

Q2, 2005 Quarterly Commentary***“Conundrum” Times Two:
Interest Rates and the U.S. Dollar***

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In this paper I will discuss two vexing economic “conundrums”— the failure of long term interest rates to increase despite sharply increasing short term rates, and the surprising reversal of the U.S. dollar’s slide against most foreign currencies despite the continuation of our enormous trade deficit. For each issue I will first better define the conundrum, then offer my analysis of the reasons it should not be happening, and then the reasons that perhaps explain why it is, nevertheless, happening. I will conclude by discussing the implications for investment policy, including the specifics of what I plan to do about them.

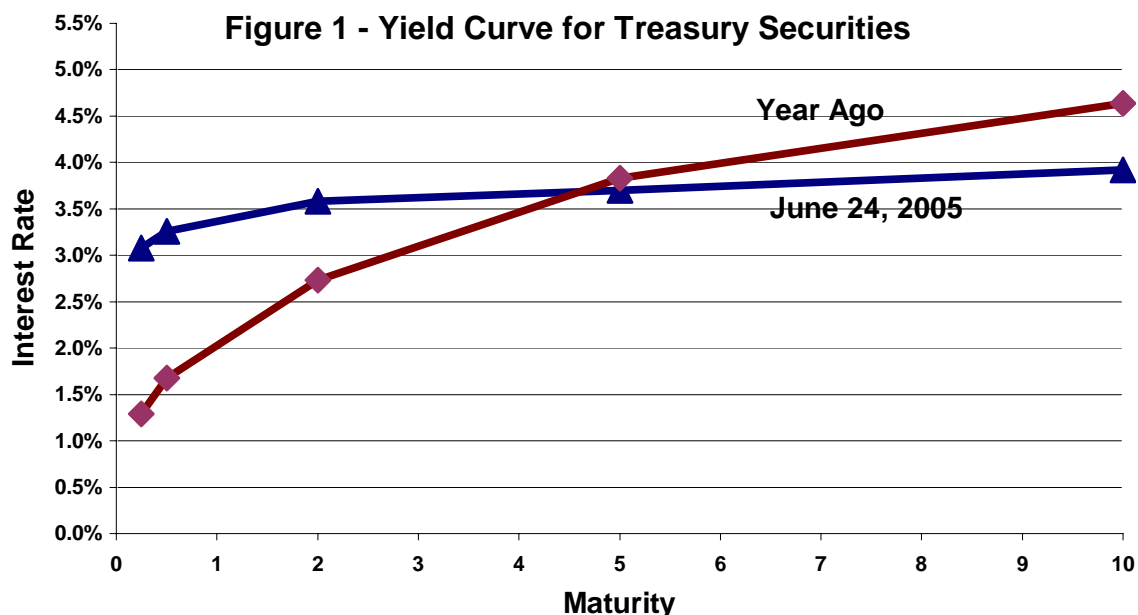
The Interest Rate “Conundrum” Revisited**Conundrum Defined**

In Congressional testimony early this year, Alan Greenspan created a new buzzword when he said that the failure of longer term U.S. interest rates to follow short term rates upwards was a “conundrum”. After all the Fed has raised the Federal funds rate from 1% all the way up to 3.25% in just over a year, but rather than following suit, longer term rates have held steady and even decreased. Even Alan Greenspan was at a loss as to how this could keep happening. Three months ago it appeared that longer term rates had finally begun an upward march. As I wrote to you in last quarter’s commentary, the 10 Year Treasury yield had climbed to 4.6% by the end of Q1, more than 80 basis points above its year ago level. But since then, there has been a substantial reversal, as long term interest rates have headed back downwards. By the end of the second quarter, the Ten Year Treasury was yielding only about 3.9%, a drop of 70 basis points since last quarter’s end, and a level that is also roughly 70 basis points *less* than one year ago¹. As a result, the yield curve has flattened dramatically (see Figure 1). So Greenspan’s conundrum continues, as strong as ever.

