SMS Capital Management, LLC

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Soaking Up Liquidity

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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 twelve 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. 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 CFA Institute and the Houston Society of Financial Analysts (HSFA).

In investing, logic does not always win out. It appears that saying goes for the Houston Texans as well, who continue to make *"What were they thinking?"* moves at every possible turn (yes, a direct reference to their draft pick).

There are, however, basic "cause and effect" logical economic relationships that we can count on to play out again and again. One example is the relationship between **interest rates and economic growth. Over time, lower interest rates will stimulate an economy while higher interest rates will slow it down**. Currently, the U.S., the world's largest economy, is well into its interest rate rising cycle, and the world's second large economy, Japan, is just getting started. As a result, **investors should prepare their portfolios now for the slower growth environment that may lie ahead.**

Fed Action

With the 10-year U.S. Treasury bond now finally yielding over 5% for the first time since 2002, the Federal Reserve is posturing to end its interest rate raising campaign sometime this year. Due to the time lag for interest rates to take effect, we have yet to see the full impact on growth. Just as lower interest rates took some time to get the economy moving again after the recession following the tech bust in 2000, higher interest rates will also take some time to work their magic. Inevitably, the U.S. economy will slow from its current pace as higher borrowing costs take their toll on the U.S. consumer spending and crimp corporate profits. The stock market tends to top out 6-12 months before an economic slowdown, thereby acting as a leading indicator to some degree.

Japan…Out of their Funk

On April 28, 2006, the Bank of Japan (BOJ) released its biannual outlook for the Japanese economy and consumer prices. The report, which forecasts continued economic expansion along with increasing inflation, lends further support to the notion that the BOJ's super expansionary, zero-rate policy is coming to an end soon. **Now, the big question in economists' and investors' minds is not if the BOJ will make a move with higher interest rates, but what are the global economic ramifications that result.**

Since 2001 when the BOJ pushed interest rates down to zero in an all desperate attempt to reverse a serious bout of deflation, Japan and the rest of the world have been awash in cheap capital. Global investors could borrow in Japan at practically no cost and invest in higher yielding financial securities around the world, including in the U.S.

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The Japanese central bank would buy U.S. Treasury securities for another reason. For years, Japan has intervened in the currency markets to keep the value of the yen from rising too much against its trading partners' currencies. An expensive yen would hurt Japanese exports, making them less competitive in the global marketplace. When the Japanese central bank bought U.S. dollars and sold yen, they would use their dollars to purchase U.S. Treasury Bonds. Now, with the Japanese economy back on track and domestic consumption showing signs of sustained life, there is less of a need for the BOJ to keep its currency artificially weak.

As the chart below shows, Japan is by far the largest foreign purchaser of U.S. Treasury securities. Any significant curtailment of their purchasing could put further upward pressure on U.S. interest rates.

Major Foreign Holders of U.S. Treasury Securities

($ in Billions)

Country	**2006 Feb**	**2006 Jan**	**2005 Jan**
Japan	673.1	669.1	679.4
Mainland China	265.2	262.1	223.5
United Kingdom	250.8	245.2	101.0
Caribbean Banking Centers	94.1	105.1	97.1
OPEC	84.9	78.0	67.1
Others	864.2	844.3	743.4
Grant Total	**2232.3**	**2203.8**	**1911.5**

Source: Dept. of Treasury/Federal Reserve Board

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Portfolio Adjustments

As the trend towards higher interest rates continues to unfold, investors should consider the following portfolio strategies over the course of the year:

Climb up the safety ladder by sticking to short-term U.S. Treasury bonds, high quality corporate bonds, and other secure fixed income investments so as to minimize the damage should interest rates continue to rise or credit spreads widen. Junk bonds and emerging market bonds will likely falter in a global slowdown.

Diversify equity holding to include non-U.S. denominated securities (particularly exposure to Japan). This will offer protection against a slowing U.S. economy and from further devaluation of the U.S. dollar.

Take profits from small and mid cap stocks and re-invest in large cap stocks. Should there be a flight to quality, smaller companies with less dependable earnings will be less attractive to larger multinationals with more dependable earnings.