy has yet to feel the negative impact of the housing reversal, insuring disappointing growth in 2007. Despite the prospect for below trend growth over the next several quarters, and the subsequent creation of more excess capacity and looser labor markets, long dated bonds are still viewed as risky because of the large trade deficit and its imagined impact on interest rates.

### THE TRADE DEFICIT

One of the most persistent worries concerning the bond market is the record trade deficit. As the logic goes, the deficit is so unmanageable that at any point foreign investors (who have taken U.S. paper in exchange for our "excessive" buying of their goods) may dump their dollars, forcing the dollar downward and the U.S. inflation rate upward. Our research indicates that these concerns are entirely misplaced.

First, attempting to find a correlation between the U.S. dollar and the trade deficit fails. Since 1974 the trade weighted dollar and the trade deficit register a correlation coefficient of 0. The "t" stat is a statistically insignificant .001 and carries the wrong sign. The obvious lack of correlation is confirmed by a graph of the two variables (Chart 3). For example, from 1995 to 2002, the trade deficit deteriorated by 442% while

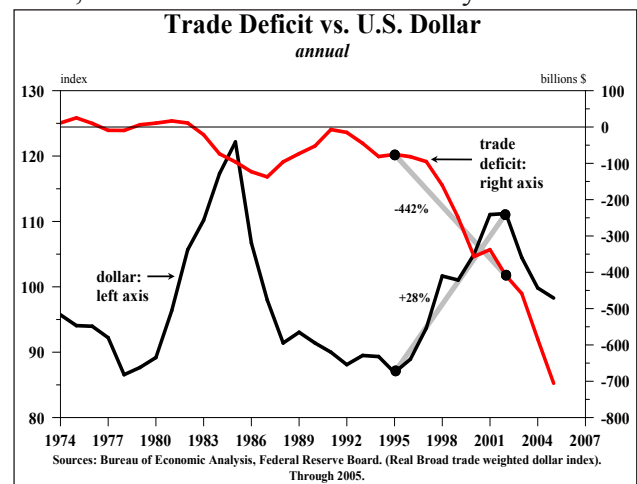


Chart 3

the dollar gained 28%. In other words, there has never been a correlation between the U.S. dollar and the trade deficit. Assuming dollar weakness just based on trade is an unproven, and highly suspect conclusion.

Second, the trade deficit and its associated internal capital flows have allowed foreigners to amass a total of \$13.6 trillion in claims on U.S. assets. From the U.S. position, this could be seen as \$13.6 trillion in debt or, conversely, from the foreigner's perspective they hold \$13.6 trillion of U.S. assets. This could be of great concern since it does represent 106% of one year's total U.S. economic growth. However, this statistic ignores the important fact that U.S. investors hold \$11.1 trillion in foreign assets. In other words, the world is in debt to us by \$11.1 trillion. Of significance, the difference is \$2.5 trillion, only 20% of one year's income or GDP for the United States. This ratio is about the same as the average homeowner pays for housing expenses, or about 20% of income. Two Nobel Laureates, Milton Friedman and Edward Prescott, shed significant light on this complex problem. They maintain that any impact on the dollar comes from the difference in what is earned on the \$11.1 trillion that we own versus what foreigners earn on their \$13.6 trillion. In Chart 4 we derived the yield on those various assets. As evident in the graph, historically U.S. investors have achieved a higher yield than their foreign counterparts. And, this differential is much more closely correlated with movements in the dollar (Chart 5).

