

INVESTMENT UPDATE

In the days immediately following this month's national election, the stock market rose while the bond market fell, sending rates higher. "Aha!" cheered the Republicans, "The stock market is telling us that our policies are clearly good for America!" "Not so fast," countered the Democrats, "Your policies are already pushing up borrowing costs for the average American."

While we may never settle the argument of whose policies are "best" for the country, from an investor's standpoint it's a good idea to make some projections for what the next four years may hold.

In the first weeks of his new term, President Bush has announced a fairly aggressive agenda on US fiscal policy. His first order of business will almost certainly be to convince Congress to pass legislation to make permanent many of the provisions of his

2001 and 2003 tax packages that are due to roll off over the next few years. We can assume that with a Republican majority in both houses of Congress these extensions will go through. But the President has also stated that his administration will be looking into deeper tax reform and tax

simplification issues, which we believe will produce more in the way of debate and discussion than actual legislation. Flat taxes and value added taxes are unlikely to appeal to the average American as "core" issues, and we doubt that Republicans will be willing to spend political capital to advance these issues.

Despite expected opposition from Democrats, tax reform (or at least low tax rates) is at the heart of Mr. Bush's pro-business policies that seek to relieve the tax burden on workers and investors while stimulating capital formation for business. The Republicans will rightly argue that the tax reductions in 2001 and 2003 helped pull the economy out of the doldrums following the dot-com meltdown and the 9/11 attacks; the Democrats will maintain that the economic crisis is over, and tax rates

are currently too low to support necessary social programs, including health care coverage for low-income Americans.

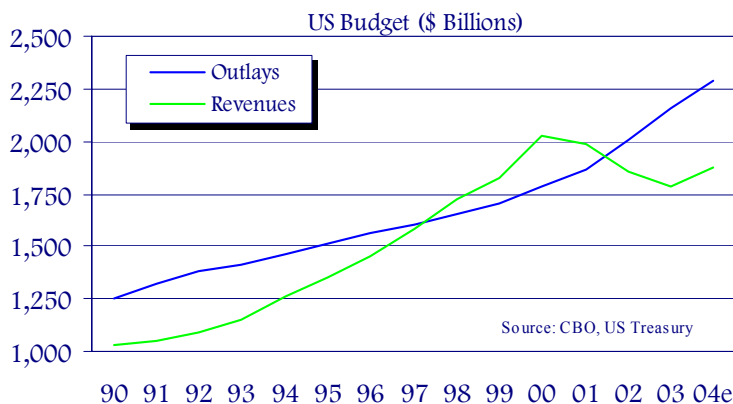
Implicit in the Republicans' policy is the notion that low taxes stimulate an economy enough *in the long run* to make up for any revenue shortfall that may occur in the short run. The decline in tax receipts in President Bush's first term was attributable to both lowered tax rates and a lower base of earnings from individuals and businesses. As the chart on this page shows, fiscal 2004 revenues were approximately \$1.9 trillion, \$100 billion less than in FY2000. And despite a relatively mild recession, revenues as a percentage of GDP fell to 16.2% in '04, the lowest in at least 40 years, and well below the 25-year average of 18.2%.

Meanwhile, Congress went on a spending spree. The current \$400+ billion budget deficit is a direct result of heavy outlays, not just on the war in Iraq and homeland security, but on hundreds of obscure special interest programs and tax breaks passed by Congress, none of which were vetoed by the President. Spending has been, by almost any measure, out of control.

Some would say that these are short term issues

and point out that, given a fairly healthy economy, the budget deficit will be cut roughly in half over the next four years. Yet soon afterwards, the real trouble begins, as the aging baby boomers begin to move into retirement age. As the US population distribution moves from a youth-dominated demographic to one more evenly distributed, the cost of Federal entitlement programs will skyrocket. Without reform, Social Security goes into the red in approximately 14 years.

Fiscally conservative watchdog groups such as the Concord Coalition paint a grim picture of US finances in the "out" years, and believe that more should be done now to begin to address those problems. They point out that even President Bush's Social Security reform initiative will put between \$1 and \$2 trillion less into the System over its



first ten years, as employees direct their funds into private accounts. The 2004 annual reports of the Social Security and Medicare Trustees reported some staggering numbers: if these programs were accounted for in the same way that corporate pension and medical retirement benefits were calculated, they would be underfunded by a combined \$74 trillion. Even if Medicare and Social Security were closed to new entrants today, the liability today still works out to \$42 trillion.

Maybe bond investors were looking for tougher talk on deficit reduction in the President's recent remarks, or perhaps other factors caused the market to sell off, but rates rose in the days following the election. While the connection between budget deficits and interest rates is somewhat tenuous, the laws of supply and demand have not been rescinded. As long as budget deficits remain a permanent feature of our landscape, there will continue to be a glut of Treasury borrowing (a new quarterly record of \$147 billion in the first three months of the 2005 budget was just announced). Holding all other variables constant, more supply means lower prices and higher yields for bonds.

Fortunately for bond investors (and borrowers of dollar-denominated assets) interest rates have remained low at least in part due to extremely strong demand from foreign investors. As our trade deficit has exploded over the past decade, foreign central banks have seen their dollar holdings skyrocket. In order to keep their products cheap in the global marketplace, these countries cannot let their currency rise and many keep their currency "pegged" to the US dollar. Today these countries (the biggest of which is China) have the choice of reinvesting these dollars into US securities and propping up the dollar or selling the dollars into the open market and watching their currency rise against the US dollar.

The chart on this page shows the net foreign purchases of US securities by year since 1991. In just the first nine months of 2004, we have already seen a new record set for net purchases of US securities in a single year. The US current account deficit today stands at \$2.4 trillion.

The connection between the US budget deficit and the US trade deficit is quite clear. The US borrows money from foreigners to drive our economy, while US consumers

buy foreign goods which drives the economy of many export-driven foreign economies. Meanwhile, the US becomes increasingly indebted to foreign countries, a debt that must eventually be paid back. If that sounds like an arrangement that is unsustainable, it's because it is. At the very least, it subjects the financing of the US economy to the whims of foreign governments' fiscal and currency policies. Where would bond prices be without the support of foreign investors?

An indirect result of this trade imbalance is that prices of imported goods have been rising. You may recall that in the late 1990's, cheap imported goods helped keep US inflation low despite a vigorous economy. Today, import prices (even after excluding rising petroleum prices) are rising at more than 3%. Other measures of US inflation are rising as well; even if we assume that energy prices have topped out with crude oil hovering around \$50 per barrel, that's still a doubling of its level from a year ago.

"Core" CPI, which excludes food and energy, has risen from 1.1% to 2.0% this year, and is likely to move higher once the increases in energy prices filter down into the cost of many other consumer items.

More expensive foreign goods could dampen, at

least at the margin, US consumers' appetite for imports, which in turn would lead to a reduction in our current account deficit. But less dollars flowing overseas means fewer dollars for foreigners to invest back in the US bond market. A combination of rising inflation and slumping demand for US fixed income securities from abroad could test the remarkable resilience that the bond market has shown this year.

Of course, forecasting interest rates is the most frustrating exercise bond managers pursue—even if one's analysis is air tight, bond prices are ultimately determined by the animal spirits of the markets' participants. While we have a high degree of faith that, *over the long term*, prices reflect the true value of the markets' underlying securities, we have little confidence in our ability to call short term interest rate movements.

We'll just leave it at this: there appears to be ample grounds for bond investors to be cautious about the future direction of interest rates.

