

THE FED AND ECONOMY

The FOMC minutes released last week lacked the surprise factor of the previous set, but did contain an interesting discussion of the implications of slower growth in productivity. Chairman Greenspan is proud that he was early in recognizing that the exceptional growth in labor productivity would be a major factor keeping inflation low. In these minutes, however, some members worried that unit labor costs had accelerated last year as productivity growth slowed. If businesses believe the increases in labor costs are permanent, cost pressures might be passed through rather quickly to consumer prices. Consequently, "careful attention would need to be paid to...unit labor costs and profit margins."



"No in-laws, no office parties, no shopping...I'm experiencing a post-holiday high."

Barron's

Despite those concerns, core inflation was expected to remain low, "assuming further removal of policy accommodation". Recent comments by the Chairman introduce some doubt about what "accommodation" means. Nearly everyone has assumed that it was a euphemism for the funds rate. That may be too simple. Mr. Greenspan may now be including bond yields and other measures of financial conditions in his definition of accommodation. That would explain why he spent so much time discussing the behavior of those yields when he appeared before Congress. The removal of policy accommodation necessary to keep inflation low may include getting note and bond yields somewhat higher than they are now. If so, the Fed has barely begun the task of removing accommodation.

Attention now shifts to the employment data to be released on Friday. The consensus forecast for payroll employment of around 225,000 incorporates some rebound from weather related softness during January. There is a risk that the consensus forecast is too conservative. Labor Department data found considerable evidence that bad weather affected a variety of industries, including manufacturing and construction. An above-consensus jump in employment would not change the most likely outcome of the next FOMC meeting, but it would be another indication that the economy remains quite robust despite the 150 basis point rise in the funds rate.

THE MARKETS

For the second consecutive month, the high yield market was the outlier in the performance derby. In January, it recorded a negative total return when other sectors had positive results, and in February it has a strong positive total return while most other sectors did poorly. Some of the recovery in high yield occurred during the final days of January when fears of a GM downgrade subsided. That was a huge relief to the market, and the more confident tone carried into February. Credit fundamentals, particularly corporate cash flow, remain excellent and a strong force for narrow high-yield spreads.

BOND MARKET TOTAL RETURNS

Market	2002	2003	2004	Jan.05	Feb. 05	YTD
Master Index	10.40%	4.12%	4.34%	0.65%	-0.25%	0.40%
Corporate	10.15%	8.30%	5.42%	0.81%	-0.25%	0.55%
Treasuries	11.55%	2.25%	3.50%	0.72%	-0.45%	0.30%
Agencies	10.75%	2.60%	3.26%	0.40%	-0.25%	0.15%
Mortgages	9.40%	3.30%	4.74%	0.55%	-0.15%	0.40%
Asset Backed	4.85%	2.25%	2.33%	0.29%	0.12%	0.40%
High-Yield	-1.15%	27.20%	10.76%	-0.08%	1.45%	1.35%
Municipal	10.70%	6.18%	5.45%	0.96%	0.01%	0.98%
2yr Treasury	6.85%	2.20%	0.75%	-0.11%	-0.20%	-0.33%
5yr Treasury	12.35%	2.40%	2.40%	-0.06%	-0.70%	-0.75%
10yr Treasury	14.60%	1.15%	4.83%	1.02%	-0.90%	0.10%
30yr Treasury	16.25%	0.65%	8.88%	3.80%	-0.50%	3.30%

Source: Merrill Lynch

In another departure from recent experience, the longer Treasury maturities performed worse than the 2- and 3-year notes. The yield curve flattened somewhat further in February, but not enough to prevent bigger price declines on the longer notes and bonds. Perhaps Mr. Greenspan will find the February performance pattern less of a conundrum than that of January and most of 2004. It is too early to conclude that the bull-flattening phase of this cycle has ended, but the long end of the Treasury market lost much of its optimism in the past two weeks.

The relatively short duration sectors—MBS and ABS—performed reasonably well in February, as would be expected when yields are rising. Thus far in 2005, the performance of the mortgage market has equaled that of the investment grade corporate market. Among the corporates, the BBB credits continue to perform better than the stronger credits. Within the Government sector, agencies performed much better than Treasuries, in large part because of aggressive debt buybacks by FNMA and prospects of less new-issue supply in the future.

The municipal market performed quite well in February, despite the longer average duration. Demand from the P&C companies remains excellent and individual investors have been active despite the low yields. A portion of the individual demand was probably seasonal in nature, so this market may have difficulty sustaining the January-February performance record in the months ahead.

