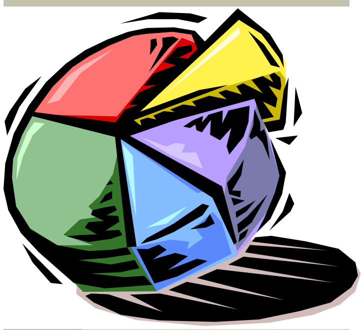
May 2004

Interest Rates: Dangerous Curves Ahead?



TD Capital Management LLC

"...EFFICIENT PORTFOLIOS FOR RATIONAL INVESTORS."

Dear Clients & Friends:

I haven't had any medical procedures (lately); the shameful behavior of some mutual fund companies continues to be brought to light, but there haven't been any actual revelations in the last few weeks; Janet Jackson hasn't revealed anything new since the Super Bowl; the local weather has been fairly passive; stock prices and returns have been boring (so far this year); in short – nobody's given me anything cute to write about.

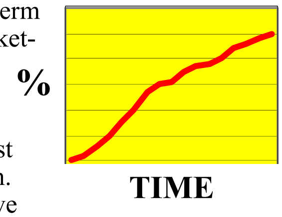
The "Fed" met this week. The meeting and its resulting information disclosure were much anticipated, but also much misunderstood by most folks. Following the meeting, the Fed announced the decision to hold its controlled interest rates at their current levels while setting the stage for increasing rates in the fairly near future.

The Fed is the Federal Reserve Board – which oversees the U.S. central bank and banking system. The meeting is actually a scheduled meeting of the Federal Open Market Committee (FOMC). Among other things, the FOMC studies, discusses, and reacts to factors in the economy like inflation indicators, economic activity, consumer sentiment, etc., etc. ad-nauseum. The committee then establishes policy and/or adjusts interest rates to fine-tune our economy.

The Fed only directly controls and/or influences short-term interest rates. They can establish rates the Federal Reserve Banks charge their member banks (discount rate – currently 1%), raise or lower member bank reserve requirements (influencing supply of available funds for loans), and participate in buying or selling government securities in the open-market (supply and demand influences prices). Meanwhile longer term rates are essentially controlled by the invisible hand(s) of the marketplace.

You may have noticed that long term rates (like mortgages) are significantly higher than short term rates (like interest on checking balances, money markets, cd's, etc.). This situation is called the term structure of interest rates and is often pictured in a graph called a yield curve.

The slope of the yield curve (the difference between short term rates and long term rates) is an important factor in determining economic and investment policies. Currently, we have a "steep" yield curve as a result of an "accommodating" policy of the Fed.
This steep situation is a result of the Fed's control of short-term rates and their attempts to stimulate the economy, while the long-term rates reflect the marketplace's (investors, issuers, lenders, and borrowers) prediction of higher interest rates and/or inflation. This steep yield curve condition usually develops early in an economic cycle (as we recover from downturns and recessions).



So what? The Fed is usually reluctant to make aggressive moves during an election year, so we don't expect anything hugely significant until the fall. However, they will likely begin to make small (maybe inconspicuous) moves to increase shorter rates and return to a more "normal" yield curve as we enter the middle of an economic cycle. As we anticipate higher rates, we will be doing at least two things in your portfolios. First, we will reduce the total allocation of bonds in your portfolios. Second, we will shorten the average maturities in your cash/near-cash/bond holdings. The result will be significantly less exposure to the risk of price declines due to higher interest rates, at the small expense of lower yields in the short run. In the longer run, we will have cash and allocation availability to invest at higher rates.

Call, email, come see us, whatever. Just stay in touch.

God Bless always,

Doug

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