The Lam Group
Investment Management

The Lam Group Newsletter Vol. 4, No. 2
Second Quarter 2004

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The Big Picture: The Yield Curve
On June 30, 2004, the Federal Reserve raised short-term interest rates 25bps to 1.25%, the first Fed-initiated interest rate increase in four years. The rate increase was no surprise as the specter of higher US rates affected the global equity and fixed income markets well before the end of the quarter. With the surprising improvement in the employment data in April, the reality of higher rates and the possibility of a flattening yield curve caused all asset classes to suffer. While most asset classes recovered in May and June (some more than others), 2Q 2004 was indeed a volatile quarter.

With the reality of rising US interest rates now upon us, many market participants wonder:

How much and how fast is the Federal Reserve going to raise interest rates?

The real question, however, is not how much and how fast, rather, in what manner will rising US interest rates affect the shape of the US Treasury yield curve and who will raise US interest rates? ***It may not be who you think.***

Will the US Treasury yield curve steepen or flatten is response to rising interest rates?

The *yield curve* is a graphical presentation illustrating the relationship (at a given point in time) between yield (vertical axis) and current maturity (horizontal axis) of fixed income securities of the same credit risk. Generally, yield curves are positively sloped (higher yields are for longer maturities) as investors (lenders) require higher yields to compensate for the greater risk of lending money for longer periods of time (maturities). The most watched yield curve in the world is for US Treasury securities.

Why is the shape of the yield curve important?

The shape of a yield curve can tell us many things. A steep or steepening yield curve (long rates higher than short rates) often implies a desire for economic expansion. Historically, yield curves have steepened when central banks (such as our Federal Reserve) have simulated economic growth by lowering short interest rates. By keeping short interest rates low, the government is effectively "printing money" by providing a greater supply of US dollars to be invested in the economy.

At the same time, with our growing budget deficit, the US Treasury Department is issuing more fixed income securities than ever before (issuing bonds is another way of printing money). The explosion in the issuance of US Treasury securities may eventually cause fixed income investors to demand more yield to accept the growing universe of US dollar denominated debt. It is worth noting that over 40% of US Treasury debt is owned by foreign investors and central banks, and that these foreign investors are growing more sensitive to the effects of inflation on the value of their US bond portfolios.

While a steep yield curve may indicate that rates may go higher some time in the future, a steep (or steepening) yield curve allows finance-based entities such as banks, corporations and hedge funds to borrow at very low short-term rates and make investments in higher returning assets such as longer maturity (and/or higher credit risk) bonds or other higher yielding assets. Borrowing at low short rates to buy other higher returning assets further out on the yield curve is an investment strategy known as the "carry trade", which is simply a nice sounding way of juicing up asset returns by employing financial leverage.

The carry trade only works in a steep yield curve environment. *It is worth noting that a steep yield curve often implies future inflation, and that inflation is the enemy to holders of fixed income securities.*

A flat or flattening yield curve (long and short rates are not that different) often implies a desire for economic contraction or "cooling off". Historically, yield curves have flattened when central banks want to slow an economic expansion to prevent inflationary pressures from taking hold. A flat or flattening yield curve can dramatically decrease the profitability and viability of the "carry trade" and gives fixed income investors less incentive (yield) to lend money for longer periods of time (further out on the yield curve).

A byproduct of the last 4 years of monetary policy-driven economic stimulation has been the weakening of the US dollar relative to the currencies of other developed countries. A weakening US dollar can have inflationary effects as our dollars are increasingly worth less than they used to be. As a consequence, more dollars are required to buy goods and services globally. The recent increases in the price of gasoline, building materials, and other commodities are early signs of the inflationary effects of a weakening US dollar.

Who Will Raise Rates?
As the Federal Reserve only has control of US monetary policy, it can only change short interest rates by manipulating/setting the Fed Funds rate. When the Fed began raising short interest rates last month, it signaled to the global markets that they are prepared to raise rates to slow our improving economy, to fight inflationary pressures, and to perhaps defend/strengthen the US dollar.

If the Fed raises short-term interest rates quickly, it may succeed in curbing inflation, and, as a consequence, the yield curve may flatten, led by rising short rates. The risk inherent with the Fed aggressively raising short interest rates is that such an increase may put a damper on the domestic economy. The possibility of rising rates slowing our economy is more problematic given that we are in the midst of an election year. Beneficiaries of the "carry trade" and other highly-leveraged entities and households will also suffer; particularly those who have borrowed on a floating rate basis. It is worth noting that approximately 30% of all residential mortgages outstanding are adjustable rate. By not locking in “long and low” when interest rates bottomed last year, borrowers utilizing floating/adjustable rate debt are especially vulnerable in the presence of rising interest rates.

