



CAPITAL MANAGEMENT, LLC

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February 2004

By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Author

Steven Sheldon has more than ten years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group where he managed a \$100 million portfolio. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the Association for Investment Management and Research (AIMR) and the Houston Society of Financial Analysts (HSFA).

Why Aren't Interest Rates Going Up?

Like a shopaholic scavenging through the Sunday paper for the best weekend sales, investors are keeping a watchful eye out for any sign of inflation in reported government statistics.

According to conventional economic wisdom, as the economy continues to build momentum and the demand for goods and services outpaces their supply, inflationary pressures arise. Inflation then leads to higher interest rates because bondholders require higher yields to preserve a real return (an amount over and above the rate of inflation) on their money.

Undoubtedly, when the CPI (Consumer Price Index), which measures the rate of inflation in the economy, finally breaks out of its sustained flat line pattern, skittish investors will likely send interest rates markedly higher.

However, with everyone waiting and watching for inflation and higher interest rates, consumer inflation is nowhere to be seen (at least not in the government data). As a result, interest rates are standing pat. In fact, since the first week of January 2004, the yield on the 10-year U.S. Treasury Bond has actually dropped, falling from 4.40% to 4.2% (as of Jan. 28rd). Many market strategists and economists had forecast the 10-year rate to be well over 4.5% at this point in the cycle.

The Not So Normal Recovery

Already dubbed the "Jobless Recovery", perhaps another fitting name might be the "Rebate and Refinancing Recovery", given the home refinancing boom and consumer merchandise bargains. In the 3rd quarter of 2003, the economy (as measured by GDP) grew at a blistering 8.2%, yet in December, the CPI barely budged, registering a mere 0.1% growth rate over the prior month.

To a large degree, tremendous overcapacity and slack in the system created by the 1990s boom, along with higher productivity, have enabled the economy to grow at an accelerated pace without inflation. This situation, which may persist for some time, only explains part of the reason why interest rates have stayed so low for so long.



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Best Buy

Like a home electronics store that undercuts its competition to draw in business, U.S. economic policy makers are essentially trying to do the same thing. By holding down short term interest rates and utilizing other expansionary measures, U.S. officials have orchestrated a decline in the value of the U.S. dollar relative to other major currencies. In doing so, the U.S. is essentially offering foreign countries a discount off our already low prices in the hopes of making our goods more cost-competitive in the global market place. More goods sold will provide a much-needed spark to the U.S. manufacturing sector and lead to more job creation and growth.

So far, this strategy seems to be working. Exports have steadily grown as the dollar has depreciated against the Euro and other foreign currencies over the last several months.

So how does this affect interest rates?

As it turns out, there are other countries in the world that want to sell their goods in the global market as well. These countries have utilized a form of “guaranteed match pricing” policy to stay competitive. This policy involves keeping their currencies either pegged to the value of the dollar or driving down the value of their currencies relative to the dollar. To accomplish this, these countries’ central banks must sell their currencies and buy U.S. dollars in the open market. The extra demand for U.S. dollars strengthens the value of the dollar and weakens the value of the foreign currency.

Once the foreign banks own U.S. dollars, they must decide on what to do with all those U.S. dollar-denominated funds. As the chart below illustrates, it is apparent that some foreign central bankers have a bit of a “shopping problem” themselves and have used these funds to go on a U.S. Treasury Securities buying binge.

Major Foreign Holders of Treasury Securities (in billions)

Country	Nov 2003	% of Total	Jan 2003	% of Total
Japan	\$525.5	34.9%	\$385.0	31.0%
Mainland China	\$143.8	9.6%	\$120.7	9.7%
United Kingdom	\$111.7	7.4%	\$81.0	6.5%
Others	\$723.4	48.1%	\$653.7	52.7%
Totals	\$1,504.4	100.0%	\$1,240.4	100.0%

Source: Department of the Treasury



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Furthermore, heavy foreign purchases of U.S. Treasury securities have helped put a lid on U.S. interest rates, given the increased demand for dollar denominated assets. In particular, foreign countries like Japan and China have gobbled up U.S. Treasuries at a feverish pace and represent our biggest customers. China pegs its currency, the Yuan, to the U.S. dollar while the Japanese Yen floats freely.

When Does the Sale End?

Unfortunately, all good sales must come to an end. However, as long as foreign countries continue to absorb our debt and inflation stays under control, rates could stay relatively low for some time. When this trend finally reverses itself and U.S. Treasury securities are not as appealing to these foreign banks, hopefully by then the U.S. won't be so dependent on these few large customers.

In the meantime, investors should have some vehicles in their portfolio that offer a hedge against the prospects for higher inflation and higher interest rates including TIPS (inflation adjusted securities), precious metals, natural resources, non-U.S. government bonds, and floating rate securities.

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