

SKBA CAPITAL MANAGEMENT, LLC

June 2004

So What Should You Do in Your Portfolio – Say Bye Bye or Buy Buy to Bonds?

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We've just experienced a whirlwind of economic news that has driven bond yields dramatically higher. From the March 23 low, the 10-Year Treasury bond has seen its yield rise by over 110 basis points from 3.7% to 4.8%. This dramatic yield change over such a short time period almost seems routine these days. Indeed, we witnessed a similar "blood bath" in bonds (with large price declines in long-term bonds) in June and July of 2003. Yet in order for such a change to occur, there must have been a commensurate dramatic shift in economic news and/or investor sentiment and expectations. So it seems worthy to ask the question: Are we at the beginning of a rash of bad news that will drive bond prices down further and yields up substantially, or is this a good time to lock in today's higher yields?

While it's far too early to pound the table with a "buy" recommendation on bonds, we do not believe that one should panic either and say "goodbye" to bonds in your portfolio.

Clearly, the recently reported rise in the Consumer Price Index (CPI) has led to a rise in inflation expectations. A rising inflation rate is the number one enemy of bond returns. Using the difference between nominal bond yields and the yield on Treasury Inflation-Protected Securities (TIPS), one can observe this rise over the last few months in implied inflation rate expectations at different points along the yield curve.

IMPLIED RATE OF CPI INFLATION

<u>As Of:</u>	<u>3-Year</u>	<u>10-Year</u>	<u>30-Year</u>
6/04/04	2.6%	2.7%	3.1%
3/23/04	<u>1.9%</u>	<u>2.3%</u>	<u>2.8%</u>
Change	+0.7%	+0.4%	+0.5%

Some observers have claimed that a rise in overall CPI is just a temporary blip due to the upward spikes in energy and commodity prices. Since the "core" CPI (less food and energy) hasn't seen the same rate of acceleration, one shouldn't worry - so this argument states. In our view, however, the preconditions

for rising inflation have been in place for months. Furthermore, no one "eats" the core CPI - we all, whether individuals or corporations, face erosion in the purchasing power of our dollars based on the overall CPI, not the core. The core CPI is more apt to follow the trend in the CPI than vice versa.

One can see the problem developing from the dramatic increase in commodity prices with a year-to-year change in the CRB (Commodity Research Bureau) of +14% and still more in indexes heavily weighted in energy. The Producer Price Index (PPI) is up 3.9% year to year. Although the core PPI rose only 1.5% over this same period, it rose 0.7% in April alone. The ratio of PPI crude materials to the PPI for intermediate goods bottomed in 2002 at a ratio of 0.92 and has since risen to 1.3, the highest level since 1995. The ratio of the PPI Intermediate Goods to the PPI for Finished Goods similarly hit a low of 0.91 in 2002 has seen a more moderate advance to 0.96. Cost pressures are undoubtedly making their way through the system. The pig (cost increases) is already working its way through the python (inflation rate), and it is a fat pig at that! It is our belief that we have experienced the end of the secular downtrend in inflation that began in 1982! This is not good news for bonds.

So how bad will it get and is the current upsurge just a cyclical phenomenon or the beginning of a secular problem? It is true that real economic growth in and of itself does not cause the inflation rate to rise. The 1980s decade was the "disinflation" decade in which high inflation was wrung out of the system. Much of the 1990s was characterized as the "perfection" decade in which inflation stabilized at a low level (1.5% and less) as the real economy boomed. A classic "boom" economy cycle in which both real growth and inflation rise at a 4% rate or more hasn't been seen since the 1970s. This is because the Fed pursued a strong dollar policy, international trade turned the production of tradable goods into a low-cost commodity activity, low tax rates stimulated investment and risk taking by entrepreneurs, labor productivity soared, and energy prices remained stable. Not a bad combination of favorable developments in our opinion.

What we seem to be encountering today, however, is more like the "perfect storm" of inflation forces with the erosion in the exchange value of the U.S. dollar and the dramatic rise in demand for and prices of industrial and energy commodities. In developing countries over this period, capacity expansion in

commodity industries has often been undertaken to generate hard currency earnings and employment rather than to pursue the profit motive. The result was perennial overcapacity.