On the other hand, in an election year, it is quite possible that the Fed may prefer to raise short term interest rates slowly to keep our domestic economy growing. There are, however, significant risks on a global scale if the Fed raises interest rates too slowly. By keeping our interest rates too low and allowing our currency to continue to depreciate, there is a strong possibility of a significant increase in inflation.

As inflation is the enemy of the fixed income investor and the fact that ~40% of our US Treasury debt is held by foreign investors, it would be devastating to our capital markets if these investors stopped buying our bonds, or worse, wanted to sell their existing holdings. A “buyer’s strike” of US Treasuries by foreign investors would cause interest rates to rise and the yield curve to steepen.

In 2003, the total return (interest income plus price appreciation) of the Lehman Brothers US Government Bond Index was: +2.37% (in US dollar terms). During the same year, the value of the US dollar fell over 16% versus the Euro and almost 10% versus the Yen. Taking all aspects of their US fixed income investment into consideration, foreign investors holding US Treasury securities received negative total returns last year.

*Me tromper une fois, l'honte sur vous, me tromper deux fois, l'honte sur moi…**

*Überlisten Sie mich einmal, Schande auf Ihnen, Überlisten Sie mich zweimal, Schande auf mir…**

*Usowa Ikkai Dake…**

*Translated from French, German and Japanese: trick me once, shame on you, trick me twice, shame on me…

As a consequence of our growing dependence on foreign capital to finance our growing deficits, it appears Fed Chairman Alan Greenspan is not the only one who can raise US interest rates. Foreign investors, fearing the value-eroding effects of inflation on their fixed income holdings could stage a “buyer’s strike” and limit or stop future bond US Treasury purchases until interest rates rise high enough to make owning fixed income investments in an inflationary environment worthwhile. Can this really happen? Ask anyone who was old enough to be an investor in the mid-to-late ‘70s.

With the global economy and markets at a crossroads, the question of whether the ***Fed will get ahead of the curve*** (raise rates aggressively, flatten the yield curve, and risk an economic downturn domestically), or the ***Fed will fall behind the curve*** (raise interest rates too slowly, steepen the yield curve via foreign selling of longer maturity bonds and risk an inflationary environment) is extremely important. The answer to this question has huge ramifications on the value of the US dollar (and US assets in general) and is further complicated by the uncertainties introduced by the upcoming Presidential elections and the ever-present possibility of domestic terrorism.

To paraphrase Bill Gross, Managing Director of PIMCO (whose mutual funds are the largest bond investor in the world), the United States has moved from a manufacturing-based economy from the 1950's and '60's, to a service-based economy in the 1970's and '80s, to finally a financed-based economy in the 1990's and the new millennium. With many of our largest companies generating a majority of their earnings from financed-based activities (over 50% of GE's earnings are from finance operations, not manufacturing), the shape of the US Treasury yield curve and the factors that affect it are exceedingly important.

Will the Fed get ahead or behind the curve? A lot depends on who raises interest rates…

The Lam Group

While the possibility of rising rates caused great volatility for all asset classes in 2Q 2004 and brought increased uncertainty to the stock and bond markets globally, we continue to believe a properly balanced portfolio and disciplined adherence to a thoughtful asset allocation plan are safe harbors in times of stormy markets.

That being said, the standard "balanced" asset allocation approach that includes only domestic large cap stocks (S&P 500) and investment grade bonds (Lehman Aggregate) is no longer relevant given the increasingly global nature of the markets and the growing sensitivity to currency valuations and their effects on inflation. Investment portfolios without asset class exposures to non-$ markets and inflation-protected holdings cannot be considered properly balanced or adequately diversified.

We remain fully weighted to the asset classes that will benefit from a weaker US dollar, rising inflation, and the continued growth in emerging economies with cheaper labor costs; at the same time, we continue to monitor, and in some cases modify, exposures to asset classes that may be negatively impacted by rising interest rates, higher inflation, and/or a weakening US dollar.

For those readers who would like to know us better, our website (www.thelamgroup.com) has added several new features, including a Frequently Asked Questions section to address questions prospective clients may have about our firm.

