

Hoisington

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Quarterly Review and Outlook

Fourth Quarter 2007

Treasury Bonds Outperform

The longest-dated Treasury bond ended 2007 at a 4.45% yield. This was 35 basis points below the 2006 close, and marked the lowest year-end interest rate on a long Treasury security in 42 years. The capital gain associated with this yield reduction, plus the coupon, generated a 10 ½% return for investors, well above the 7% total registered by the Lehman Aggregate Bond Index. This credit risk-free security also eclipsed the returns of the NASDAQ (9%), DOW (5%), and S&P (6%) for 2007. Non-income producing assets such as grains and foodstuffs (the Reuters/Jefferies CRB Index) and precious metals (Dow Jones Precious Metals Index), posted outsized gains of 20% and 24% respectively. Advancing commodity prices helped propel the Consumer Price Index to a seventeen-year high of an estimated 4% last year, elevating inflationary fears. Normally, Treasury securities do not perform well when inflation is ascendant, but 2007 served anything but the usual economic fare.

The beginning of what will surely be considered the greatest credit event since the 1930s emerged in 2007 with the discovery that derivatives multiply bad credit. The “seizing up” of credit markets resulted in a worldwide reduction of credit issuance from \$2.5 trillion in the 2nd quarter to \$1.3 trillion in the 4th quarter, a near 50% reduction according to a recent *New York Times* article. A supply shrinkage of over \$1 trillion is enough to shift the supply curve to the left, resulting in a bond price increase and lower yields in high quality fixed income securities. This more than offset an increase in inflationary expectations, and was most likely the proximate cause of the sharp reduction in Treasury interest rates in the latter half of 2007.

In our April letter last year we opined the high probability of a recession beginning in the latter part of 2007 or early 2008. This judgment was based on the predictive history of the yield curve and Leading Economic Indicators (LEI). The latter has a 100% batting

average on a quarterly basis in calling economic slumps since 1969, and appears to be on the mark for the 7th perfect call in a row as economic conditions are signaling the cessation of economic expansion.

Normally back to back declines in quarterly GDP must occur to constitute a recession. However, in the 2000 recession, alternating quarterly contractions were observed. This pattern could well develop in 2008 since bloated inventories, the typical driver of consecutive quarterly declines, is not present. Also, the relatively stable private service sector constitutes a record share of the U.S. economy. Rather, a slow contraction of credit availability will cause the consumer to feel the impact of declining wealth from falling home prices, fewer employment opportunities, faltering wage gains, and a monstrous debt burden. This should cause the U.S. economy to rotate in a pattern of stagnant economic conditions, recessionary at times, and growth recessionary at others. The growing excess capacity of our capital structure, along with falling profits, will hinder capital spending increases, reinforcing slower consumption. Increases in federal government spending, along with improvement in our trade balance from shrinking imports, will provide stability in the aggregate economic statistics, while the domestic private economy contracts.

In this environment, short-term interest rates will continue to move downward, reinforced by several reductions in the administered Federal funds rate. The long end of the Treasury market will benefit from two factors. First, investor desire for risk-free assets will increase at a time when default rates will be soaring on other fixed income securities. Second, the overall reduction in credit market instruments will mean fewer alternatives for those desiring a fixed rate of return. By the end of 2008 we would expect new record low yields in Treasuries for this cycle.

As a firm, we have been accused by some with large vocabularies of being ever-lugubrious (pessimistic in plain terms). Indeed softer economic conditions do bring lower interest rates, which generally are beneficial

to those who hold long duration, high quality portfolios. Notwithstanding our personal predilections, the following unbiased statistical research clearly points to a considerable period of subdued economic activity.

Leading Indicators Inconsistent with the Consensus Forecast

The consensus forecast calls for the economy to slow to roughly a 1% annual rate in the first half of this year, and then accelerate to a 2.5% pace in the second half. This view is based on the assumption that the Federal Reserve is on the job, providing considerable stimulus to the pipeline. The Fed's support, it is argued, will allow the economy to overcome headwinds mentioned earlier. The LEI, however, suggests this conventional wisdom is faulty since it is still accelerating to the downside. In the twelve months ending November, the LEI fell .9%, the steepest drop since the recession year of 2001 (Chart 1). The ratio of coincident to lagging economic indicators, also a leading indicator of economic conditions, contracted an even greater 1.1% over this span. Historically, the LEI has turned positive on average seven to eight months prior to economic accelerations. No such signal is in sight, so there is little support for strengthening economic activity in the latter half of 2008.

