

June 20, 2005

AN INTEREST RATE CONUNDRUM

Executive Summary

Why Aren't Long-Term Interest Rates Rising?-- Above average economic growth, rising commodity prices and record federal budget and trade deficits historically would be correlated with rising interest rates. Even Fed Board Chairman Alan Greenspan has no satisfactory explanation and called it a conundrum.

Inflation -- After bottoming in mid-2002 at a 1.1% annual rate, the CPI has drifted higher due primarily to rising energy and food prices. However, recent inflation statistics suggest that the rate of inflation may have peaked.

Rate of Economic Growth -- Growth in real Gross Domestic Product (GDP) peaked in the U.S. in the third quarter of 2003 at a 7.2% annual rate. Growth in real GDP has slowed to a 3.5% annual rate in the first quarter of 2005, and most economists expect real GDP to average between 3.0%-3.5% for the remainder of 2005. Real economic growth in most other countries has roughly followed this same decelerating trend.

The Impact of Budget and Trade Deficits -- While the U.S. had a record \$400 billion budget deficit in 2004, as a percent of GDP, this deficit was not unusual. The amount of U.S. government debt relative to GDP is also not unusual compared to that of other major industrial nations. However, the size in both dollars and as a percent of GDP for the trade deficit is historically significant.

A Worldwide Savings Glut -- Federal Reserve Governor Ben Bernanke recently presented a hypothesis that the world economy is currently experiencing a savings glut. This has been caused, according to Mr. Bernanke, as a result of developing countries, viewed as a whole, going from being net users of capital to net providers of capital to financial markets. This savings glut has not only financed the U.S. current account deficit, it has also reduced yields on bonds all around the globe.

Investment Strategy -- Our fixed income investment strategy is framed by: (1) a very flat yield curve; (2) narrow spreads over Treasury yields for lower quality securities and; (3) low historical real yields. For investors who have a primary investment objective of maximizing total risk-adjusted return and are indifferent to the level of current income, we are recommending investments in U.S. Government and investment grade securities with relatively short average maturities (3-7 years). For investors who have a primary objective of maximizing current income, we have identified six ways for investors to maintain and increase income streams.

Why Aren't Long-Term Interest Rates Rising?

The Federal Reserve has increased its target rate on Fed Funds a quarter of one percent at each of its last eight meetings, Gross Domestic Product (GDP) has increased at an average real rate in excess of the 3.5% long-term historical average for the past three years, commodity prices as measured by the CRB Index have increased at a 15% annual rate over the past 31/2 years, unemployment has declined to 5.1%, and the size of the U.S. federal budget and international trade deficits have been setting new records. Given this fact set, any economist worth his or her salt would predict that long-term interest rates should be rising. In fact this is exactly what happened initially as the yield on the 10-year Treasury bond went from a low of 3.11% on June 13, 2003 to a high of 4.87% one year later on June 14, 2004. However, since then yields have remained in a range between 4.0% and 4.6%. Then on May 31, 2005, these rates declined below 4.0% on their way to a new 12-month low. Federal Reserve Board Chairman Alan Greenspan called this contrary trend in long-term interest rates a "conundrum" for which he had no satisfactory explanation. Wall Street economists are equally divided on their interest rate forecasts. Some continue to forecast rising long-term rates over the next year while others are now forecasting a drop in long-term interest rates and a prediction that the yield on the 10-year Treasury could reach 3% over the next year. In light of this confusion, members of our professional staff have studied the factors that we believe have an impact on long-term interest rates, and our findings are summarized in this newsletter.

Inflation

The most obvious determinant of long-term interest rates is the expected inflation rate since a rational investor is going to require a yield that is higher than the annual amount of purchasing power loss caused by inflation. Inflation as measured by the Consumer Price Index (CPI) has been in a long-term secular decline since peaking in 1980. However, after bottoming in mid-2002 at a 1.1% annual rate, the CPI has drifted higher due primarily to rising energy and food prices. However, recent inflation statistics suggest that the rate of inflation may have peaked. Producer prices (PPI) declined 0.6% in May 2005 compared to a 0.6% increase in April largely due to declines in energy and food prices. The May decline was the largest drop in the PPI in nearly two years. The so-called "core" PPI rate, which excludes energy and food prices, increased only 0.1% in May compared to a 0.3% increase in April. Year-over-year, the PPI increased 3.5% and the core PPI increased 2.6%. In May of 2005, the CPI declined 0.1% for the month compared to a 0.5% increase in April. Year-over-year the CPI was 2.8% higher in May compared to 3.5% higher in April. The "core" CPI rate, which excludes energy and food prices, was up only 0.1% in May, and this rate held flat in April and was up only 2.2% compared to one year ago. Most economists believe that the annualized rate of global economic growth has peaked, which should reduce pressure on energy and commodity prices. As a reflection of possible demand factors, the CRB Index of commodity prices peaked on March 16, 2005 and has declined over 6% since then due to weakness in the prices of most agricultural products and metals. As a result, investors may be assuming that inflation rates have peaked and, therefore, they are willing to accept lower interest yields from fixed income securities.

