

## ***THE ROAD TO NEUTRAL***

**By DOMINIC NOLAN, VICE PRESIDENT**

*“The rising prices of stocks, bonds, and, more recently, of homes, have engendered a large increase in the market value of claims, which, when converted to cash, are a source of purchasing power...Such an increase in market value is too often viewed by market participants as structural and permanent....But what they perceive as newly abundant liquidity can readily disappear.”*

- Alan Greenspan, August 26, at a symposium sponsored by the Kansas City Fed in Jackson Hole, Wyoming.

Since the beginning of this tightening cycle, the Fed’s rhetoric about raising short term rates, as well as comments about their concerns on home equity extraction, financial leverage, and decreasing risk premiums have gone largely unnoticed at the long end of the yield curve. The Fed Funds rate hikes from 1.0% - 3.0% were widely expected, yet the 10-year note and the long bond remained unchanged in yield. Now that we are getting to the point where monetary policy is becoming less accommodative, the attention and scrutiny of each Fed move and comment increases exponentially.

Realizing that the first ten rate hikes did not lead to the desired outcome of risk reduction, the Fed essentially “raised its voice”. On Friday, August 26th, Greenspan’s comments at the Jackson Hole symposium were considered to be the most aggressive in this current Fed tightening cycle. The effects of his statements on bond yields were essentially delayed due to Hurricane Katrina wreaking havoc in the Gulf States the following Monday. Once the initial shock of Katrina diminished, the 10-year Treasury yield climbed from an intraday low near 4.0% on September 1st, to a yield of 4.5% over the next six weeks. Although the Treasury sell-off may have been provoked by Greenspan’s comments, the September Beige Book report, when coupled with hawkish comments made by

several Fed Governors during September, provided added fuel.

Entering the third quarter, many felt that a ‘neutral’ Fed Funds rate was the Fed’s final destination. As the Fed increased rates “at a measured pace” to the lower end of a ‘neutral’ zone, the Fed rhetoric seemed to become more hawkish. Even though the Fed continues to address inflation expectations, economic data indicate that longer term inflation is not a concern to investors. We must now wonder if ‘neutral’ is no longer the destination.

Since the early 1980’s, the Fed has been vocal about fighting inflation. However, higher input prices and lower long term Treasury yields are being driven by global factors beyond the Fed’s reach. The Fed is attempting to address what it can domestically, which is liquidity and risk premiums. Greenspan’s comments shed some light on a battle the Fed has been fighting, and most likely will continue to fight. In our opinion, if we hope to get a clearer picture on where the Fed will pause, we must view risk premiums with regard to various asset classes. If there is some unwinding of risk premiums when Fed Funds arrive at ‘neutral’, then perhaps the Fed will see room to pause; otherwise, ‘neutral’ may be a wishful dream.

# EMERGING MARKETS ECONOMIC COMMENTARY

LUIS MAIZEL, SENIOR MANAGING DIRECTOR

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The third quarter was again favorable for EMD in spite of the lateral move of the Treasury markets and two additional increases in the Fed Funds rate.

The economies of the emerging markets are mostly commodity based and with the dramatic increases seen in raw material prices ranging from oil to iron ore to bauxite, etc. their reserves have increased considerably and their foreign debt, as a percentage of GDP, has been reduced significantly. This created a much healthier picture for investors and led to the narrowest spreads since the indices were developed in the mid 1980's.

After Argentina exited from its restructuring, one of the major clouds over the entire asset class was eliminated and, even though the settlement was the equivalent of highway robbery, it was a good exercise in proving that individual emerging markets are well isolated from each other; none of the other Latin American countries (except Uruguay, its next door neighbor) were dragged down by the Argentinean crisis.

Brazil has been in the spotlight due to corruption accusations that included the Finance Minister but stopped short of reaching President Lula. If they don't implicate the President, I think the economic conditions, represented by a large trade surplus and a strengthening of the Real, will prevail; but if something comes out involving the President, then the situation could get messy.

Venezuela continues with very high revenues due to the spike in oil prices but the populist policies of President Chavez still create a government budget deficit. A drop in revenues could force them to stop servicing their debt obligations, so we continue to avoid Venezuelan debt.

Mexico is entering a tough political year with the leftist candidate leading in the early polls. Since the spreads on investment grade Mexican debt have narrowed to historically tight levels, we caution investors that the risk/reward relationship appears unattractive.

Large issuance by major borrowers in emerging country local currencies was met with a strong response from investors. We are still cautious as past experiences have shown that the solvency of these countries can change rapidly and currencies can be easily devalued.

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The Federal Reserve has continued to raise the Fed Funds Rate during 2005, culminating in a 4.00% level in November, 2005. The Fed is clearly concerned about elevated inflation pressures in an environment of sustained economic growth greater than 3.0% and higher energy and raw material prices.

The fixed income market changed its reaction to the continued rate hikes during the third quarter. Previously, the market displayed high volatility with severe curve flattening produced at both the short and long end of the yield curve; short rates rose as long term rates declined, an unusual occurrence. Although high volatility and directional change continued in the third quarter, yield curve movement became more parallel across the curve. In this environment, portfolio changes enacted in the previous quarter provided improved portfolio performance. The portfolio's slightly short duration relative to the benchmark, coupled with an overweight in corporate securities, contributed to the slightly better performance. The negative credit events that impacted the corporate sector in the second quarter have passed and some of those securities rebounded strongly in recent weeks. However, we are closely monitoring the auto sector in particular and plan to reduce our exposure to this area during the fourth quarter. While we do not expect to make changes to this strategy in the immediate future, we believe that the Fed's tightening cycle may come to a close early in 2006. Therefore, we might expect the market to rally in anticipation of this event and we are watching our economic indicators for signals that may prompt the FOMC to bring this tightening cycle to a close. These events would prompt us to lengthen the portfolio's duration and review our sector allocation weightings.

We believe bond investors are focused on the continued strong economic growth and rising inflation concerns. These factors are tempered by falling consumer confidence and the negative economic impact of a higher interest rate environment. The situation is further complicated by the retirement of Fed Chairman Greenspan and the direction that his successor, Dr. Ben Bernanke, will take in guiding the Fed. In this situation, we remain committed to follow the Trend Identification Score derived from our matrix of global economic data to guide our portfolio duration as we approach the New Year.

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## LM CAPITAL ADDS OVER \$128 MILLION IN NEW ASSETS

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LM Capital Group is very pleased to announce the addition of two new client relationships and the award of additional assets from an existing client. LM Capital Group was selected by Northern Trust Company of Connecticut to manage a \$30 million opportunistic core fixed income portfolio. In addition, LM Capital Group was chosen to work with Progress Investment Management and manage a \$28 million opportunistic core fixed income portfolio for Connecticut Horizon Fund.

Finally, Los Angeles Fire and Police awarded LM Capital Group an additional \$70 million in the opportunistic core portfolio to bring their total allocation to \$150 million.

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