Fed Policy--not Stimulative

Yield Curve

Three considerations—the shape of the yield curve, the velocity of money, and the economy's credit elasticity--suggest that the Fed has yet to adopt a stimulative stance. The yield curve remains inverted. The ten year note less the Federal funds rate (that measures the

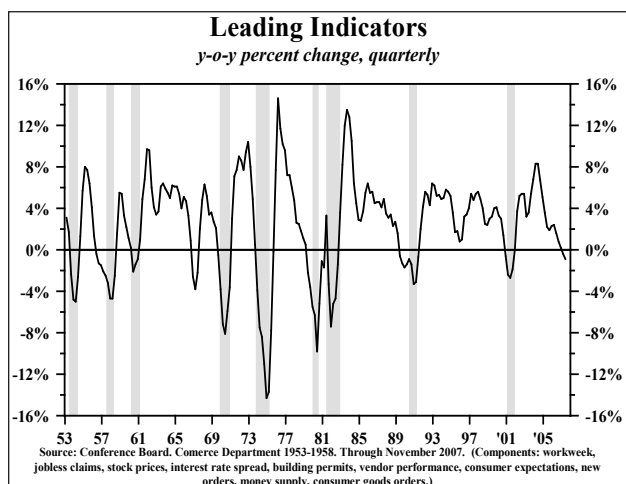


Chart 1

slope of the yield curve and is included in the LEI) has been inverted for 18 months. This is one month longer than the average of all yield curve inversions since 1945. An inverted yield curve is one of the most prescient leading indicators, as highlighted by recent research of the Federal Reserve Bank of San Francisco. Importantly, the yield curve is not only predictive but is also causative in that it helps to create slower growth since the carry trade is eliminated.

Financial sector liquidity cannot be restored until the curve moves to a positive slope. However, a return to a positive yield curve does not immediately restore healthy financial conditions and economic growth since long lags can be expected. From the month when the yield curve returned to a positive shape to the start of the recovery, the average lead time has been 7.4 months (excluding 1980). The lead time extended to an average of eleven months in the last two recoveries since the economy has become more leveraged and more time is required to improve weakened balance sheets. Hence the yield curve is the leading indicator on the way up, as well as a predictor of downturns. Until a positive yield curve is realized, monetary restraint is still hampering the economy. Thus, fledgling signs of recovery that will naturally occur from time to time in 2008 will prove ephemeral. The lags are just too long to get any meaningful result from monetary stimulus until 2009 or 2010.

Falling Money Velocity

A great deal of monetary analysis rightly focuses on the role of the Federal Reserve in creating money (exogenous money), and the power it has in fostering economic growth. Indeed, with a “stroke of the pen” the Fed adds reserves to the banking system. This raw material is multiplied into investments and loans, creating additional deposits and eventually economic expansion. However, three important constraints operate on the seemingly all-powerful Fed. First, no one in the private sector may wish to borrow. Second, impaired balance sheets may preclude the financial intermediaries from taking risk and extending credit. These first two conditions result in a buildup of reserves on bank balance sheets, with no loans or deposits being created. Of course a modern example of this central bank impotence is Japan, where no amount of reserve creation has fostered strong money growth or meaningful nominal economic activity for nearly two decades.

The third tether on Fed manipulations is the role of the private sector in creating money, known as “endogenous money”, or in Irving Fisher terms, velocity (V). The monetary process captured by Irving Fisher's

equation of exchange ($GDP=M \times V$) states that nominal GDP is equal to the stock of money (exogenous money supplied by the Fed) multiplied by the velocity of money (endogenous money created by the private sector). Under the right conditions, private sector activities can mitigate, and possibly overwhelm, actions taken by the Federal Reserve. Historically, swings in velocity have neutralized changes in the money stock many times, and currently appear to be having a profound affect on nominal GDP. During the past six quarters velocity has declined from 1.930 to an estimated 1.902 in the final quarter of 2007. At the same time, the annualized six quarter growth rate of M2 has accelerated to 5.9% from 4.3%. The interaction of these two forces has slowed the nominal growth rate to 4.9%, or 1.7% lower than the six quarter annualized growth rate prior to the peak in velocity a year and a half ago (Table 1).

