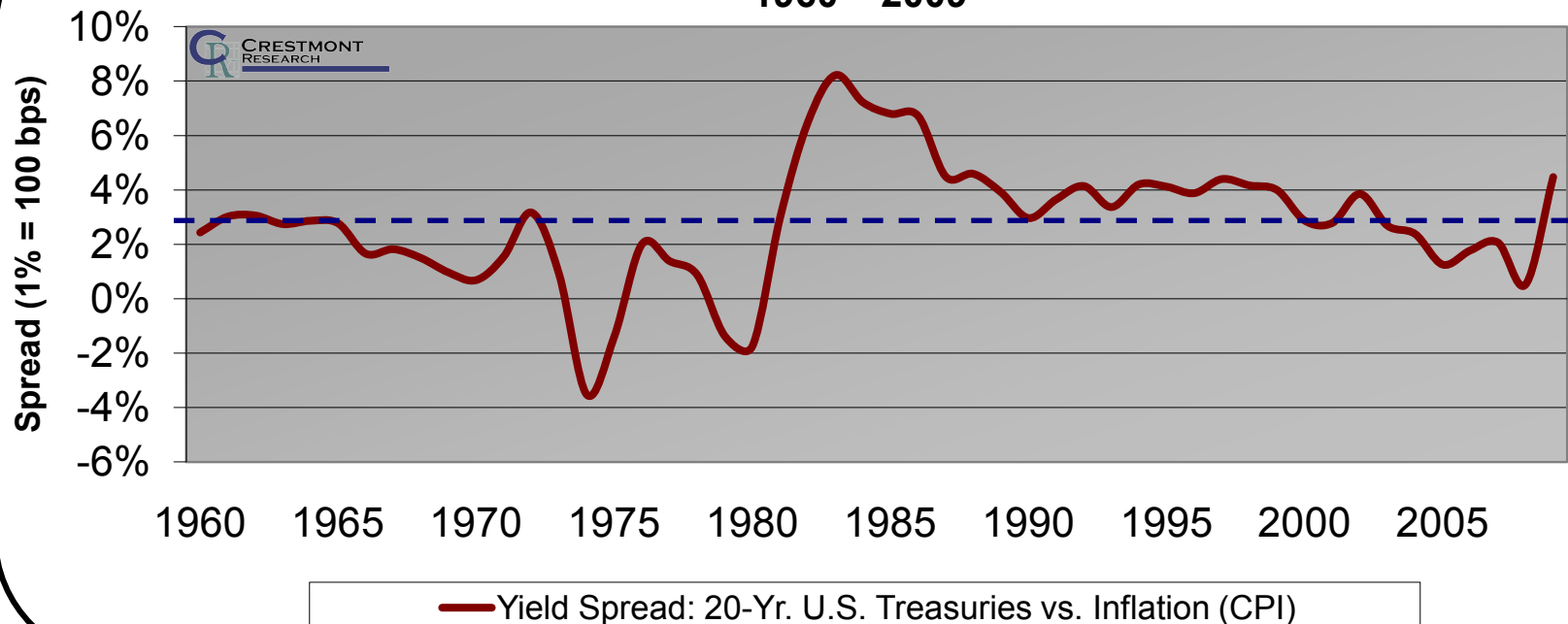


TREASURY BOND SPREAD OVER INFLATION (CPI) 1960 – 2009



DECADE	SPREAD AVERAGE	INFLATION (CPI) AVERAGE
1960s	2.3%	2.4%
1970s	0.4%	7.1%
1980s	5.0%	5.6%
1990s	3.9%	3.0%
2000s	2.5%	2.6%

BOND YIELDS: REASONABLE EXPECTATIONS

Is 4% on the 10-year Treasury bond high, low, or just about right? Although the average spread for Treasury bonds over the inflation rate has been 2.8%, the average consists of periods that were above the average and periods that were below the average. Specifically, the 1960s reflected fairly modest inflation and a spread of 2.3%. The inflation-infected 1970s surprised bond investors and they were slow to adjust their required returns. By the 1980s, much like a battered insurance company that raises premiums, the inflation spread rose to 5.0% to adjust to the newly-realized inflation risks.

As Volker and Greenspan at the Fed maintained a campaign to tame and control inflation, the bond market began to calm its demand for an inflation-risk premium. By the 1990s, the inflation spread declined to 3.9%. For the 2000s, the spread averaged 2.5%—despite its recent surge to more than 4% as a result of the near-zero short-term rate policy. In the longer-run, the Bernanke Fed appears to be targeting inflation between 1% and 2%. By adding a 2%-3% inflation-risk spread, 4% or lower may be just about right for the 20-year bond. As for the 10-year, something in the 3% range appears to be a reasonable yield for now.

During 2010, the Fed is expected to begin raising short-term interest rates. Reports may begin soon about Conundrum II...the redux of the period in 2005 when long-term interest rates (yields) remained low as the Fed raised short-term rates. As/If the Fed again demonstrates its conviction to control inflation, we should not be surprised to see bond yields remain steady or even decline based upon historical spreads over inflation.