ECONOMIC RELEASES FOR 02/28-03/04

Date	Time (CST)	Indicator	Prior	Projected	Actual
2/28	7:30	Personal Income (Jan)	3.7%	-2.6%	-2.3%
2/28	7:30	Personal Spending (Jan)	0.8%	0.1%	0.0%
2/28	7:30	PCE Deflator Y-o-Y (Jan)	2.4%	2.2%	2.2%
2/28	7:30	PCE Core Y-o-Y (Jan)	1.5%	1.5%	1.6%
2/28	9:00	New Home Sales (Jan)	1098K	1125K	
2/28	9:00	Chicago Purchasing Manager (Feb)	62.4	60.5	
3/1	9:00	Construction Spending M-o-M (Jan)	1.1%	0.4%	
3/1	9:00	ISM Manufacturing (Feb)	56.4	56.9	
3/1	9:00	ISM Prices Paid (Feb)	69.0	67.0	
3/1		Total Vehicle Sales (Feb)	16.2M	16.6M	
3/1		Domestic Vehicles Sales (Feb)	13.0M	13.4M	
3/1	5:30	ABC Consumer Confidence (Feb 27)	-11		
3/2	6:00	MBA Mortgage Applications (Feb 25)	-0.6%		
3/3	7:30	Nonfarm Productivity (4Q F)	0.8%	1.5%	
3/3	7:30	Unit Labor Costs (4Q F)	2.3%	1.8%	
3/3	7:30	Initial Jobless Claims (Feb 26)	312K	310K	
3/3	7:30	Continuing Claims (Feb 19)	2650K	2665K	
3/3	9:00	ISM Non-Manufacturing (Feb)	59.2	60.0	
3/4	7:30	Unemployment Rate (Feb)	5.2%	5.2%	
3/4	7:30	Average Hourly Earnings M-o-M (Feb)	0.2%	0.2%	
3/4	7:30	Average Hourly Earning Y-o-Y (Feb)	2.6%		
3/4	7:30	Change in Nonfarm Payrolls (Feb)	146K	225K	
3/4	7:30	Change in Manufact. Payrolls (Feb)	-25K	8K	
3/4	7:30	Average Weekly Hours (Feb)	33.7	33.8	
3/4	8:45	U. of Michigan Confidence (Feb F)	94.2	94.3	
3/4	9:00	Factory Orders (Jan)	0.3%	0.0%	

Source: Bloomberg

BOTTOM LINE

Employment data are always important, but in recent days, other, more fundamental considerations have taken hold in the bond markets. Mr. Greenspan's comments on the yield curve are now widely viewed as a warning that he regards the longer notes and bonds

as mispriced. The report that South Korea may buy fewer dollar denominated assets suggests that some central banks share the Chairman's view. Even a friendly CPI report did not dispel the gloom, perhaps because too many other inflation indicators are flashing yellow. Over the past two weeks, the CRB index of spot prices of raw materials has resumed an uptrend. The FOMC minutes suggested that we pay close attention to unit labor costs. In view of this growing list of troublesome developments, employment figures that are somewhat stronger or weaker than consensus may not be as meaningful as they have been over the past two years.

Since last August, the 10-year Treasury yield range has been essentially 4% to 4.40%, with very little time spent above 4.30%. Once again, a decline in the yield to below 4% proved to be a good sell signal. A yield above 4.30% has been a buy signal, and may be again as long as inflation stays low and the Fed stays with its go-slow strategy. It is worth noting, however, that this yield was around 4.60% before the Fed started tightening last June. Mr. Greenspan may now be inclined to keep raising the funds rate until that yield moves back to or above that level. That would be one indication that monetary policy, as measured by financial conditions, was in fact becoming less accommodative.

WEEKEND PRESS

Business Week

The latest jump in oil prices comes at a bad time for the world economy. Growth has slowed in several industrialized nations. In Japan, GDP contracted at a 0.5% annual rate last quarter, the third consecutive drop. Much of the fourth quarter weakness may have been due to extremely bad weather. In Germany, GDP fell at a 0.9% rate and in Italy, GDP fell at a 1.2% annual rate. Growth in the developed world was already expected to be slower than in 2004, and now high oil prices are further depressing consumer demand.

Emerging countries may be hurt even more by high oil prices because they are less energy efficient. China uses 10 times more energy per unit of GDP than does Japan. India uses 2-1/2 times as much energy per unit of GDP than the U.S.

In February, the Conference Board's measure of optimism about the current state of the economy finally moved back to the level that was reported just before the 9/11 attacks.