In the past three months, M2 growth has moderated to about a 4 ½% annual growth rate. If velocity continues to fall at a 1% pace, as it has over the last six quarters, then nominal GDP would slow to a 3 ½% pace. In view of the continuing rise in fuel and food costs and an aggregate inflation rate about 3%, there is little room for any increase in real GDP.

Velocity is functionally related to the rate of increase in financial innovation, rising when innovations are occurring rapidly. Due to innovations in mortgage finance that made mortgages available to households previously deemed not credit worthy, as well as the spread of collateralized debt obligations (CDOs) and structured investment vehicles (SIVs), velocity increased from 1.82 in 2003 to its peak of 1.92 in mid 2006. With these innovations dramatically reversed, velocity is likely to continue to fall significantly.

Even with no opinion about the upcoming course

Falling Velocity Dominates Modest M2 Acceleration				
<i>6 quarter % change, annual rate</i>				
		<i>M2</i>	<i>Velocity</i>	<i>GDP</i>
		<i>1.</i>	<i>2.</i>	<i>3.</i>
<i>1.</i>	2006 - Q2	4.3%	2.2%	6.6%
<i>2.</i>	2007 - Q3	5.9%	-1.0%	4.9%

Source: Bureau of Economic Analysis, Federal Reserve.

Table 1

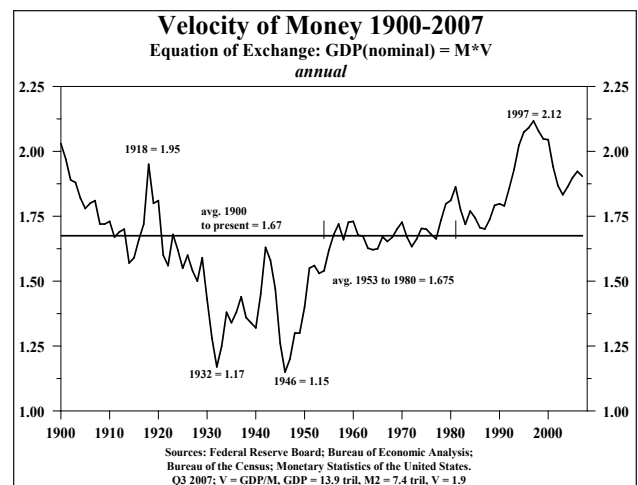
of velocity, one can cite a purely statistical consideration pointing to its decline. Over the very long run, the level of velocity tends to revert to its average. In spite of the recent modest declines in velocity, the latest level is far above the post 1959 average of 1.80 (Chart 2). Even with further declines at a conceivable 2% annual rate, velocity would not return to its post 1959 average until the first quarter of 2010, providing a meaningful offset to money growth. Indeed, at a 4 ½% growth rate in M2, a rise of 2 ½% in nominal GDP could be expected—a pace that would not cover inflation. Real GDP would turn negative and cement recessionary conditions. The downturn in velocity and the persistent inverted yield curve suggest that the Fed remains behind the cumulating economic weakness.

If you waded through that analysis without falling asleep, you are obviously interested in the conceptual aspects of monetary policy and its shortcomings! To further test your thirst for the obscure, we have one more mind bender to consider—elasticity.

Diminishing Credit Elasticity

Elasticity—a measure of the percentage change in one variable in respect to the percentage change in another variable—is an important concept in economics. Price elasticity, for example, is the percentage change in demand in response to a percentage change in price. Thus, credit elasticity is a percentage change in nominal GDP expressed as a percentage change in non-financial debt, or as the mathematician would say, the first derivative of GDP with respect to debt.

In this decade, credit elasticity dropped to 0.66, the lowest on record for a series that began in 1952 (Table 2). This means that GDP increased only 66 cents for each \$1 rise in non-financial debt. In this decade, debt has



Velocity of Money 1900-2007
Equation of Exchange: $GDP(\text{nominal}) = M \times V$
annual

Sources: Federal Reserve Board; Bureau of Economic Analysis; Bureau of the Census; Monetary Statistics of the United States. Q3 2007; V = GDP/M, GDP = 13.9 tril, M2 = 7.4 tril, V = 1.9

Chart 2

Responsiveness of GDP to Changes in Nonfinancial Debt

	Debt (% change)	GDP (% change)	Credit Elasticity (ratio of column 3/2)
1.	2.	3.	4.
1. 1950's	6.15%	5.01%	0.81
2. 1960's	6.79%	6.95%	1.02
3. 1970's	10.48%	10.23%	0.98
4. 1980's	10.91%	7.70%	0.71
5. 1990's	5.43%	5.48%	1.01
6. 2000's	7.72%	5.07%	0.66
7.			
8. Average	7.91%	6.74%	0.86

Source: Federal Reserve Board, Bureau of Economic Analysis.

