Aftermath of the Interest Rate "Shock"

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Introduction

The markets have been for waiting for Alan Greenspan and the Fed to raise interest rates for some time. Pundits have predicted and debated when and by how much the Fed would raise rates for well over a year. As of the middle of June, we are all still waiting and guessing. In the wake of powerful fiscal stimulus, and with interest rates hovering near multi-decade lows, it should not have been a shock to investors that evidence would mount in support of a rate increase. Yet without any Fed action, April turned out to be one of the cruelest months in recent years for investors in fixed income and hybrid securities. The market downdraft in April, and its subsequent aftermath, provides an important case study of market action, overreaction, and rebound. Furthermore, recent market behavior highlights some of the benefits of both long-standing and newer principles of MDE's approach to wealth management; i.e., risk control through diversification, independent and forward-looking thinking, and our "blurring of the lines" themes. Below, we review recent market events and offer our views on the best ways to position your portfolio for the future.

What Caused the Sharp Rise in Market Interest Rates?

The April interest rate "shock" was not caused by the Federal Reserve increasing the "Fed Funds" rate (i.e. the interest rate it charges member banks). In its March meeting the Fed merely shifted to a "neutral" stance and indicated that a continuation of current economic trends may result in "measured" rate increases in the period ahead. However, *market* interest rates quickly reacted – perhaps overreacted – to the Fed's comments, in conjunction with contemporaneous reports of stronger economic data. In April, a number of other factors added fuel and fear to the fire, resulting in sharp movements across a number of international stock and bond markets. The most relevant of these exacerbating factors were:

- The controversy surrounding the treatment of Iraqi prisoners by some U.S. soldiers which increased political tensions and raised fresh doubts about President Bush's reelection chances.

- Oil prices passed the psychologically important $40 a barrel figure.

- China, an important global trading partner for much of the industrialized world, signaled that it was looking to slow its pace of economic growth in an effort to reduce the threat of inflation. Furthermore, there were worsening political relations between Taiwan and China.

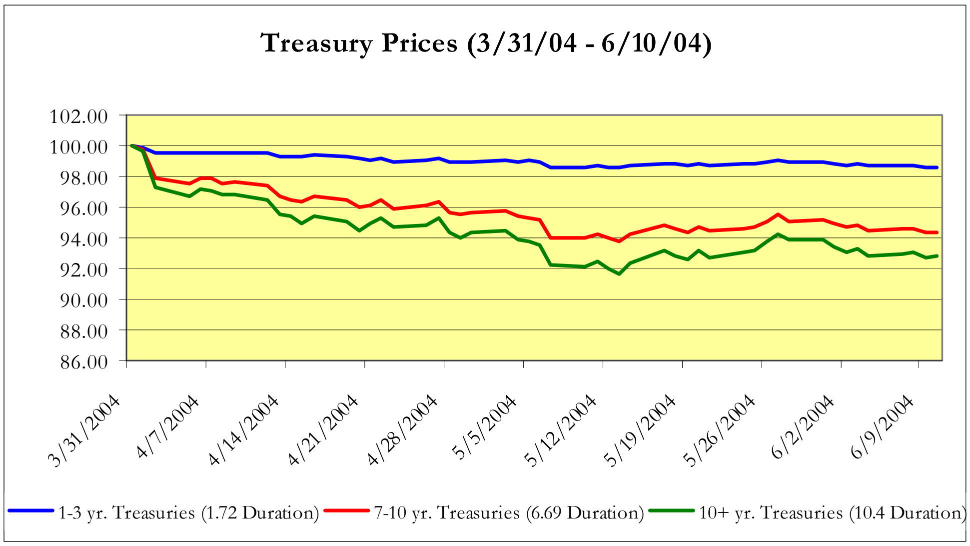
- India experienced a dose of political turmoil of its own with the expected election, then resignation, of Sonia Ghandi.

- Since approximately 50% of the trading volume is driven by short-term investors (e.g. day traders, hedge funds, Wall Street trading desks, etc.), "hot money" investors further exacerbated the downward trend by following their momentum strategies.