A weaker dollar will not narrow the trade deficit anytime soon. Imports outnumber exports by 3 to 2, so exports would need to grow at a 15% rate just to keep the gap steady if import growth were to be around 10%. Exports have not grown that fast since 1997, when world growth was much stronger than now.

Real GDP grew at a 4% rate last year in Mexico, the best since 2000. It could grow by as much as 4.5% in 2005.

The forces that kept inflation low are starting to weaken. Unit labor costs have increased in each of the last three quarters because productivity growth has been slowing. With no signs the economy is slowing from the good 2004 growth pace, companies are starting to push through more price increases. Dow Chemical has raised prices 30% over the past year, and has no plans to stop. Caterpillar has raised prices 9% over the past year. Eaton will no longer absorb cost increases as they did last year. Prices of semi-finished goods excluding energy and food are up 8.5% over the past 12 months, the fastest since the early 1980s.

Over the past year, prices of imports from industrialized nations are up 6.7%, but prices of Chinese imports are down 0.7%. This China effect has been an important factor keeping inflation low in the U.S. Any revaluation of the Chinese currency would put further upward pressure on import prices.

Many multi national companies do not want China to revalue the currency. They have invested billions in China and benefit from the low costs of production in that country. Also, China imported \$560 billion last year, and had a trade surplus with the rest of the world of only \$32 billion. Its surplus with the U.S. was \$160 billion

Barron's

The surge in issuance of CCC bonds may be creating big potential problems for the years ahead. In 2004, 20% of bonds issued in the U.S. were CCC rated, versus only 7% in 2003. The previous peak was 17% in 1988, and default rates jumped to over 10% in 1990 and remained there in 1991. The 10-year cumulative default rate for CCC bonds is 50%.

In his latest report, Bill Gross says that yields on Treasuries are artificially low by 50 to 100 basis points across the curve. He argues that 4% is the floor for the 10-year yield, and it is now time to get defensive.

The S&P 500 ended last week at 1211, or almost back to the early January high of 1217.

Equity mutual funds attracted \$1.9 billion last week, while money market funds lost \$1.8 billion. Taxable and muni bond funds gained \$420 and \$160 million, respectively.

The currency analyst from MG Financial Group suggests that many central banks are gradually diversifying their portfolios despite the denials last week. The fact that one line in a report from South Korea could create such a negative response in the markets reflects the stark realities of the dollar's dependence on these banks.

N.Y. Times

Gold is having the best run in 17 years. The price has been above \$400 an ounce for 170 consecutive days, the longest such run since 1987-88. Since the current run started on Sept. 10, the dollar is down 7.4% against the euro and gold is up 8.4%.

Henry Kaufman believes that the dollar will remain a reserve currency because the U.S. economy is performing so well. He expects the U.S. deficit to be financed as follows: Japan will continue to buy about \$200 billion per year; China will probably buy \$100 billion; the Fed will buy at least \$50 billion; oil exporting countries will buy up to \$75 billion; so there will not be much left for domestic investors to finance.

The Economist

The Fed's easy money policy is helping to produce the fastest growth in world liquidity in at least 30 years. One measure of world liquidity is the combination of the Fed's monetary base and foreign exchange reserves held by central banks around the world. That total grew at a 20% rate in 2003 and 2004. In no 2-year period since 1975 has liquidity grown that rapidly.

Institutional Fixed Income Portfolio Strategies & Analytics Group 615-341-6002

- **Additional information is available upon request.**
- **Baird or its employees may have a long or short position in the securities mentioned, and buy or sell the securities from time to time.**
- **The information contained herein has been obtained from sources we consider reliable, but we cannot guarantee the accuracy.**

This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. Baird may function as a market maker in any of these securities trading in the over the counter market. Publication of this document in the United Kingdom is directed at, and is only made available to, authorized persons and other persons falling within COB 3.2.5(1) (b) of the FSA Handbook, and may not be distributed to private clients. Issued in the United Kingdom by Robert W. Baird Limited, which has an office at Mint House 77 Mansell Street, London, E1 8AF, and is a company regulated by the FSA. The Dow Jones Industrial Average, S&P 500, S&P 400 and Russell 2000 are unmanaged common stock indices used to measure and report performance of various sectors of the stock market; direct investment in indices is not available. OUR COMPANY OR ITS OFFICERS, EMPLOYEES OR CUSTOMERS MAY HAVE A POSITION LONG OR SHORT IN THE SECURITIES MENTIONED AND BUY OR SELL THE SECURITIES FROM TIME TO TIME..