Analysis

Will long term interest rates continue to stay as low as they are today? I find this hard to believe. The Fed is not yet done raising short term rates. If they go as high as 3.75% as informed observers expect, we would have a near perfectly flat yield curve from 3 months out

¹ Other long term rates, including fixed mortgage rates are similarly lower than they were a year ago.



to 10 years. Investors would get no more reward for locking up their capital for 10 years than for 3 months. Furthermore, this implies real rates for *long* term Treasuries at only about 1.5%². This doesn't seem like a stable equilibrium to me.

On the other hand (economists always have another hand), some highly respected pundits have begun promoting a case that interest rates may well stay as low or lower than they are now for the next three years or more. In the past month, none other than PIMCO's Bill Gross, a.k.a. the "Bond King"³, has joined this camp. A year and half ago Gross was rapidly lowering the duration of his Total Return bond fund and scaring people away from his own fund based on statements about anticipated future increases in interest rates and inflation, not to mention what he said he was doing with his own money⁴! But in a 180 degree reversal, Gross says he now believes that deflationary forces will most likely prevail over inflationary forces for the next 3 to 5 years, and that long term interest rates will stay low over that time frame. The yields on 10 year Treasuries, he forecasts, will languish within a range of only 3% to 4 ½ % for the next several years. Further, the 3% end of the range is based on the possibility of recession, which he sees as a reasonable, though not highly likely, possibility. Perhaps most significantly, he and his PIMCO associates have now come to believe that inflation has essentially been tamed for the foreseeable future by a combination of monetary policy and the limitless supply of cheap labor in China and elsewhere.

² We can observe the market's forecast of inflation by subtracting the current yield on 10 year TIPS bonds from the 10 Year Treasury rate. On this basis, the market forecast for inflation is about 2.5%.

³ Bill Gross was a keynote speaker at the Morningstar Investment Conference that I attended in June and is probably the best known guru on fixed income within the investment community. He also manages the PIMCO Total Return fund, which I have used in many of our portfolios over the years.

⁴ Basically, he said he would not invest in his own fund because it would be harmed by interest rate increases.

Gross is still in a minority in these views, but he is not alone⁵. And he is so well respected that I suspect many other “experts” will be changing their views in the coming months as well.

Suppose Gross is right. If so, we will have a basically flat – or even inverted – yield curve for several years. How could this be? The answer is simple: *blame China!* China and other foreign governments (notably Japan) have been recycling the bulk of the excess dollars flowing to them due to our huge current account surplus back into U.S. Treasuries. Their overriding objective for doing this has been to keep their currency’s exchange rate stable versus the dollar, which in turn ensures continued high export-oriented employment within. They are not driven by total return objectives, which is to say they seem to be almost entirely insensitive to price. Their exorbitant demand for our debt securities has kept their prices high, which means their yields have stayed low⁶. In other words, they are willing to give us long term IOU’s even at ridiculously low interest rates if that’s what it takes to keep their export machine humming!

If this low interest rate world continues, is this good or bad for U.S. investors and the U.S. economy? All in all, it would be a mixed bag. It would mean continued low yields for fixed income investors, and principal values that have a downside but no upside. For the stock market it is good. All else equal, the stock market always likes low interest rates. For the U.S. economy, low interest rates are considered expansionary but, if Gross is wrong, they could also spark inflation and throw water on the whole party. In effect, China is fighting the Fed, which wants higher interest rates. But I think the biggest potential problems with this scenario have to do with the effects on our trade imbalance and the value of the U.S. dollar, which is the subject of the next section.

So what do I believe will happen? Despite the arguments above, I still think it is more likely that long term interest rates will increase – by at least 50 – 75 basis points from current levels. But the case for the alternative view is cogent, and does have a reasonable probability in my mind. As for the implications for investment policy, I think we need to be positioned for either scenario. The game is not to make the best possible forecast of the future and bet all our investments upon it, but to consider the range of reasonably possible future and structure more of an “all weather” portfolio that will not implode in any of them. I will say more about the implications for our Investment policy in the last section of this paper.