Rate of Economic Growth

One of the factors that influence interest rates is the rate of economic growth and the concomitant increased demand for funds. As economic growth accelerates, businesses borrow to increase inventories and expand production capacity. At the same time, consumers become more confident in their economic prosperity and tend to increase their purchases of consumer goods and homes, often through borrowing. This increased demand for credit can exert upward pressure on interest rates. As economic growth ebbs, this process is reversed and the lessened demand for credit allows interest rates to eventually decline with a lagged effect. Growth in real Gross Domestic Product (GDP) peaked in the U.S. in the third quarter of 2003 at a 7.2% annual rate. Growth in real GDP has slowed to a 3.5% annual rate in the first quarter of 2005, and most economists expect real GDP to average between 3.0%-3.5% for the remainder of 2005. Real economic growth in most other countries has roughly followed this same decelerating trend. In the U.S., rising energy prices, excess capacity in many industries, sluggish employment growth (partially due to outsourcing and productivity gains), rising consumer debt levels and the build-up of inventories have coalesced to curtail the rate of economic growth. Much of Europe is struggling with high unemployment, a high operating cost structure, new competition from China and other low cost countries, and a strong Euro (which has caused manufactured goods to become less competitive). China is deliberately slowing its rate of economic growth due to concerns about inflation and shortages of certain raw materials. This deceleration of global economic growth has caused investors to reduce their expectations of future demand for credit and the level of interest rates.

Corporations have been cautious in their expenditures in capital investment. Heavy investment in technology in the late 1990's and rapid new expansion of capacity in certain industries in Asia have limited the need for new capital investment. Instead, corporations have paid down debt, increased cash reserves and repurchased shares of common stock. As a result, corporate borrowings through banks and institutional investors have been relatively mild during this economic expansion compared to past recoveries. The weakness in corporate demand for credit has partially offset the increased demand for credit from consumers and government.

The Impact of Budget and Trade Deficits

Most economists have pointed to the growing federal budget and U.S. trade deficits as a huge source of demand for funds that should put upward pressure on interest rates. The federal budget deficit was a record \$400 billion in 2004 due to the tax cuts, reduced realized capital gains, and the expense of maintaining troops and rebuilding Iraq. However, as a percent of GDP, this deficit was not unusual. The budget deficit was 3.4% of GDP in 2004, but it was well over 4% of GDP through much of the 1980's during President Reagan's tenure (and again during the last year of the first President Bush's tenure). However, despite the huge continuing deficits in the 1980's, nominal and real rates declined during this period due to a more disciplined monetary policy and declining inflation. The amount of U.S. government debt relative to GDP is also not unusual compared to that of other major industrial nations as shown in Exhibit 1.

Exhibit 1

Gross Government Debt as a Percent of GDP

<u>Nation</u>	<u>2000</u>	<u>2004</u>
Canada	82%	70%
France	65%	72%
Germany	61%	66%
Italy	124%	120%
Japan	131%	160%
United Kingdom	46%	42%
United States	40%	39%

Source: OECD

Of course we are not advocating that large federal budget deficits should be encouraged. Quite the contrary -- we expect the Administration and Congress to reduce the size of the deficit over time through economic growth, constraint on expenditures and selected increases in taxes. This presentation is just trying to put the size of the current federal deficit into perspective and to establish the premise that large budget deficits have historically had a low correlation with rising interest rates.

The U.S. trade deficit totalled over \$600 billion in 2004 and accounted for the majority of the so-called current account deficit of \$666 billion, which in addition to trade includes financial payments such as interest, dividends and other cross-border remittances. Much has been written about the causes of the trade deficit, including the movement of manufacturing and services to lower cost countries and Americans' voracious appetite for foreign-made consumer goods and foreign-produced petroleum. A breakdown of the U.S. merchandise trade in the fourth quarter of 2004 by end use category is presented in Exhibit 2.