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July 19, 2004

Archives for The Lam Group Newsletter are available at our website: www.thelamgroup.com

Asset Class Investment Results:
All portfolios constructed and managed by The Lam Group are designed for an individual client's specific risk tolerances, income requirements and investment horizon. Our investment management approach includes the design of a customized asset allocation plan, the research and selection of the most appropriate and cost-effective asset class investments for the client's specific investment policy, and the on-going monitoring and disciplined rebalancing of the aggregate portfolio to optimize return, manage risk and minimize taxes.

As different clients have different goals, risk profiles and investment horizons, it is not useful to publish a track record of specifically-managed portfolios. The investment performance data below illustrate the returns of some of the actual mutual funds utilized by The Lam Group for specific asset class allocations in the construction of investment portfolios we manage.

Equity Asset Class Category	**2Q2004**	**YTD**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Total Equity Market				
-Wilshire 5000 Index (Total Dom. Eq. Market)	+ 1.28%	+ 3.93%	+ 0.77%	+ 0.99
US Total Market Fund	+ 1.28%	+ 3.90%	+ 0.62%	+ 0.99
Domestic Large Cap Stocks				
-S&P 500 Index	+ 1.72%	+ 3.44%	- 0.69%	+ 1.00
Domestic Large Cap Value Fund	+ 1.83%	+ 5.79%	+ 4.71%	+ 0.93
Domestic Small Cap Stocks				
-CRSP 6 -10 Index	N/A	N/A	N/A	N/A
-Russell 2000 Index	+ 0.47%	+ 6.76%	+ 6.23%	+ 0.83
Domestic Small Cap Value Fund	+ 3.70%	+11.35%	+16.99%	+ 0.78
Real Estate Investment Trusts (REITs)				
-Wilshire REIT Index	- 5.43%	+ 5.99%	+ 15.21%	+ 0.35
REIT Fund	- 5.52%	+ 5.84%	+ 15.35%	+ 0.33
Real Estate Fund	- 0.78%	+ 7.39%	+ 16.75%	+ 0.54
International Large Cap Stocks				
-MSCI EAFE Index	+ 0.22%	+ 4.56%	+ 3.87%	+ 0.88
International Large Cap Value Fund	+ 1.98%	+ 9.36%	+10.67%	+ 0.80
International Small Cap Stocks				
-MSCI Small Cap EAFE Index (in US $, px only)	- 0.18%	+11.62%	+12.16%	+ 0.68
International Small Cap Value Fund	- 0.13%	+13.81%	+21.98%	+ 0.58
Emerging Markets Equity				
-MSCI Emerging Markets Free Index	-10.34%	- 2.39%	+10.21%	+ 0.82
Emerging Markets Value Fund	- 8.14%	+ 1.75%	+21.88%	+ 0.79

* 3 yr correlation using monthly data

Fixed Income Asset Class Category	**2Q2004**	**YTD**	**3 Year Annualized**	**Correlation w/ S&P 500***
Domestic Investment Grade Bonds				
-Lehman 1-3 year Govt Bond Index	- 1.13%	- 0.05%	+ 4.08%	- 0.57
Short Duration Domestic Inv. Gr. Bond Fund	- 0.65%	+ 0.51%	+ 4.84%	- 0.36
Short Duration Domestic Muni Bond Fund	- 1.36%	- 0.65%	N/A	N/A
-Lehman Aggregate Bond Index	- 2.44%	+ 0.15%	+ 6.36%	- 0.38
Domestic Investment Grade Bond Fund	- 2.18%	+ 0.45%	+ 7.64%	- 0.30
Domestic High Yield Bonds				
-CSFB High Yield Index	- 0.19%	+ 2.47%	+11.10%	+0.59
High Yield Fund	+ 0.66%	+ 2.43%	+ 8.63%	+0.70
Inflation-Linked Bonds				
-Lehman TIPS Index	- 3.10%	+ 1.88%	+ 9.25%	N/A
TIPS Fund	- 2.96%	+ 2.13%	+ 9.50%	- 0.31
Commodities-Linked Fund	- 7.31%	+ 8.24%	N/A	N/A
International (non-US $) Bonds				
-Salomon Brothers Non-$ World Govt Index	- 3.33%	- 1.53%	+11.94%	- 0.25
Non-$ Bond Fund	- 3.28%	- 1.62%	+14.26%	- 0.17
Emerging Markets Debt				
-JP Morgan EMBI+ Index	- 5.47%	- 2.27%	+ 9.99 %	N/A
Emerging Markets Debt Fund	- 6.23%	- 3.20%	+18.70%	+0.53

* 3 yr correlation using monthly data