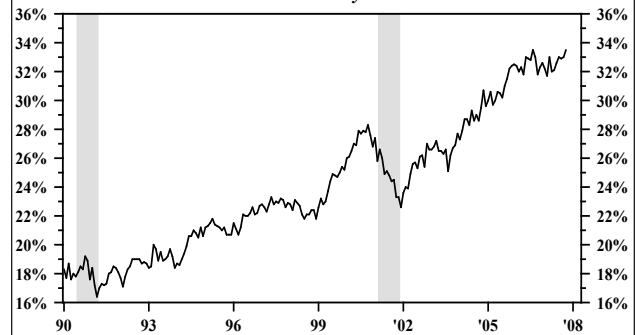
Table 2

increased 7.72% per annum while GDP rose only 5.07% per annum. As such, credit elasticity in this decade was almost a quarter less than the long-term average. In short, the economy got considerably less bang for its borrowed buck in this decade than in any other.

Two considerations may account for the reduced credit elasticity of the U.S. economy. First, at the margin more of the debt undoubtedly went to borrowers who generated a weaker multiplier effect on the rest of the economy. Economists have long recognized that the eventual rise in spending may exceed by several times the amount of the initial debt generated. Accordingly, for the economy's ultimate performance it matters a great deal how the increased debt is used. For example, if debt at the margin was increased for households that were essentially using the funds to maintain or expand current consumption, this would have a far smaller multiplier than if the debt financed capital expenditures, research, invention and innovation. Debt for commercial construction would also produce greater second and third round benefits than debt for housing.

Second, the diminished credit elasticity also reflected that a higher portion of the increased debt was utilized for the purchase of imported rather than domestically produced goods. Chart 3 shows that a proxy for imported consumer goods to total consumer expenditures for goods rose from 23% in 2001 to almost 34% in the third quarter of 2007. This greater reliance on imports meant that the U.S. economy benefited less directly from the increasing leverage, but that foreign economies gained even more significantly. As the U.S. went deeper into debt, imports surged, the trade deficit worsened, and foreign economic growth was boosted. Much of this increased leverage reflected nearly \$1.3 trillion of cash obtained from home equity cash-outs as

Ratio of Proxy for Imported Consumer Goods to Total Consumer Expenditures for Goods
monthly



Source: BEA. Through October 2007. Numerator includes: Imports for petroleum, foods and beverages, computers, computer accessories, telecommunications equipment, nonfood consumer goods, automotive vehicles and parts. Proxy includes some overlap with business goods but sufficient detail is unavailable to exclude those items.

Chart 3

home prices surged to record levels. With house prices continuing to erode, equity cash-outs should diminish sharply. Thus, imports are likely to weaken further. While this will serve to offset declines in domestic demand, the weakness in imports will be the mechanism that transmits the U.S. downturn to the rest of the world. During the course of this year, the U.S. trade deficit will undergo a major improvement.

If the economy could overcome the impaired capital of borrowers and lenders, and if credit creation would begin to recover late this year or in 2009, the unprecedented low level of credit elasticity suggests that the monetary policy lags will be longer than normal. This suggests that the duration of subdued economic activity will be elongated compared to earlier postwar slumps.

Present circumstances suggest that quick resolution by monetary and fiscal authorities to overcome these economic conditions is overrated. Of course, this does not mean a depression or a re-visitation to the conditions of the 1930s. Well over 90% of the population will have jobs; individual companies will profit; innovation will continue; the population will expand; certain prices will rise, and shortages of individual materials will certainly occur. However, persistent excess capacity in both labor and capital will erode aggregate pricing power and put greater downward pressure on corporate profits and inflation. If commodity costs manage to rise in this environment, they increase the risk of recession, not inflation. Finally, the intersection of supply and demand for credit will be lower, suggesting a period of sustained low interest rates.

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