April 2011

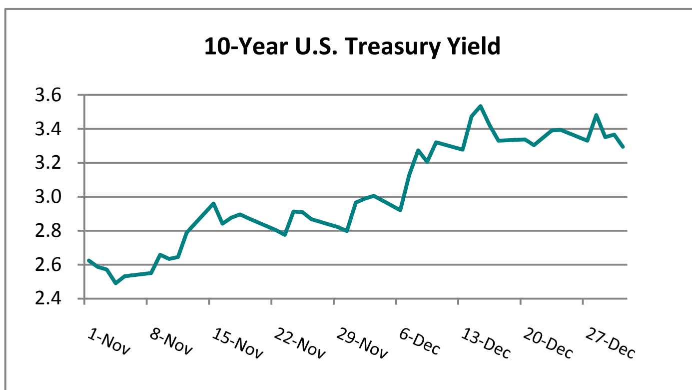
GH&A
GARCIA HAMILTON & ASSOCIATES, L.P.

"Going our own way"

While returning from an Easter weekend getaway with my family, I pulled over to a gas station. When my kids are involved, pumping gas includes buying Icees, gum and assorted chips. At that moment the car radio was playing the classic Fleetwood Mac tune, "Go Your Own Way." In the market, it often pays to "go your own way."

As a reminder, the foundation of our investment process revolves around five investment factors - sentiment, monetary, economic, inflation and valuation. Of these, sentiment has been the primary factor driving our investment decisions over the past ten years. During this time period, we heard time after time that interest rates were going to rise. Most investment surveys reported that large money managers were negative on the bond market and were maintaining a duration (interest rate exposure) below their benchmarks. Because sentiment is such a great short-term contra-indicator, we went against the grain for most of this time period and were generally either neutral or long duration versus our benchmarks. This served us well as interest rates have been stable to lower.

In mid-2010, we moved to a defensive position as the 10-year Treasury yield nearly tested all-time lows and declined to 2.48%. But as the market became increasingly skeptical of Fed policy, interest rates made a violent move at the end of 2010. In November, the 10-year Treasury yield rose over 100 basis points in less than 45 days and hit a near-term high of 3.52%. At that moment, we felt the market had moved too far, too fast. In our view, with unemployment still high and the housing market still soft, any further meaningful increase in interest rates would jeopardize the recovery. So here we went again, like most of the past ten years, going long the market. We have now maintained this position all of 2011.

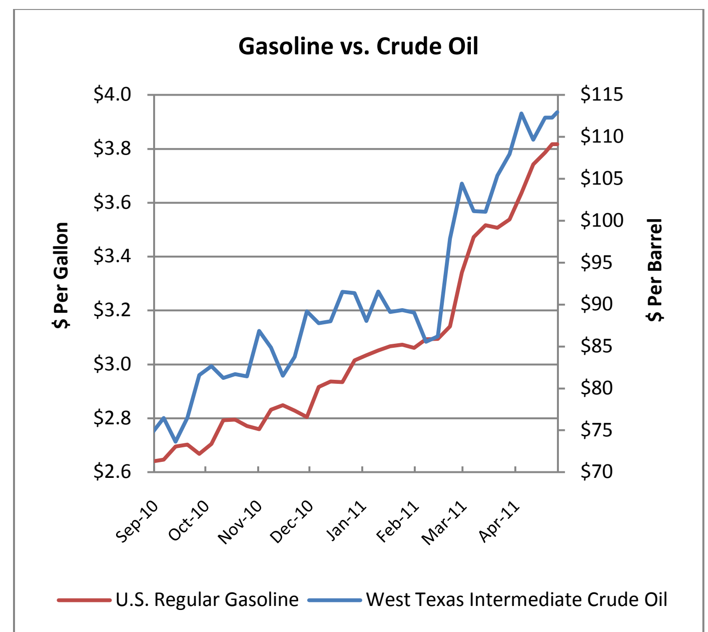


Source: Bloomberg

Once again, the overwhelming consensus is that interest rates will soon rise significantly. Even the most famous names in the bond business appear on CNBC giving alarming predictions that interest rates will rise due to runaway inflation and a crisis of confidence in our bond market.

Remembering the value of sentiment, the more we hear this chatter, the more confident we are that rates won't rise in the near term. Clearly, the year has seen some big events like the Japanese tsunami and the recent negative credit outlook on the US. As for the tsunami, while terrible, it probably will have no major impact on rates. As for the negative credit outlook, this action is no surprise as the rating agencies, along with everybody else, have grown tired of the budget impasse in Washington. But, any downgrade is probably a few years away and most likely already discounted by the market.

To us, the three biggest issues affecting the economy and interest rates today are lower government spending, high oil prices and a struggling housing market. While strong government spending had been an economic driver the past two years, government is now looking to reduce non-essential services and workers. This includes cities, counties, transit authorities, school districts, states and even the federal government. As for oil prices, studies suggest that every $10 increase in oil prices cuts GDP by 0.2% the following year. Another rule of thumb is that every one cent increase in gas prices takes $1 billion out of consumers' pockets. In just the past eight months, oil prices have increased from $74.60 to $112.90 per barrel leading gasoline prices to go from $2.64 to $3.82 per gallon. How's that for an unexpected tax increase? Additionally, in contrast to past recoveries which were boosted by a robust housing market, the current housing climate remains soft. On average, home prices are down 31.8% since 2006 and still falling in many cities.



Sources: U.S. Energy Information Administration, Bloomberg

Going back to my family's Easter trip, when I finished filling up my car the price on the pump totaled just under $70 - not including the Icees, gum and assorted chips! I almost fainted. And, I drive a Chrysler 4 - door sedan, not a big SUV. Even more shocking, it wasn't even empty when I started.

At GH&A, we will stick to the fundamentals and continue to use our economic factors as the foundation of our investment process. With overwhelming negative bond sentiment, drastic cuts in government spending, high gasoline prices and a weak housing market, don't be surprised if we continue to "go our own way."

Gilbert Andrew Garcia, CFA
Managing Partner
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A copy of our Form ADV, Part II is available upon request.
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