THE Neal Spelce AUSTIN LETTER

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Dear Client:

Short-term interest rates are at the *highest* level since shortly after the 9/11/01 terrorist attacks. But rates on 30-year mortgages have fallen to their *lowest* level in 15 months.

We first pointed out this dichotomy a month ago (6/10/05). But it is so significant we need to explore it further. This trend has been in the making for some time now, so the question is – will it continue? You need to break that question into two parts to get a better answer.

The first part, short-term rates, is the relatively easy part. The Federal Reserve Board recently raised short-term interest rates for the ninth time in a year. In so doing, **they gave no indication they intend to pause anytime soon in their campaign to tighten your credit**. Just the opposite. The central bankers said they expect to continue to raise rates at a "measured pace."

It's almost as if the Feds are operating on autopilot. This means you can **look for another quarter of a percentage point hike 8/8/05** when the policy-makers next meet. So, if you wait another month to go to your bank to borrow money, it will cost you more. And, if your line of credit is tied to prime, it will jump a bit more. Your sliding scale credit card debt will also go up next month. It's a safe bet this trend will continue.

The 2nd point – long-term mortgage debt — is a bit dicey to predict. Looking *back*, the trend is clear. Rates on long-term mortgages have been *falling* over the past year – even as short-term rates have *risen* steadily from their lowest level in 46 years. **It's almost as if the two rates are moving in opposite lock-step**. But, looking *forward*, whether this will continue – and long-term debt will continue to drop – is subject to much speculation. You need to hedge your bet on this one.

Given that short-term rates will continue to rise and the future trend for long-term rates is iffy at best, one course of action pops up as pretty clear for both areas. You would be well-advised to **lock-in a rate for your anticipated bank borrowings** (because the rates will keep going up) and you need to **lock-in a rate for your mortgage or home re-financing** (because the future is uncertain and the rate is at its lowest level in more than a year).

Either way, it's wise to avoid procrastination and make a decision as soon as possible.

You can thank the Chinese for your low mortgage rates. Say, what? That's right, China.

Mortgage interest rates are not tied to the prime rate. They are functions of the rates paid for US Treasury bonds. Now, don't let your eyes glaze over. A strong demand for Treasury bonds means the less the Treasury has to pay in interest rates to sell them. **These low interest rates keep your home mortgages low. John W. Schoen** has the reasons why China is playing a big role in keeping your home mortgage at a low level. Stay with me now, this is interesting.

> Say you buy a new pair of sneakers at Wal-Mart (or tires, or kitchenware, or electronics) that were made outside the US. A few of your dollars end up at Wal-Mart. A few more wind up in the US import company. A few more go to the truckers and cargo companies that brought them to the US. **But a significant chunk of your dollars end up in the country where the products were made.**
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> Okay, you're following along so far. Last year, something like $650 billion ended up outside the US. China, had the biggest part of that, with $162 billion. **So, what would you do if you were China with all that money from the US?** You can't spend it on goods and services because your country has bought all the stuff from the US that it needs, wants or can afford.
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> You could put it in a bank, but for many countries holding surplus trade dollars, especially those with shaky banking systems, this is not necessarily the safest place to put it. **But US Treasuries are still one of the safest places in the world to stash cash. And there is one other factor – the value of the dollar.**
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> One reason China is getting so much attention – aside from the huge chunk of the trade deficit it generates – is that it has kept its own currency (the yuan) artificially low by pegging it to the dollar.

President **George W. Bush** has been pushing the Chinese to let the yuan float. If the yuan rises against the dollar, Chinese products don't look so cheap anymore. But China has been resisting the move, according to Schoen, in part because it **already holds close to $225 billion in US Treasuries**. Stay with me now. If the dollar weakens relative to the yuan, that investment in treasuries shrinks in local value. By keeping the yuan fixed, Chinese officials are preserving the value of their investment and this keeps your mortgage rates low.

> If the dollar slides gradually, all this may work out just fine. But a *sharp drop* in the dollar would almost certainly bring **higher long-term interest rates in the US**.

Nobody wants to buy US treasuries if they know they're going to be worth less tomorrow. **So if foreigners, especially the Chinese, stop buying the paper used to fund our federal spending spree, long-term interest rates could rise sharply.** This is something to think about next time you're looking for a new pair of sneakers at Wal-Mart.