Exhibit 2U.S. Merchandise Trade in Fourth Quarter of 2004
(Annualized in Billions of Dollars)

<u>Category</u>	<u>Exports</u>	<u>Imports</u>	<u>Balance</u>
Foods, Feeds & Beverages	48.1	58.9	-10.8
Industrial Supplies & Materials, Excluding Petroleum	176.0	210.8	-34.8
Capital Goods Excluding Autos	343.0	394.1	-51.1
Auto Vehicles, Engines and Parts	89.5	222.9	-133.4
Consumer Goods Excluding Autos	106.8	393.9	-287.1
Petroleum & Products	0	146.6	-146.6
Other	39.3	78.6	-39.3
Residual	<u>- 2.6</u>	<u>0.5</u>	<u>-3.1</u>
Total	800.1	1506.3	-706.2

Source: Bureau of Economic Analysis

The statistics in Exhibit 2 include only merchandise trade activity and not the value of services provided. The U.S. actually ran a trade surplus on services of \$67 billion in the fourth quarter with exports of \$365 billion compared to imports of \$298 billion. As you can see, consumer goods, autos and petroleum accounted for most of our nation's merchandise trade deficit.

More telling than the absolute size of the current account deficit is the trend in the deficit over time both in terms of dollars and percent of GDP as shown in Exhibit 3.

Exhibit 3

U.S. Current Account Deficit

	<u>1996</u>	<u>2000</u>	<u>2004</u>
Billions of Dollars	-120.2	-413.4	-665.9
Percent of GDP	1.5%	4.2%	5.8%

Source: Bureau of Economic Analysis

Clearly, this trend is significant in both dollars and as a percent of GDP. The expansion in the current account deficit has required an additional financing of \$253 billion since 2000 and an additional \$546 billion of financing since 1996. All things being equal, this increase in demand for funds should have caused long-term interest rates to rise. The fact that interest rates haven't increased suggests that either worldwide demand for funds has declined in other places and/or there have been new sources of funds added to the worldwide supply.

A Worldwide Savings Glut

Federal Reserve Governor Ben Bernanke recently presented a hypothesis that the world economy is currently experiencing a savings glut. This has been caused, according to Mr. Bernanke, as a result of developing countries, viewed as a whole, going from being net users of capital to net providers of capital to financial markets. This analysis is based on a study of global current account balances, which is presented in part in Exhibit 4.

Exhibit 4Global Current Account Balances
(Billions of U.S. Dollars)

<u>Countries</u>	<u>1996</u>	<u>2000</u>	<u>2004</u>
<u>Industrial</u>	41.5	-331.4	-400.3
United States	-120.2	-413.4	-665.9
Japan	65.7	119.6	171.8
Europe	78.5	-71.7	53.0
Other	17.5	34.2	40.8
<u>Developing</u>	-90.4	131.2	326.4
Asia	-40.6	86.8	179.5
Latin America	-39.4	-47.9	8.5
Middle East & Africa	1.1	74.5	116.4
E. Europe and former USSR	-13.5	16.8	12.0

Sources: IMF and European Central Bank

As you can see, the industrial countries were net providers of capital in 1996, and the developing countries were net users of capital. Mr. Bernanke believes that this phenomenon is what economists would normally expect to see. Industrial countries have more mature economies with fewer investment opportunities, as well as aging and relatively wealthy populations that are saving for retirement. Conversely, developing countries have many investment opportunities along with growing and relatively poor populations that want to improve their standard of living. Except for the U.S. and a few other countries, the industrial nations continue to be net providers of capital in 2004. However, these developing countries have reversed roles, and they have also become net providers of capital in recent years.

Mr. Bernanke believes that the reason for the change was the series of financial crises in the developing countries: Mexico in 1994, East Asian countries in 1997-98, Russia in 1998, Brazil in 1999 and Argentina in 2002. These crises were caused by heavy debts, poorly governed banking systems and fixed currency exchange rates. The effects of these crises included rapid capital outflows, currency depreciation, sharp declines in domestic asset prices, weakened banking systems, and recession. In response to these crises, emerging-market nations either chose or were forced into new strategies that included reducing debt and building up foreign currency reserves. Other contributing factors included the significant increase in

petroleum prices, which increased the current balances of oil exporting countries, the expansion of world trade and the outsourcing of manufacturing to low cost countries, and the effects of some countries (like China) pegging the value of their currencies to the dollar, which exacerbates trade imbalances and expands the pegging country's money supply and foreign currency reserves.

Much has been written about how the U.S. balance of payments is being financed by Japan, China and the Middle Eastern countries, and the data in Exhibit 4 supports this notion. Some commentators have expressed concern that this capital could be deployed elsewhere, which would cause interest rates in the U.S. to rise. However, global investors like the political stability, strong private property rights, highly liquid and transparent capital markets, and competitive returns that they find in the U.S. The reality is that investment returns have declined all across the globe and not just in the U.S. For example, current real yields on government securities in the U.S. are very competitive with those in Europe, and they are much higher than those in Japan. The concept of a global savings glut is also supported by the declining real yield on the 10-year Treasury bond as shown in Exhibit 5. The "real" yield adjusts the nominal yield by an inflation index, such as the Consumer Price Index in this case. Financial theory states that an investor is going to demand an investment return that compensates them for the loss of purchasing power from inflation in addition to a real economic return. By eliminating impact of inflation on interest rates, the result is a better measure of the impact of supply and demand on setting interest rates.

