

Tax Efficient Fixed Income

4th Quarter 2004 Review and Outlook

The sense of calm and tranquility pervading the securities markets during the fourth quarter was at odds with the significant shifts that occurred beneath the surface. While the U.S. economy continues to grow at a healthy, moderate pace, and CPI has accelerated from a 2.5% annual rate to a 3.5% annual rate, the bond market has remained serene and undisturbed. Longer term interest rates remain near twenty-year record low levels, despite the fact that the Federal Reserve added two more 25 basis point tightening moves to its measured pace. Though the yield on the one-year Treasury rose from 2.18% to 2.79% during the quarter, the yield on the ten-year Treasury note increased just 9 basis points to close at 4.25%.

This pattern of shorter rates rising more than longer rates, often referred to as a flatter yield curve, also characterized the changes that occurred in the bond market for the entire year. Five tightening moves by the Fed drove short and intermediate rates higher while yields on issues due in ten years and longer showed remarkably little change. While a flatter yield curve during an economic expansion is not unusual, the lack of any upward pressure on long rates is rare.

The outperformance of longer maturity bonds is particularly curious, or perhaps ominous, when compared to the Fed's previous two tightening cycles which occurred in 1994 and 1999. In 1999, longer maturity municipal bonds (as measured by the Merrill Lynch 7-12 Year Municipal Bond Index) had a -1.2% return while shorter maturity bonds provided a relative safe haven with a +2.5% return. The difference between short and longer maturity municipal returns was even more striking in 1994. Longer municipals returned -3.6%, while shorter municipals returned +1.3%. In contrast, longer maturity municipals provided a +4.3% return in 2004, while shorter maturity bonds returned just +1.3%. Not only did longer maturity bonds register a positive performance, when in previous Fed tightening cycles the performance was negative, but that positive performance exceeded the returns of short maturity bonds. Yields on bonds due beyond seven years have been held in check by two heroic assumptions: (1) Inflation will be suppressed by intense global competition and a resolute Federal Reserve and (2) Foreign (particularly Asian) central banks will continue to purchase vast quantities of U.S. bonds as a by-product of their effort to support the U.S. dollar. Either we have entered a new age of investing (please see new age investing for equities circa 1999), or the market will have a considerable re-pricing in the months ahead.

Corporate profits and cash flow continued to rebound and municipal credits quality is on an upswing as well. Even the Federal Budget deficit is coming in below expectations, helped by the rising tax receipts generated by the improving economy. During the fourth quarter, stocks registered sizable and steady gains, price volatility has declined to new lows and credit spreads continued to contract. Each reflects the equity market's confidence in the future growth of the economy and its assumption that the Fed will maintain its gradual pace of tightening. Market indicators seem to project these happy circumstances well into the future. About the only ripples on the pond (or are those termites?) are the sharp fluctuations in oil prices and the steady selling of the dollar against non-managed currencies such as the Euro.

Municipals, adjusted for taxes, outperformed Treasuries in 2004 and are beginning the year priced fairly versus the Treasury curve. We can discern in the price structure of municipals no worry over President Bush's tax reform. Trends in overall municipal credit quality improved, with the number of upgrades in the fourth quarter far exceeding the number of downgrades. Two credits with troubled pasts are particularly noteworthy. In November, Moody's upgraded the State of New York's general obligation bond rating to A1 from A2 and assigned a positive outlook. The upgrade was due to a recovering economy, increased tax revenues and improved liquidity. New York is one of two states rated A1 (the other is Louisiana), which places it in the second lowest rating category among states, with only California rated lower at A3. California's bonds have also recovered significantly from their depressed levels.

We remain convinced that the price of adding marginal yield is unacceptably high, whether it is to be gained by reaching out the curve or by downgrading credit quality. Moving from two years to ten years on the Treasury curve results in 118 basis points incremental yield, compared to 241 twelve months ago. Buying a

seven-year Mexican sovereign bond picks up just 120 basis points over a comparable U.S. Treasury; a ten-year Fannie Mae note adds just 40 basis points; and a portfolio modeled on the Lehman Aggregate Index offers just 86 additional basis points. After two years of strong returns, the high-yield market is also overpriced. These narrow spreads can be justified only by projecting low volatility well into the future. That in turn requires an assumption of no imbalances in the global market for goods, services and securities and no nasty surprises – the serenity to which we referred above.

We regret that we cannot share the market's sanguinity. The Fed will continue to raise short rates as the real Fed Funds rate is still below zero and the dollar's weakness, the budget deficit and commodity price increases will place a floor under the broad inflation rate. Unlike in 2004, we expect the New Year to bring increased bond price volatility and gradual upward pressure on bond yields. The duration of Samson's client portfolios has been defensive, and we have made no purchases of longer maturity bonds while rates remain this low. With volatility sure to increase, we may take advantage of any sharp uptick in interest rates to lengthen portfolios' duration back to more benchmark (market) neutral ranges. This won't be a knee-jerk reaction to a rise in rates; we will assess the reasons for any rate back-up and consider carefully whether it represents an opportunity of any kind. In the meantime, portfolios are fully invested.

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