There are some interesting developments affecting the major airlines that serve Austin. In fact, if you haven't been following this closely, the trend may be surprising.

Most airline observers know **Austin's #1 carrier**, **Southwest Airlines**, has been profitable every quarter – even during the tragic days following 9/11/01. Its market cap almost triples all other major airlines combined. Conversely, the troubles of all other airlines, including **Austin's #2 carrier**, **American Airlines**, have been well chronicled. Hardly a month has gone by since 9/11 that someone hasn't predicted the death of some of the large legacy airlines.

> But, hey, there's an interesting dynamic developing. First of all, here at home, **American Airlines increased its passenger traffic at Austin-Bergstrom International Airport (ABIA) in May 2005 by 15%** over May 2004. Southwest was up by only 0.3%. American is showing some real competitive strength. Southwest is still dominant at ABIA, but American is gaining on the Top Dog.

Is Ft. Worth-based American finally overcoming the overall airline industry problems, as well as the fact the terrorists used AA airliners in the 9/11/01 terrorist attack on the US? Could be. Consider this. AA's parent, AMR Corp, tallied a loss of $162 million in the first quarter 2005. **But, had AA paid the same price for jet fuel that it paid a year earlier, AMR would have earned a *profit* of $184 million**. Think about this. Only inordinately high fuel prices that have hammered all of us kept American Airlines from making a tidy profit.

> How has this happened? American persuaded its union employees to work more efficiently, including longer hours at lower pay rates. It has smoothed schedules at its hubs to boost efficiency of operation. And – this is key – it is slowly **winning back travelers from the discounters**, such as Southwest, by simplifying its fare structure and capping business fares.

Dallas-based Southwest, on the other hand, is making changes that some say are a bit riskier. The airline expects to **increase its capacity** this year by at least 10% (as other airlines are shrinking). It will add 29 planes to its fleet of 417 Boeing 737s. It's **going into bigger markets** it has avoided in the past. In fact some observers are saying Southwest may actually be **creating a hub** – or what passes for it – at Chicago's Midway Airport, where Southwest has just added daily non-stops to Austin.

> All this change is occurring at the same time other airlines are emulating Southwest Airlines' former business model. The gap is closing. **Southwest is becoming more like the legacy airlines and many legacy airlines are becoming more like the old Southwest** – at the same time upstart airlines such as JetBlue are trying to be "Southwest, with amenities."

These new flight plans for American and Southwest will have an important impact on Austin's economic vitality. We'll continue tracking them for you.

Ever since the printed word became commonplace there have been mistakes. And some have turned out humorously. It's even more fun when the corrections compound the error.

A classic error occurred recently on CNN. It wasn't the correction, but the response, that generated the most humor. CNN reported in a story about an aging **Alan Greenspan** that the Chairman of the Federal Reserve Board had been hospitalized because of an "**enlarged *prostitute***." His wife, NBC's **Andrea Mitchell**, responded "**He should be so lucky**!" and that got more attention than the correction (CNN, of course, said it meant *prostate*).

But the corrections themselves are sometimes more interesting than the errors. One of the classic corrections was printed in the *San Antonio News*. Follow along. "The pilot was **not a former Air Force pilot**, as reported, but had been in the Air Force pilot training program … He **wasn't flying an aircraft** owned by Beck Concrete Co. He was in a plane owned by Crow Aviation Co., where he was a student working toward a commercial pilot's license."

Hang on, there's more to this newspaper correction. "He was not making a mechanical check of the plane and was **not trying to land**. He was making a low-level pass. He was **not trying to lower the landing gear**. He had been flying in a two-plane formation with Harry Perez, **not Joe Perez**, and Perez did not circle the area until help arrived. Perez was already on the ground when the crash happened … **The victim was not trapped** between the instrument panel and engine, but between the seat and the instrument panel."

What in the world did the editor say when asked how such an error-filled story could get printed in his newspaper? His response: "**That reporter didn't know a danged thing**!"

Dr. Louis Overholster's favorite correction itself needed correcting. Check the spelling here. "Our newspaper carried the notice last week that Mr. Oscar Hoffnagle is a defective on the police force. This was a typographical error. Mr. Hoffnagle is, of course, a detective on the police farce."

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Sincerely

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