The Other Conundrum: Value of the U.S. Dollar

Conundrum Defined

Even more surprising than the persistence of low long term interest rates has been the recent sharp rally of the U.S. dollar relative to other currencies. I have been writing to you in the last several commentaries, going back at least to 2003 about U.S. dollar weakness relative to our

⁵ Another top flight company in the fixed income world with which I have an ongoing relationship is Yield Quest. They have actually been promoting a position similar to Gross’s new view for a long time, and they are acting pretty smug now about the Bond King finally seeing things their way!

⁶ Bond economics work like this. The bond issuer offers a fixed periodic nominal interest payment. The price of the bond, however is set by supply and demand, so the higher the price of the bond, the lower will be the interest payment as a percent of the bond price. That percentage is the bond’s yield or interest rate.

trading partners' currencies. As of year-end 2004, the dollar had been sliding more or less steadily for four years, and still, the proximate causes of U.S. dollar weakness, namely our "twin" fiscal and trade deficits, had only gotten worse. So it appeared at the time that the dollar's slide would continue for some time. And yet, over the past few months, the dollar has completely changed course and has been rapidly *appreciating* versus most major currencies. In fact it has already more than gained back all of its losses of 2004 in the first two quarters of this year.

There are numerous ways to measure the value of the dollar: its exchange rate relative to individual currencies or relative to some weighted "basket" of other currencies. Another way that is particularly relevant to us as investors is to compare the total returns of the EAFE index in local currencies to the total returns measured in U.S. dollars. The EAFE index⁷ is the most widely used index of stock market performance outside of the U.S. The return in local currencies is what we would receive if we invested in a fund that fully hedges its currency exposures by buying currency futures. The return in U.S. dollars is what we would receive if we invested in funds that are fully unhedged with respect to currencies.

Over the three calendar years ending with 2004, the EAFE's cumulative total return measured in U.S. dollars (what an unhedged U.S. investor would earn) was **40.1%**. But in local currencies (what a foreign investor or a fully hedged U.S. investor would have earned), an investor would have barely broken even at **0.2%**. This is a huge cumulative difference of 40%, and still the U.S. current account deficit has just continued to grow, until now it has reached nearly \$700 billion per year⁸. Without the dollar decline the deficit would almost certainly have grown larger still, but clearly it did not weaken sufficiently to make even a dent in the absolute magnitude of the trade imbalance. A trade deficit, especially one as huge as ours is today, is supposed to put strong downward pressures on the currency of the debtor country. And therein lies the surprise in the dollar's dramatic turnabout this year.

Analysis

What is going on? While I don't pretend to fully understand the situation – I don't think anybody does - I will try to provide you with an economic framework that can increase your understanding of recent goings on, and perhaps give you a better feel for types of future scenarios that may unfold.

The Current Account Deficit - I mentioned in the first paragraph that our "twin" deficits were the proximate causes of U.S. dollar weakness. But why should these deficits cause the dollar to decline? Let's take them one at a time. First, consider the current account deficit, which is a somewhat broader-defined version of the foreign trade deficit. When we import more than we export, foreigners end up holding more U.S. dollars than we hold of their currencies. The simplest explanation for why this leads to a weak dollar is that currency markets behave similarly to any market influenced by supply and demand. To say there is an excess of U.S. dollars in the currency markets is to say there is a greater supply of dollars than of potential demand (since dollars can only be "demanded" by someone holding a foreign currency to exchange for them). To equilibrate such a supply-demand imbalance, the price of

⁷ "EAFE" stands for "Europe, Australia and Far East".

⁸ The current account deficit in 2004 was \$668 billion, which is 5.7% of GDP.

the currency will naturally decline. And the “price” of the U.S. dollar is by definition its exchange rate.