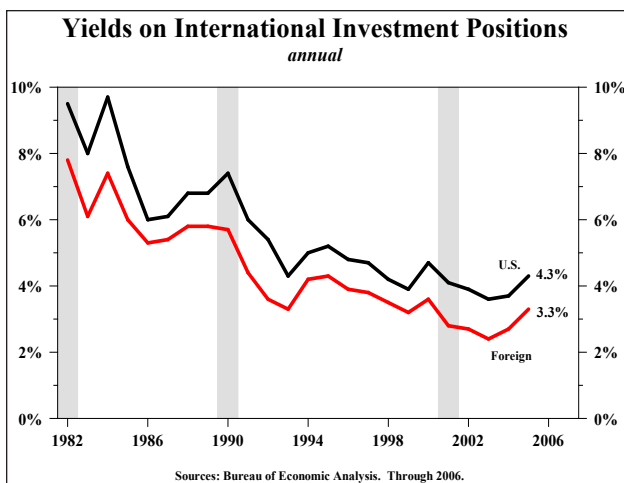


Chart 4

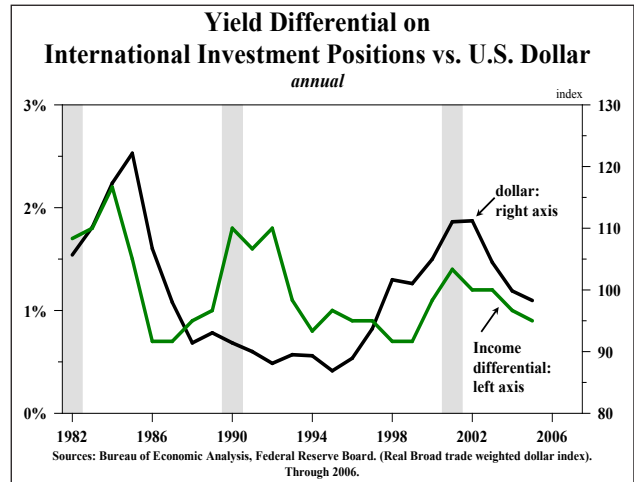


Chart 5

The great bulk of U.S. asset holdings are in the form of direct investments in plant equipment and companies. On these assets we enjoy a higher income and a gain from the rise of their value. The rest of the world, however, invests heavily in U.S. securities that provide lower yields and less potential for capital appreciation. The most recent statistics (Table 1) reveal that, of the \$13.6 trillion, the rest of the world held \$6.4 trillion in long term securities, with \$2.1 trillion in equities and \$4.2 trillion in debt. As the table indicates, the debt instruments are highly concentrated in the short end of the market. With the recent rise in the Fed funds rate, yields on short dated instruments have risen, and therefore essentially evened the yield differential in this calendar year. As short term U.S. rates fall away, the spread will move back in favor of U.S. asset holders. Therefore, concerns regarding the dollar and its impact on U.S. interest rates are fundamentally unfounded if they are based on the trade deficit or massive foreign holdings of U.S. assets.

		Long Term Securities (col. 2)			Long Term Debt (col. 4)		U.S. Treasury Securities (col. 7 plus Treasury bills)				
		Long-Term securities	Equities	Debt	Corporate	U.S. Agency	U.S. Treasury	5 years and less	5 - 10 years	over 10 years	
		1.	2.	3.	4.	5.	6.	7.	8.	9.	10.
1.	*Trillions (\$)	6.3	2.1	4.1	1.7	0.8	1.6	1.4	0.3	0.1	
2.	2005	100%	34%	66%	28%	13%	26%	75%	18%	8%	

\* may not sum due to rounding.

Source: U.S. Treasury Department

Table 1

**COUNTERVAILING FORCES**

Recent revisions in the payroll series for the year ending fiscal March 2006 revealed a much stronger recovery and level of economic activity for that period than was previously known. Further, the very modest, 103,000 job gains in private payroll employment over the past six months is called into question as the Department of Labor could also be understating present job growth. Thus, economic circumstances could be understated. This would imply that the Federal Reserve's pause is just that, and a further tightening of monetary policy would be required over the next several quarters to slow economic activity below potential. Of course this could cause the entire yield curve to move upward.

Mitigating that bearish conclusion are the following facts: a) significant restraint has already been applied to the system, as evidenced by the 5% decline in total reserves over the past twelve months (Chart 6), and the slow 4.7% M2 growth rate for the past year; b) housing, as previously noted, is declining sharply and new regulations setting higher standards for lending, which were just issued, will create continued downward pressure on that sector; c) fiscal stimulus has been significantly reduced this year as the deficit totaled

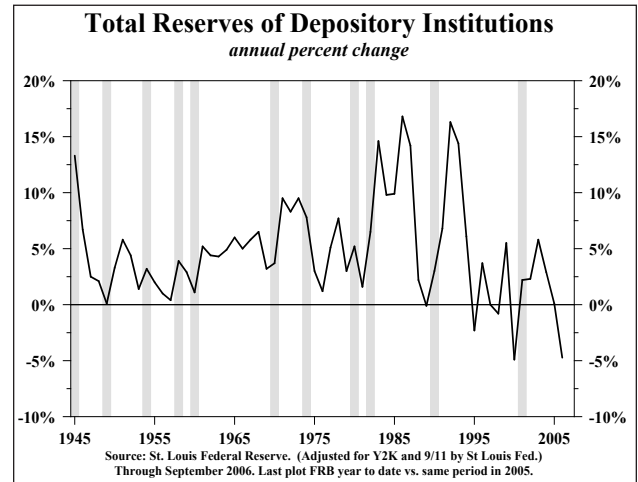


Chart 6

about \$250 billion compared with \$318 billion and \$411 billion in the two previous fiscal years; d) the leading economic indicators of world economic activity, as well as the U.S., are pointed toward much slower growth; e) commodity prices have fallen roughly 20% from their peaks, implying softer economic activity and; f) real GDP has eased to the 2 1/2% range, well below the 3.5% growth rates of the past two years.

On balance, we believe the lagged impact of Federal Reserve policy actions and mounting weakness in specific sectors will cumulate toward much slower growth in 2007. Interest rates should decline reflecting that slower growth scenario.