As you can see on Appendix A, prior to 1982 except for brief periods in the early 1970's and early 1980's when inflation was at double digit levels (and arguably distorting the real rate), the real yield on the 10-year Treasury stayed largely in a range of 1% to 4%. The real yield rose above this range briefly in the mid-1980's, when investors lost confidence in government's ability to manage the Country's monetary and fiscal policy in a non-inflationary manner. The real yield on the 10-year Treasury returned to the 1%-4% range during the 1990's. However, the real yield has declined to the bottom of this range in the last several years, indicating a willingness of investors to accept lower real returns. This observation could reflect evidence of a savings glut. In Exhibit 5, we show comparisons of 10-year government bonds from selected countries.

Exhibit 510-Year Government Bond Yields: Country Comparison
June 13, 2005

<u>Country</u>	<u>Yield</u>	<u>Country</u>	<u>Yield</u>
Japan	1.23	Portugal	3.70
Taiwan	1.85	Canada	3.81
Switzerland	1.90	U.S.	3.95
Singapore	2.61	Thailand	4.03
Sweden	3.07	Korea	4.21
Finland	3.09	Malaysia	4.24
Spain	3.12	U.K.	4.24
Germany	3.13	Poland	4.96
France	3.16	Australia	5.10
Ireland	3.16	New Zealand	5.62
Austria	3.16	Hungary	6.80
Belgium	3.20	India	6.80
Netherlands	3.28	South Africa	8.04
Italy	3.34	Mexico	9.67
Greece	3.38		
Norway	3.52	Average	4.05

Source: BCA Research

Investment Strategy

Now that we have identified possible reasons why interest rates have remained lower than forecast, how do we position our clients' portfolios in order to maximize return during the next year and longer? As the track record of most economists attest, predicting the future course of interest rates has always been a very difficult endeavor. It seems to be especially so in the current environment with the expansion of world trade, large trade imbalances, increased flow of investment funds across foreign borders, and emerging economic powers.

There are three facts that currently frame our fixed income investment strategy. First, the yield curve is currently very flat as shown in Appendix B. For example, on June 20, 2005, the yield on the 30-year Treasury was 4.4% compared to a yield of 4.1% on a 10-year Treasury and a yield of 2.9% on a 90-day Treasury bill. In other words, the investor is being paid a very small premium in terms of a higher yield compared to the historical average for extending maturities and assuming increased market price risk should interest rates rise in the future. The yield curve could become even flatter if the Federal Reserve continues to push up short-term rates through increases in its target rate on Fed Funds. Second, the "spread" or increased yield of lower quality fixed-income securities over that of Treasuries is currently very low compared to the historical average as shown in Appendix C. Thus, the investor is being paid a very small premium for assuming a higher risk of default on lower quality bonds. Third, the real or inflation-adjusted interest rate is at the low end of the

historical range (see Appendix A). This suggests that bonds are currently overvalued compared to the historical average real yield and/or that most investors believe inflation will decline.

For investors who have a primary investment objective of maximizing total risk-adjusted return and are indifferent to the level of current income, we are recommending investments in U.S. Government and investment grade securities with relatively short average maturities (3-7 years). In terms of asset allocation, the currently low historical real yields on fixed income investments drive us to minimize the allocation to fixed income within each client's target allocation range.

For investors who have a primary objective of maximizing current income, the choices are more challenging, especially for those clients who currently own securities that will mature or be called in the near future that carry higher interest rates than can be purchased in current and prospective markets. In order to maintain and increase income streams on an aggregate basis to these investors, we have considered the following strategy actions: (1) sell some low yielding stocks and replace them with higher yielding stocks and fixed income securities; (2) purchase non-callable fixed income issues selling at a premium to par; (3) reinvest a portion of the cash reserves in two-to-three year maturity Treasury and Federal Agency securities; (4) acquire bonds that step up interest rates sequentially over time at stated amounts and dates; (5) purchase a limited amount of lower rated/higher risk securities in the short to medium maturity ranges that we have carefully analyzed; and (6) purchase specialty high income securities such as REITs and publicly-traded master limited partnerships.

We have used all of these strategies in some portfolios to varying degrees over the past two years. We expect to expand their application on a progressive basis where the needs for generating annual income streams are paramount and in market circumstances when abnormally low interest rates persist.

These thoughts will be explained on an individual basis when they are to be used in your particular situation, although we are pleased to receive your questions and visit with you whenever you wish.

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