There is more to the story than this, however. If foreigners tried to instantly exchange every last dollar back into their currencies, the dollar’s value would fall through the floor. We currently have a current account deficit near \$700 billion per year, which is much larger in magnitude than the combined current account deficits of all other countries in the world with trade deficits. The other things foreigners can do with their excess dollars include:

- buying and holding U.S. securities (stocks and bonds),
- making direct investments here (in real estate or private companies), or
- just holding the dollars as un-invested reserves.

In fact, the first of these, buying U.S. securities, is where almost all of the excess goes. And in recent years, largely due to the preferences of the Chinese and Japanese, the security of choice has been U.S. Treasuries. (As mentioned above, this has been one explanation for the first conundrum, why longer term U.S. interest rates have stayed so low. High demand for Treasuries drives their prices upwards, and consequently their interest rates downwards.)

So while the dollar value has been declining for four years due to the currency supply-demand imbalance, the decline has been reasonably slow and well-behaved due to the foreigners’ willingness to just hold IOU’s – which is what the government bonds really are -- in exchange for their goods and services, rather than trying to cash them in right away. The big question is can and will this go on indefinitely? Will foreign governments and investors be willing to continue recycling so much of their export earnings into our securities markets?

So long as the dollar keeps declining, they face a strong headwind. A declining dollar means foreign investors are losing ground on their dollar denominated investments, (the flip side of the explanation about U.S. investors gaining from the dollar’s decline). What if the Chinese government and others decide to “diversify” their investments by buying stuff other than U.S. Treasuries? Such action could flood the market with more dollars looking to be exchanged, cause a sharp decline in the dollar. And since this would exacerbate the situation for all foreign investors holding our securities, other may follow suit. As this process feeds back onto itself it could well spiral into a dollar crisis. And then it would not only be the dollar that would suffer. Our interest rates would soar as a consequence of the loss of foreign demand for Treasuries. And higher interest rates would in turn provide a stimulus for stock prices to fall. This is the dollar crisis scenario many have worried about, and which I have tried to partially protect us from by holding a portion of our investments in unhedged foreign securities.

But even if no such acute scenario develops, the mountain of IOU’s held by foreigners must eventually be cashed in, and this makes the longer term prospects for the dollar gloomy so long as we keep running such huge current account deficits. What the deficit really means is that we are consuming more than we are producing as a nation, and just as a household cannot hold credit card debt forever, eventually we will have to produce more than we consume in order to pay down the debt. To bet all of our investment dollars on the hope that we can avoid this day of reckoning indefinitely seems unwise to me. In other words, a weak U.S. dollar has to be a consideration in our investment strategy, even if not the guiding force.

The Fiscal Budget Deficit - Now what about the fiscal deficit, which is the excess of government spending over tax revenues? What does this have to do with the dollar's value? When the federal government spends more than it takes in these days, it borrows the difference. It doesn't just "print more money", at least not since the Fed learned that this is how you create hyper-inflation. But from whom does it borrow the money? Unfortunately, the net savings rate of U.S. consumers is now just about zero⁹. In fact these days we are borrowing the difference from foreigners – both foreign governments and foreign investors. The way the math works is this: if in a given time period the sum total of all U.S. consumer and business savings net of domestic investment is not at least as large as the government's fiscal deficit, then we have no choice but to look to foreign investors to come to the rescue. This is not economic theory; it is accounting reality. And in fact these days our domestic savings are nowhere near sufficient to cover our fiscal deficit. It used to be said by some that fiscal deficits don't matter because we owe the debt to ourselves.¹⁰ But this isn't true anymore. We owe it to China and Japan and other foreigners.

So this is where the twin deficits are tied together. It is the Asian and other foreign buyers of U.S. Treasuries who are currently financing 100% and more of our fiscal budget deficit. And where does their capital come from? From the trade deficit of course! It is an identity (i.e., based on definition not theory) that our capital account surplus (the excess of foreign investments in the U.S. over U.S. investments overseas) is equal in magnitude and opposite in sign to our current account deficit. And this is where the real tie in comes to play: *we have to run a trade deficit if we are going to insist on running a fiscal deficit in a society that does not save enough to cover it.* There is no other way (other than printing money and thereby stoking up inflation) to finance our fiscal deficit. As a result, we can't really resolve our trade deficit problem without also addressing our fiscal deficit.