Currently, the liberalization of economic policies in China and India has created booming economic conditions and soaring demand for commodities, goods and services. The upward shift in the growth trend of energy consumption (and the outward shift in the demand curve) has resulted in both an increase in real consumption and in the normal range of energy prices (or long-term equilibrium levels). The combination of demand-pull and cost-push sources of upward pressure on the CPI is not likely to disappear soon.

In fact, markets have already pronounced their verdict on this debate, and the damage has been done. Inflation of 2.5% is widely discounted into today's yields compared to the more optimistic expectation of only 1.5% a few months ago. The real debate now should be focused on whether or not inflation is sustained at 2.5% or accelerates further to 4% or higher. From our perspective, the likelihood that CPI inflation over the next three years might be either near 2.5% or 4% or more is roughly a 55%/45% probability split.

The Federal Reserve Board has compounded today's inflation problem by pegging short rates at less than the rate of inflation. Negative real interest rates encourage all kinds of price speculation – in commodities, gold, energy, real estate, and “carry trades” that use inexpensive short-term borrowing to fund longer duration financial or real asset contracts. Negative real interest rates also encourage the debasement of the exchange value of the currency, and the U.S. dollar's decline does not appear to be over. Yet, with robust real growth in the U.S., the Fed cannot possibly justify a continuation of this policy.

Indeed, Chairman Greenspan's recent testimony before Congress marked a significant change in official rhetoric and inaugurated the new era of Fed rate hikes that will likely be needed to control inflationary pressures.

Inflation in the CPI is inherently a monetary phenomenon. The folly of believing that such an “easy” Fed policy causes real economic growth to permanently accelerate rather than lead to higher inflation arises out of incorrect assumptions that the real economy is highly sensitive to interest rate changes. It isn't. Instead, the sensitivity of the real economy to Fed policy changes has been declining since 1981 when Reg Q was eliminated. With it, the Fed lost its ability to disintermediate financial institutions. Thus, it takes far lower interest rates to stimulate the economy than in the past and far higher rates to restrain inflation increases when they get out of hand. The likely rise we face in interest rates is not likely to cause a significant slowing in the next two years' real economic growth.

So the danger looking forward is that interest rates must rise to much-higher-than-expected levels and “overshoot” underlying inflation fundamentals in order to tame today's rising inflation

rate. What might this level be in an environment in which inflation rises to 4% or more and investors believe this will persist? A sustained 4% inflation rate would likely drive T-Bill yields up to 4.5-5% and long-term T-Bond yields up to 6.5-7%. T-Bond returns would be negative over this period.

A possible positive outcome might be that in finally taking action to raise the Discount and Fed Funds rates at the June 30 meeting, the Fed might begin to convince the market that it is willing to defend the purchasing power of the dollar. A full restoration of confidence isn't likely to come until short-rates once again provide a positive real interest rate, however; so don't be surprised if by the end of 2005, T-Bill yields return to 3.5%, and long T-Bonds (>25 years to maturity) yield 6-6.5%.

As rates rise, however, much of the increase will come in real interest rates as robust economic growth around the world (ex western Europe which appears to be lagging) drives rates of return on capital higher and restores a required real rate on long-term Treasury bonds toward 3% from today's 2.4%. A 3% real rate and a sustained 4% rate of inflation could easily boost T-Bond yields to 7% over the next 2-3 years. This would contrast with T-Bond yields rising to only around 5.75% if the market perceived that the inflation problem would result in a sustained inflation rate above 2.5%.

None of these inflation levels should derail our current robust economic expansion, but the yield curve should flatten and real interest rates should rise.

Does this mean there's no place in client portfolios' for bonds? No, bonds can still play an important role, albeit with a shorter duration than relevant benchmarks. Since so much of the Fed's likely increase in short rates is already discounted by the bond market (as evidenced by the steep yield curve), we believe that a barbell strategy seems most appropriate. This includes owning 2-5 year maturities (to gain income while having bonds mature as rates rise) and 20-year bonds (to lock in higher income in the event the Fed gains control over the inflation outlook quicker than expected). We would avoid the 10-year area which sells at too large of a yield discount to longer maturity bonds.

Furthermore, since the continuation of a robust economic expansion should result in improving interest coverage over at least the next two years, corporate bond spreads are likely to narrow or remain narrow. Where corporate bonds can be owned, we'd concentrate the 2-5 year maturities.

So while it's far too early to pound the table with an across the board “buy” recommendation on bonds, we don't believe that one should panic and say “goodbye” to bonds in one's portfolio.

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