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## PERFORMANCE

The U.S. bond market rallied sharply in the third quarter, providing HIMCO accounts with an 8.8% rate of return. Over the past twelve months the return was 1.7%. The Lehman Aggregate Index recorded 3.8% and 3.7%, respectively, over the same time frames. The longer-term advantage of HIMCO returns over the Lehman Index has varied between 360 basis points on a three year time horizon to 240 basis points on a fifteen year basis. Interestingly, the HIMCO returns of 8.0% and 9.3% respectively for the five and ten year compounded periods exceeded the S&P, which compounded at 7.0% and 8.6% over the same time frames.

### FISCAL YEAR PERFORMANCE ENDING SEPTEMBER 2006 PERCENT CHANGE

	Q2 2006 %	One Year %	Annualized				
			Three Year %	Five Year %	Ten Year %	Fifteen Year %	Twenty Year %
<b>HOISINGTON MANAGEMENT</b> <i>(gross of fees)</i>	<b>8.8</b>	<b>1.7</b>	<b>7.0</b>	<b>8.0</b>	<b>9.3</b>	<b>9.2</b>	<b>9.9</b>
<i>net of fees</i>	8.7	1.5	6.8	7.8	9.1	9.0	9.6
Lehman Aggregate Bond Index	3.8	3.7	3.4	4.8	6.4	6.8	7.5
30-year bonds *	8.1	1.6	5.7	7.2	7.8	7.8	7.5
5-year notes *	3.4	1.5	1.3	3.6	5.6	5.8	6.3
Treasury Bills	1.3	4.5	2.7	2.3	3.7	3.9	4.7
CPI (est.)	0.7	3.7	3.6	2.9	2.7	2.8	3.2
S&P 500	5.7	10.8	12.3	7.0	8.6	10.8	11.7

Hoisington Investment Management Company (HIMCO) has prepared and presented this report in compliance with the Global Performance Standards (GIPS). HIMCO is a registered investment advisor specializing in the management of fixed income portfolios. The firm was founded in 1980 and is not affiliated with any parent organization. Additional information regarding the firm's policies and procedures for calculating and reporting performance results is available upon request. Performance numbers reflect actual composite returns of accounts managed in the Marcocconomic Fixed Income style, and the composite began in 1981. The performance numbers do not reflect custody fees or other fees charged by third parties, but do include all trading expenses. Net of fee performance reflects actual management fees and trading expenses, but does not reflect custody fees or other fees charged by third parties. HIMCO's fee schedule is included in this publication. Internal dispersion is calculated using the equal-weighted standard deviation of all portfolios that were included in the composite for the entire year. The benchmark is the Lehman Brothers U.S. Aggregate Bond Index. This composite includes 35 accounts totaling \$3.516 billion, or 76.1% of assets managed by HIMCO at the end of Q3, 2006. No leverage has been used, and HIMCO does not manage any balanced or non-fee-paying accounts. Valuations are computed and performance is reported in U.S. dollars. Performance prior to 1992 was calculated using annual weighting according to A.I.M.R. recommended guidelines for retroactive compliance, and a list and description of all HIMCO composites is available. There is no assurance that past performance is predictive of future performance. The following are required disclosures for the years presented. Standard deviation of accounts in the composite: 2005:1.06; 2004:0.86; 2003:0.47; 2002:0.80; 2001:0.63; 2000:1.31; 1999:1.10; 1998:0.57; 1997:1.28; 1996:0.61; 1995:1.83; 1994:0.65; 1993:0.92; 1992:0.28; 1991:0.15; 1990:0.12; 1989:0.23; 1988:0.18; 1987:0.25. Market value of composite (\$millions): 2005:3.194; 2004:3.246; 2003:3.456; 2002:3.377; 2001:3.434; 2000:4.064; 1999:3.599; 1998:3.715; 1997:2.619; 1996:2.551; 1995:2.733; 1994:2.242; 1993:2.600; 1992:1.986; 1991:1.310; 1990:1.160; 1989:884; 1988:682; 1987:591. Number of accounts in composite and percent of firm assets in composite, respectively: 2005:29,74.4%; 2004:30,97.8%; 2003:33,97.7%; 2002:34,93.8%; 2001:35, 94.3%; 2000:35, 95.0%; 1999:41, 97.6%; 1998:42, 99.3%; 1997:37, 97.7%; 1996:41, 99.3%; 1995:38,96.8%; 1994:41,98.8%; 1993:42,98.1%; 1992:39,95.0%; 1991:28,70.8%; 1990:27,96.7%; 1989:22,85.0%; 1988:17,82.7%; 1987:15,93.1%.

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\* current issues linked by HIMCO

Information herein has been obtained from sources believed to be reliable, but HIMCO does not warrant its completeness or accuracy; opinions and estimates constitute our judgment as of this date, and are subject to change without notice. This material is for informational purposes only.