The "Other Hand" – Why Might the Dollar Go Up Anyway? - By now you will (I hope) be saying, that these explanations seem to make sense. But everything I've said so far is consistent with a declining U.S. dollar. So then why has the dollar been going up this year? There must be more to the story. Well yes, there is. I still do have another "other hand" or two to offer.

I said earlier that the big question for the dollar was "will foreign governments and investors be willing to continue recycling so much of their export earnings into our securities markets?" Well the answer recently has been a resounding "yes!" and then some. Foreigners have not only been willing to recycle all of their net export earnings into our investment markets, they want to invest even more dollars in our markets. This sops up not only the excess dollars generated by the current trade imbalance; it even pulls more dollars out of reserves and thereby places upward pressure on the price of the dollar.

The key reasons for this excess demand for U.S. securities fall into two categories:

⁹ While U.S. citizens certainly buy lots of Treasury bonds, they are balanced off by other U.S. citizens who taking on more debt.

¹⁰ If U.S. investors were buying sufficient amounts of Treasuries to finance the deficit, then we would essentially owe the deficit to them. The current recipients of government benefits would be consuming more than they were producing, but the Treasury buyers were net savers, that is, consuming less than they were producing. As a society, it would all net out, with production and consumption balanced. There was simply a transfer of debt amongst internal groups.

- Asian (mostly Chinese) currency policies
- Economic weakness in Europe and Japan

The first of these has been discussed earlier. The Chinese are committed to keeping a constant exchange rate for the yuan, and will buy enough Treasuries to make it so no matter what the price. Japan and other Asian countries intervene in the currency markets to keep their currencies from getting too strong (which is to say to keep their export prices low), but to much lesser extents than China.

The second of these is the newer factor. I have focused on U.S. economic problems until now, but the U.S. economy is a blooming rose compared to the developing situation in Europe and the longstanding quagmire in Japan. There are at least three sets of issues:

- Anemic growth and high unemployment
- Really low interest rates
- Spillover of European Union problems to the Euro

While the U.S. GDP growth rate has been slowing, its current rate north of 3% is miles ahead of the growth rates in Japan and most European countries. Current unemployment rates in Germany, France and other parts of Euroland would be considered at crisis levels in the U.S. As for interest rates, with the exception of Great Britain, our 4% rate for a ten year government bond looks absolutely juicy. The 10 year government bond rate is only 1.2% in Japan and 3.2% in Germany. And due to their extremely weak economies, the political forces there are towards cutting rates, not increasing them as in the U.S. Finally, the French and Dutch rejection of the proposed EU constitution has brought new doubt and uncertainty to the future of the Euro, which is cited as contributing to its weakness in the currency markets.

The combined effect of these factors has been that foreign investors have shown increasing preferences for investing their assets in U.S. bonds and stocks, even if currency movements appeared (at least initially) to present a nasty headwind. And this has been pushing the U.S. dollar value upwards, which can only contribute to increasing our current account deficit even further.

How long can this continue? I don't know, nor does anyone else, but I don't expect it can continue indefinitely. The fundamental economics of a huge trade imbalance indicate downward pressure on the value of the debtors' currency; at least until the trade imbalance starts to diminish. But far from diminishing, ours is growing. And even if the relative strengths of economies continue to so strongly favor the U.S., the inflows of foreign capital to our markets that go with a rising dollar should eventually increase our stock prices and decrease our interest rates relative to those in overseas markets, and thereby improve the relative valuations of foreign securities. As for the investment implications of all this, please see the next section.

Investment Implications of the Conundrums

General Comments - To re-cap, the two conundrums in our financial markets are long term interest rates that are falling when the "should" be rising, and a U.S. dollar that is rising when it "should" be falling. We can analyze and rationalize forever, but as investors, we have to decide what to do now.

