

Tax Efficient Fixed Income

1st Quarter 2005 Review and Outlook

Our last quarterly review focused on the shrinking risk premiums that developed in most markets through 2004. Two years of aggressively stimulative monetary policies on the part of the world's central banks, our own prominently among them, left the world awash in liquidity and investors gasping for yield. Investors responded as they always have, and as the central bankers hoped they would, by reaching for longer-dated and lower-rated bonds. They also borrowed to purchase new homes and consumer items, thereby driving the global recovery. Credit spreads narrowed as the stock market surged and emerging markets and high yield debt outperformed. Central bankers were able to pursue this tactic without generating inflation because the glut in worldwide supply of productive capacity, especially labor, at first made it impossible for businesses to raise prices. This all began to change in the quarter just ended.

Inflation became a concern for the first time in several years. Commodity prices, including petroleum, spiked sharply higher and the Fed acknowledged that price increases were starting to stick. As the Fed continued its measured march toward tighter credit, the yield curve continued to flatten but long-dated yields also moved higher. Municipals performed better than Treasuries, as they usually do during periods of rising rates. Other risk assets, however, responded to General Motors' mid-February earnings warning and AIG's accounting problems by falling sharply. Equities, Emerging Markets, and High Yield bonds all performed poorly during the latter weeks of the quarter.

Since we founded Samson Capital last June, we have managed our clients' portfolios very defensively, investing in high grade securities with durations below those of our longer term targets. We wanted to preserve principal and flexibility so that we could increase interest rate exposure for our clients when longer maturities were properly priced. We remain convinced that June 2003 marked the end of a twenty year bull market in bonds and that yields will move higher from here. The markets have priced another one percent increase in the Fed Funds rate, which is still accommodative in real terms.

As interest rates increased toward the end of March, the Investment Committee decided to take advantage of the increased yields and edge our duration target slightly longer while still remaining short of our longer term target. We did so because real yields are no longer negative and the chances that rising rates and gasoline prices will slow the economy have also increased. We intend to eventually move the duration of portfolios back to its normal range, and perhaps to add some credit spread, when signs of that slowing become apparent.

There is no guarantee that the forecasts and opinions expressed in this article will be realized. The statements in this article are opinions only and are not guarantees or projections of future performance.