

INVESTMENT UPDATE

Now that the dust has settled from this summer's bond market implosion, it's a good time to examine the causes of the sell-off, put them into historical context and make some observations about where the bond market may go from here.

First, the facts: in the wake of last year's "flight to quality," interest rates descended to their lowest levels in four decades in the late spring of 2003. Benchmark ten-year US Treasuries, stuck in a trading range of 3.75%-4.25% from September '02 to May of this year, dropped to a low of 3.10% on June 13th. Despite the relatively quick resolution (at least on the battlefield) of the war in Iraq, investors kept buying bonds—the overwhelming sentiment was that the economy was having trouble pulling out of recession and the Fed, even after lowering the Fed funds rate to 1.25%, was not succeeding in rekindling growth.

The Fed itself hinted at its own frustration in this regard in comments made in May of this year by various Fed officials; Greenspan himself warned Congress on May 21st that "the probability of an unwelcome substantial fall in inflation over the next few quarters, though minor, exceeds that of a pickup in inflation." This

and other comments implied that the Fed would take whatever measures necessary to keep the US from going into a Japan-style deflationary spiral.

Paradoxically, by the time the Fed lowered the funds rate by .25% to 1.00% on June 25th, yields had already been moving up. Rates rose in seven of nine weeks from mid-June through early August. By the second week of August, ten-year Treasury yields were almost 1.5% higher than they had been at their low point in June. As rates rose, bond prices got hammered. July's return of -3.36% for the Lehman Aggregate Index was the worst monthly performance in 22 years. Treasuries were the worst performers in July,

down 4.39%, the second-worst month in the more than 30-year history of the Lehman Indices.

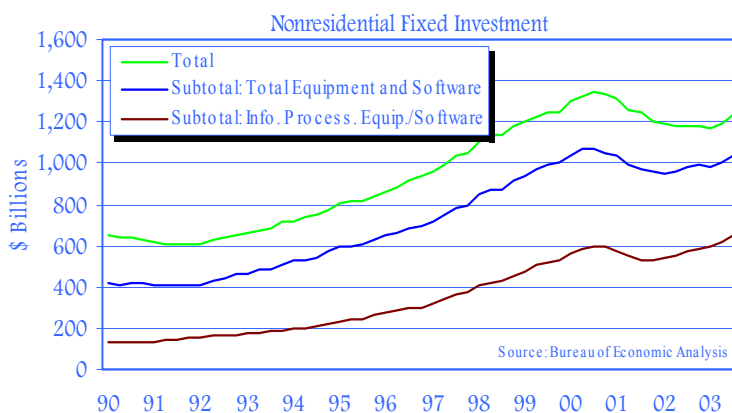
What caused the market to turn around so violently? First, as now seems so clear in hindsight, the bond market got well ahead of itself in the late spring. Economic sentiment was overwhelmingly negative and investors were panicked over the prospect of deflation. Earnings had been lackluster, leaving little demand for stocks. In general, despite yields that were at decades-low levels (and inflation-adjusted yields approaching zero on many intermediate-maturity Treasuries), investors chose to buy not because bonds had value, but because they were afraid of missing out on a further bond rally. While not exactly "the bond market's dot-bomb," there was certainly an element of speculation in bond prices this past spring.

There was no single event that "triggered" the sell-off, but a combination of fundamental and technical factors. Fundamentally, the economy was already on the mend by late spring, but the "numbers" didn't start showing up until June. After seeing these early signs of growth, the Fed announced in June that it wouldn't be taking any "extraordinary" measures to stimulate the

economy. Shortly thereafter, US GDP was reported to have grown by 2.4% in the second quarter (revised later to up 3.1%), much higher than was forecast in the early spring. The specter of a massive increase in Treasury supply began to weigh on investors (one-half trillion dollar deficits will do that). Institutions and foreign cen-

tral banks were early sellers; individual investors followed in July and August, according to mutual fund flows.

By mid-year even the industrial sector, the most growth-challenged segment of the economy, was showing signs of life. As the chart above shows, spending on equipment and software (which includes computers,



software, and industrial and transportation equipment), after turning positive last year accelerated in the first half of 2003. In fact, in the second quarter spending on the all-important information processing hardware and software components finally exceeded the previous all-time high, set in the fourth quarter of 2000. The only “major” spending component (totaling approximately 11% of nonresidential fixed investment) that continued to fall was transportation equipment, down 7% from the second quarter of 2002.

There was another powerful force that, while not changing the direction of rates, certainly intensified the upward movement of rates once it started: mortgage hedging activity. In simple terms, many mortgage players (including banks, originators and hedge funds, as well as FNMA and FHLMC) assume that the mortgages they have on their books have a defined duration, or average maturity. When rates fall, refinancing of mortgages goes up and the duration of mortgages and securities backed by mortgages falls. When this happens, these “hedged” mortgage players must buy other securities (usually Treasuries) to maintain their portfolio’s duration target. But when rates rise, the opposite effect takes

place—the mortgages in their portfolio (or pipeline, in the case of mortgage originators) extend and duration must be shed. The more the mortgage market sells off, the more Treasuries must be sold; rates rise as sellers outnumber buyers and even more Treasuries are sold, and a painful spiral ensues. With the market value of the mortgage market now almost 1.7 times as large as the Treasury market, Treasuries can become the tail to the mortgage market’s dog. The top chart on this page shows just how dramatically (and rap-

idly) mortgage durations extended in this summer’s sell-off.

The combination of strong economic news (or at the very least, the abatement of weak economic news that could justify the nose-bleed level of bond prices), shifting sentiment and technical forces led to the rapid re-pricing of the bond market.

At this point, we must ask ourselves, “What’s next for bonds?”

In our estimation, the upward move in interest rates has largely run its

course, as we foresee the current modest-growth, low inflation economy continuing for the next few months. Currently, nominal yields on ten-year Treasuries stand at approximately 4.4%—low, yet right at the average for the past two years, and just below their five-year average. However, what is most important to bond investors are the real, inflation-adjusted yields on bonds, and here’s where bonds begin to look (dare we say it?) fairly attractive: with 12-month trailing “core” CPI currently at 1.5%, and with massive worldwide excess capacity and slack labor markets at home likely to push inflation even lower in the coming months,

real yields of nearly 3% on ten-year Treasuries appear to be a fairly secure investment.

As the last chart shows, the price hit the bond market took in July was the worst in more than twenty years; yet we know that the bond market can

withstand considerable month-to-month price volatility and still pump out respectable returns. While the easy double-digit returns of the past few years are unlikely to return any time soon, we view July as a historical anomaly, an ugly month that the market “had coming.” As when a physician resets a broken bone, a quick adjustment is extremely painful, but essential to align the fractured pieces and build a stronger system in the long run.