As foreshadowed earlier, I don't think our goal should be to decide which future scenario is going to happen and then act upon it. We should approach investment policy more like a decision analyst rather than an economic forecaster. We face a number of possible future scenarios, each of which has a reasonable probability of occurring. Our charge is to structure an investment portfolio that has the best combination of return and risk over all of those possibilities, appropriately weighted by their likelihoods of their occurrence. This is just a more academic way saying we should hedge our bets and be prepared for anything.

I think the whole discussion in this paper highlights the difficulty of doing "top down" investing, which is to say starting with analyses of macro level economic or political factors and using this to guide investment strategy.¹¹ With only rare exceptions, we need to stay diversified enough to weather a wide range of macro scenarios, even though it may appear "obvious" that one is going to prevail. To justify making a large bet on one outcome or another, the macro case has to be exceptionally compelling. Until recently I was beginning to think that the cases for increasing long term interest rates and a weak dollar were pretty close to qualifying. But recent developments in both of these areas serve as a reminder of just how difficult this approach is. Furthermore, even if we get the macro forecast right, the linkage to investment policy is not always as clear as you might think. As an example China's economic growth rate has been phenomenal. A recently published study¹² comparing 24 emerging markets countries shows that for the 17 years ended in 2003, China's growth rate was easily highest of all 24 countries. But when we look to investor returns, we find that investor returns in China were the *worst* of all 24 countries.

Next I will discuss what I specifically plan to do about each of the conundrums.

Interest Rates –Currently, most of our fixed income holdings at MAM are in three categories: floating rate bank loans, international bonds and inflation protected bonds (i.e., TIPS). We have close to nothing¹³ in intermediate or longer duration, interest sensitive U.S. bonds. Most of the time, this category will be the core holding in one's fixed income portfolio, so our current allocation is a pretty strong statement on my anticipation of rising interest rates.

My current plan is to move our portfolios back towards a more, but not totally, neutral position. The next time I review our portfolios in detail I will probably re-introduce a core intermediate term domestic bond fund or individual bonds into our portfolios. Even though I still think a rising longer term interest rate scenario is more likely than one with falling or stable rates, I no longer think the case for the former is so compelling that we should ignore the other scenarios. The amount I will move back into such a core position will be substantial

¹¹ The other extreme is "bottom up" investing, wherein one starts with analysis of individual securities. In this approach, the sectors and regions ultimately comprising one's portfolio are outcomes of the security analyses, rather than starting points as in the other approach.

¹² See Jeremy Siegel's excellent new book, The Future for Investors, p 229. This is the follow up to Professor Siegel's earlier book, Stocks for the Long Run, which I have quoted numerous times in earlier papers and commentaries.

¹³ From looking at the names of your fixed income mutual funds, some of you may think you have nothing invested in domestic interest sensitive bonds. However, the PIMCO Global Bond fund is truly a global fund and the manager can invest in U.S. securities as well as foreign bonds. Recently, about 15% of the fund was invested in U.S. securities.

(probably about 20% to 25% of our fixed income holdings), but still less than I would allocate in what I consider a neutral allocation. As a result, even after this change our fixed income portfolios should remain pretty well insulated against rising rates, at least compared to a more conventional or market weighted portfolio that would be dominated by interest sensitive domestic bonds.

What about the other side? If longer term interest rates do not rise, or even fall a little more, what would this mean for our portfolios? In general, I think our fixed income portfolios are structured to do reasonably well in this scenario too, even absent the change I'm suggesting. The interest rates on our bank loan funds (currently yielding 3.8%) could drop a bit, but their principal values should stay pretty constant because the loan rates are adjustable. If our economy were to sink into a recession, there would be some credit risk in such a fund, but it would be unlikely to be acute due to the high level of diversification. As for our inflation protected bonds, I don't expect TIP's or TIP's funds to earn anything like what they have in the past few years no matter what happens to interest rates¹⁴. If inflation is lower than expected (the market forecast implied in TIPS prices is about 2.5%), then these bonds could earn less than equivalent maturity Treasury bonds, but we aren't looking at double digit losses. As for our foreign bond holdings, aside from the currency risk which I will address next, I don't see how continuation of low U.S. interest rates should harm their performance. If anything, this should help their performance by keeping their rates low as well. And finally, an intermediate term domestic bond fund, such as I plan to re-introduce, would earn its interest rate yield or more if interest rates stayed level or declined, respectively.

