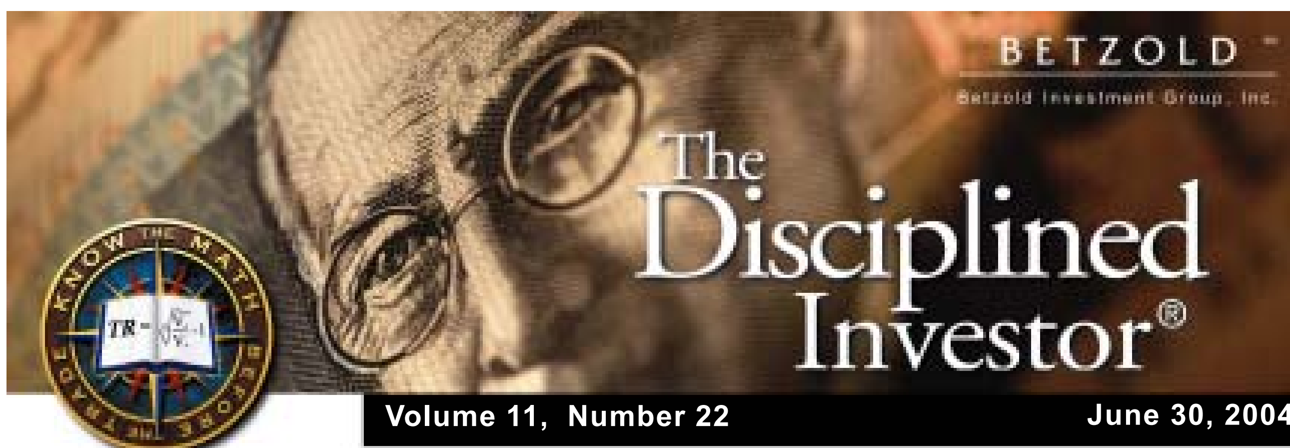

Volume 11, Number 22 **June 30, 2004**

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Disciplined Investors Don't Bet on Rates

Recently a group of top economists predicted the Federal Reserve would raise interest rates by at least 100 basis points over its next three meetings. Now that we all know where interest rates are going, can we just smile and go home or do we have to continue to manage our portfolios if we want success?

Economists Make Predictions

History teaches that when the top economists predict future interest rates, one of them is right. But it is rare indeed that the same economist is right two years in a row! We should all remember that in November 2002 the leading economists predicted that interest rates would rise steadily through 2003 to close the year 100 to 200 basis points higher.

That was hard to remember in June 2003 as mortgage rates neared their lowest level in 30 years, short term Treasury rates hit a 42 year low, and the ten-year Treasury rates neared a 45 year low. However, by November 2003,

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rates were back to unchanged from the prior November! So much for the 200 basis points rate rise predicted by the leading economists. Will the most recent prediction of a steady rise in interest rates by top economists really prove any more certain or accurate for the next 12 months?

In January 2004, the Institute for Trend Research (ITR) - one of the leading private economic firms – projected, in a meeting of CEOs representing many industries, that the US economy will experience a substantial economic slowdown by the second half of 2005. In June, the ITR noted that in April the three-month rate-of-change for retail sales hit a 38 year high only to be surpassed in May with a 48 year high, which would indicate, at least by this indicator, that the American consumer is taking advantage of historically low interest rates and buying in anticipation of higher rates. ITR also noted that crude oil prices were simultaneously experiencing dramatic rises. This would on the surface indicate that the days of cheap oil and natural gas are over, as is the age of deflation, and that inflation is now the issue of the day. Is a sustained rates up aggressive environment now upon us?

Remember that in January, ITR projected that by the latter half of 2005, the US economy would experience a substantial economic slowdown. That has not changed. ITR's leading indicator trends now suggest that we might not see a "soft-landing" in 2005-2006, but rather a severe recession.

Where will interest rates go during 2005 and 2006 if we have a recession? What if the event that the Federal Reserve is most worried about derailing the economy – another terrorist attack – occurs? What would be the economic impact of an attack, whether minor or major, one-time or sustained? The leading economists say any one of these could plunge the country into economic trouble. Where would interest rates go then? Would the Fed once more need to lower rates to avoid total financial chaos?

Given the above thoughts, are you prepared to decide whether interest rates are headed higher or lower in the coming years?

Remember Bond Math University®, where we learned about the dangers of relying on the conventional wisdom of economic forecasting and parametric analysis? Guessing interest rates does not build success.

Disciplined Investors Apply Shape Management®

When one realizes the level of uncertainty that actually exists as to what the next year or even the next month may bring, making rate predictions is not a prudent nor proven approach. It is the disciplined investor applying Shape Management® who consistently achieves the best total return and institutional success with his or her portfolio.

The experienced professional knows that this discipline is the most difficult to follow in a rising rate environment. But only disciplined Shape Management can show us where our portfolios will be in the various conflicting potential rate environments we now face. Under these conditions it is important for a disciplined portfolio manager to be proactive and focus on applying Shape Management to continuously tune the portfolio in order to address the dynamically changing conditions we see today.

Only through focused Shape Management and a proactive summer of managing your portfolio will the potential treacherous shoals of 2005 be avoided. Past experience teaches us that taking losses when necessary to achieve future success is never easy, but it leaves a better taste than the alternative the future otherwise inevitably brings. What "shape" is your portfolio in?

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