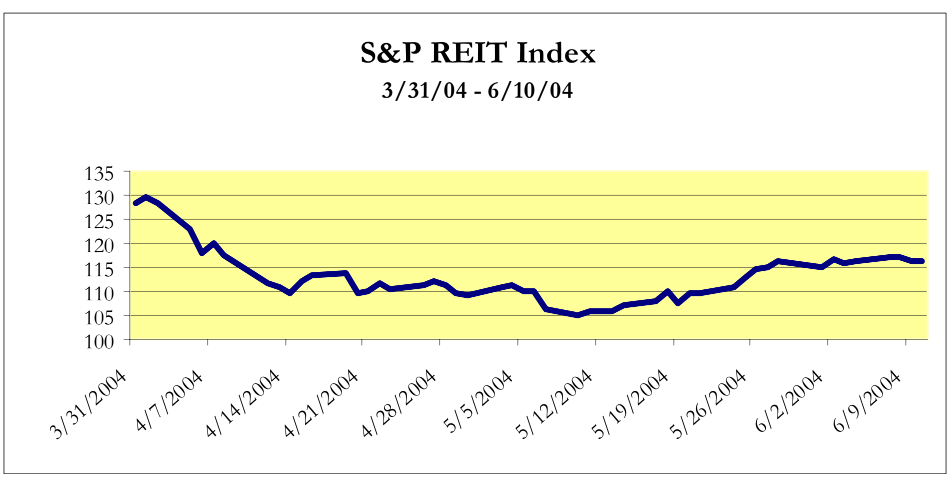
The end result was that virtually any security with an interest rate or international element experienced short-term pain, regardless of the economic fundamentals. However, sometimes the market gets it wrong and throws the "baby out with the bathwater" revealing a number of interesting opportunities for those with the fortitude to boldly tread in a milieu of market fear.

How Did Various Asset Classes React to the Interest Rate "Shock"?

The paradox of the interest rate shock is that many of the most conservative investments, according to historical risk/return metrics, experienced the largest losses. By way of example, even after recovering from their lowest levels in the middle of May, short-term treasury notes lost 1.46% of their value from 3/31/04 - 6/10/04. During this same time period, the more interest sensitive medium-term and long-term treasury bonds respectively lost 5.64% and 7.20% of value.



In comparison, Real Estate Investment Trusts ("REITs"), generally viewed as far less volatile than stocks, fell 18.14% in a little over a month. However, since many REITs, such as hospital or apartment REITs, have little correlation with interest rates, it is clear in retrospect that the market overreacted in anticipation of higher interest rates. As cooler heads prevailed, the REIT index surged upward 11.41% from its bottom in less than one month. The volatility displayed by REITs over this two-month period is more reminiscent of the movement of Internet stocks than of relatively conservative income generating investments.



Likewise, the performance of Master Limited Partnerships ("MLPs") over a similar time period further illustrates the dramatic volatility experienced by hybrid or alternative income investments. The MLP universe fell 17.08% in anticipation of rising interest rates before experiencing an 8.13% rebound from its trough. Such volatility represents an extreme overreaction to anticipated interest rate increases since the fundamental businesses of many MLPs will be unaffected by a rise in rates.

The table below summarizes the reaction to an anticipated interest rate increase of various asset classes over the April - May time period.

Asset Class	Trough	Peak	3/31/04 to Trough	Trough to Peak
10-year Government Bond	5/13/2004	5/27/2004	-7.86	2.27
10-year Corporate Bond	5/13/2004	5/31/2004	-7.63	2.25
Convertible Bond	5/17/2004	6/8/2004	-3.86	3.65
REITs	5/10/2004	6/7/2004	-18.14	11.41
MLPs	5/10/2004	6/1/2004	-17.08	8.13
Market-neutral Hedge Funds	5/7/2004	6/3/2004	-1.79	0.98
Domestic Equity	5/17/2004	6/8/2004	-3.74	5.36
International Equity	5/17/2004	6/8/2004	-5.58	6.76

What is the Antidote to Interest Rate and Stock Market Volatility?

Many investors are unsettled by a world turned upside down where historically conservative investments have generated the worst returns – at least over a narrowly prescribed time period. The table above reinforces the notion that there is no single investment that is right for all market conditions. Although we at MDE do not have a crystal ball that will predict the future, we can confidently say that diversification across a number of asset classes will reduce risk. In recent years we have expanded our client portfolios to include hedge funds and a number of hybrid or combination equity/fixed income vehicles. By blurring the lines across investment categories, we can reduce damage from an unexpected market "shock" that, by definition, is unpredictable. Moreover, when the market overreacts to such shocks, our independent thinking may enable us to move against the crowd and earn superior returns. As illustrated by the above table, investors who sold in the wake of the April panic would have missed the rebound from mid-May to the present.

The prospect of rising interest rates will remain with us for some time to come. We previously published a research report entitled "Strategies For A Rising Interest Rate Environment" that more fully explains our views on interest rates and various hedging strategies available to our clients. We continue to believe our "blurring the lines" investment theme is the best way to navigate the ever present and perhaps increasing market volatility. We note that the market has already priced in a 100 basis point rise in interest rates. Therefore, only a large unexpected rise in interest rates should persuade investors to make wholesale changes to their portfolios. In addition, research has shown that interest rate rises are not necessarily bad for the stock market, as long as they are moderate in nature and not dramatic. Your MDE Wealth Management advisor stands ready to assist you in implementing our diversification and blurring of the lines antidote for market volatility.

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