U.S. Dollar – Due to my long stated concern about continuing declines of the U.S. dollar, or worse a dollar crisis, I have sought to partially protect our portfolios by investing a substantial fraction of our assets in unhedged foreign equity and bond funds¹⁵. Currently an average of roughly 25% of both our equity and fixed income holdings at MAM are invested in unhedged international equity and bond funds. I do not plan to make any notable changes in this stance, except that some of the assets to be invested in conventional domestic bonds mentioned above will be taken out of our current international bond fund allocations. So despite the dollar's surprising strength in recent months, I think our current allocation strategy is sound. My reasoning includes the following:

1. Falling dollar is still more likely. – Recent strength notwithstanding, I still think a falling dollar is more likely than a rising dollar over the next several years.
2. Dollar crisis is the big worry. - The worst thing that could happen in a falling dollar scenario – a dollar crisis, as described above – does not have an identifiable counterpart in a rising dollar scenario. It is more important to buy insurance against

¹⁴ Our fund of choice, PIMCO Real Return fund has returned 10.0% per year for the past 5 years

¹⁵This also applies to investing in U.S. based companies that do lots of business overseas. If a U.S. based company sells goods denominated in foreign currencies, these profits get translated back to U.S. dollars, so the company will gain or lose to the extent the dollar weakens or strengthens in the meantime. Thus, a U.S. based company's overseas operations have the same effect for a U.S. investor as an investment in a foreign company. Some U.S. based companies do surprisingly large amounts of overseas business. For example, would you have guessed that 80% of Coca Cola's profits are earned in foreign currencies? Of course the opposite goes for foreign companies that sell lots of products in the U.S. Consider companies like Nestle, Unilever or Samsung. The profits they earn here are initially earned in dollars, and need to be translated back to their native currencies.

this acute outcome than to try to benefit from mild changes in currencies, be they up or down.

3. Our “play” is modest. - I don’t think that having a quarter of our assets in foreign holdings constitutes an outsized “bet” on the U.S. dollar’s strength. After all, we still have three quarters of our portfolios in purely U.S. dollar denominated assets.
4. Fund managers have discretion. - Perhaps most importantly, the assets we have in international securities are not actually fully dedicated to foreign currency exposure by fund policy. Rather, I have chosen funds in which this is up to the manager’s discretion.

In the case of international bonds, the fund I have used most extensively is the PIMCO Global Bond fund. The term “global” implies that the manager has the discretion to invest in the U.S. as well in foreign countries (although there is no currency hedging with respect to the foreign holdings they do have). The amount currently held in U.S. bonds in this fund is about 15% of the fund.

In the case of our foreign equity funds, most of our assets have been invested in three funds in which the fund manager can and does selectively hedge against some foreign currencies. When I say these funds are “unhedged” it is because our fund managers have chosen to stay predominantly unhedged at present, but this can change at their discretion¹⁶. If I have done a good job in picking quality international stock fund managers, which I think I have, then letting them have some discretion in the matter of currency exposure as well as picking stocks makes good sense.

¹⁶ One of my favorite international equity funds in the past had been the Tweedy Browne Global Value fund. However there it observes a fund-level policy for that the fund will always remain 100% hedged against foreign currency movements. It is not a decision up to the manager’s discretion. Incidentally, I met an analyst at recent conference who has been with Tweedy Browne for close to twenty years, and he told me that he personally has opened a foreign currency account as a hedge against dollar weakness.