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Help Is On The Way!

"Hang on, help is on its way." These words from a popular Little River Band song come to mind as we look out over the next six months at the economic environment.

It seems that with each day we continue to get signs of a softer domestic economy brewing on the horizon. The area that gets the most headlines today is clearly housing. After one of the greatest housing booms in history, we are seeing weakness in a number of key housing statistics. We have seen recent results in both homebuilding surveys and home pricing surveys drop to some of the lowest levels in several years. In addition, the housing sector is experiencing higher inventories and tighter lending standards. Furthermore, weakness is broad based and is being observed in several regions throughout the country. Thus, one could conclude that the housing sector will experience more softness before it improves.

The effects of a weak housing market are starting to ripple through the economy. For example, Caterpillar recently reported weaker earnings which the company attributed to a soft housing market. We are now seeing softness in the auto sector, declines in capital spending and slowing employment growth. When one combines these observations with slower nominal money growth and declining global economic indicators, a picture of slower overall future economic growth develops.

Is this slower growth picture a surprise? No! And, the reason is "in the curve." This past January, I wrote a newsletter entitled "What's In a Curve." In that letter, we used the spread between the 3-month treasury yield and the 10-year treasury yield as a proxy for the yield curve. As the Federal Reserve raises short-term interest rates, this spread generally narrows, resulting in a flatter yield curve. In some extreme cases, the curve even "inverts", as short-term rates go above long-term rates. When this happens, the odds of an economic slowdown increase dramatically.

At the time of our letter last January, this 3-month/10-year yield spread was a +18 basis points. Now, as the Fed has raised short-term interest rates another four times since that January letter, the curve has inverted with the spread at -35 basis points.

Our quantitative strategist, John Lohman, has done a lot of work examining previous Fed tightening cycles and their effects on the yield curve. In most instances, there is a reasonable time lag between the last interest rate hike and the first Fed cut. One reason for this lag is that the Fed wants to clearly insure that inflationary pressures have subsided enough to handle the stimulus from impending rate cuts. Likewise, in most instances, the bond market begins to anticipate future Fed cuts before they actually begin. This anticipation causes the yield curve to take on a more "normal" shape before any Fed cuts. The yield curve begins to steepen with short-term rates declining back below long-term rates in anticipation of future Fed cuts. In many ways, the bond market's anticipation of future Fed cuts provides much needed economic stimulus and begins "the work for the Fed."

In exhibit A, some of John's results from examining several tightening cycles over the past 35 years are displayed. Listed are the average yield spread changes for different parts of the yield curve over different time periods AFTER the last Fed hike.

Basis Point Change in Yield Spread

Months after last rate hike	3 Month/ 10 Year Yield Spread	Fed Funds/ 10 Year Yield Spread
6 Months	84	192
12 Months	99	190
18 Months	105	247
24 Months	110	244

Focusing on the same 3-month/10-year yield spread, the analysis shows that this spread changes an average of +84 basis points, six months after the last hike. This spread changes an average of almost +100 basis points one year after the last Fed hike.

For now, it appears that the Fed may have stopped raising rates this tightening cycle on June 29. Extrapolating from John's research and using June 29 as the date of the last Fed increase, it would not be a surprise to see the yield curve (3-month/10-year yield spread) move from its current -35 basis point spread to a +49 basis point spread by some time early in the New Year. Furthermore, it would not be a surprise to see the spread move from -35 to +64 by next June.

For this reason, we have begun to aggressively change our portfolio structure. For almost three years we had positioned our fixed income portfolios for a flatter/inverted yield curve by maintaining a barbell structure (combination of long and short securities). Now, as we are about to enter a new interest rate cycle of Fed cuts, we are moving out of our barbell and into a bullet structure (cluster of intermediate securities). Our portfolios' bullet structures will do better than the laddered structures of their benchmarks in a steepening yield curve environment.

With the Fed cutting rates, we expect the bond market to do well. In particular, we like short to intermediate securities in this upcoming cycle. In this scenario, we also expect stocks to do well.

So, as we continue to see the housing market and other parts of the economy slow, we must remember the Little River Band song:

Hang on, help is on its way,
I'll be there as fast as I can,
"Hang on," a tiny voice did say,
From somewhere deep inside the inner man.

That inner man could very well be today's bond market.

Gilbert A. Garcia, Principal
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A copy of our Form ADV, Part II is available upon request.
FIVE HOUSTON CENTER 1401 MCKINNEY ST., SUITE 1600 HOUSTON, TEXAS 77010 PHONE: (713) 853-2322 FAX: (713) 853-2308