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# A Savvy Bond Man Bets on Rising Inflation

*Tedford Sees Price Pressures; Time to Buy Timber?*

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By **JEFF D. OPDYKE**

Bill Tedford is encouraging investors to bet against remarks by Federal Reserve Chairman Ben Bernanke, who told a group of Washington-area business leaders this month that "inflation could move lower from here."



Rick McFarland for The Wall Street Journal  
Bill Tedford, shown on the trading floor at Stephens on Dec. 9, says that inflation is already evident.

For more than 20 years, Mr. Tedford has run a benchmark-beating bond portfolio for Little Rock, Ark.,-based Stephens Inc. And though Mr. Bernanke sees slack in the economy that could push inflation down, Mr. Tedford says inflation already is evident in the consumer-price index and will lurch higher in 2010 and 2011.

He and Stephens have begun encouraging clients to invest more money in timber, oil and gas, agricultural commodities and industrial and precious metals—historically good places to be amid rising inflation.

"The alarming part," Mr. Tedford says, "is the possibility that inflation could explode beyond the numbers we're looking at."

Across the country these days debate rages about whether U.S. fiscal policy has primed the country for a bout of inflation—and just how bad any inflation might be. Count Mr. Tedford among the group of inflation bugs who worry that all the dollars now sloshing around the economy can only have an inflationary outcome.

Also in his camp: John Paulson, the hedge-fund manager who made billions betting mortgage-backed securities would implode. Mr. Paulson, who is starting a new gold fund, told an investment conference earlier this fall that the nation's exploding monetary base is a harbinger of inflation.

For 20 years Mr. Tedford has managed a portfolio now amounting to about \$1.25 billion, including \$800 million in government bonds. During that time, his audited performance has topped the benchmark Barclays U.S. Intermediate Government Bond Index in the one-, three-, five-, 10-, 15- and 20-year periods. In the 12 months ended Sept. 30, his 8.87% return outpaced the index by more than 2.6 percentage points.

Because his focus is riskless U.S. government debt, Mr. Tedford's only concern is federal economic policy and the outlook for inflation. And these days, the model he has relied on for two decades insists that inflation is bubbling to the surface.

The key data point in Mr. Tedford's model: the monetary base, basically money circulating through the public or reserves banks on deposit with the Federal Reserve. Over long sweeps of time, he says, inflation closely tracks increases in the monetary base that exceed economic growth.

For instance, he notes, in the 40 years to 2007 the U.S. monetary base grew at 7.08% a year. Gross domestic product, meanwhile, grew at 3.04%. The resulting surplus monetary-base growth of 4.04% closely matches CPI and the personal-consumption-expenditures price index, another measure of overall inflation.

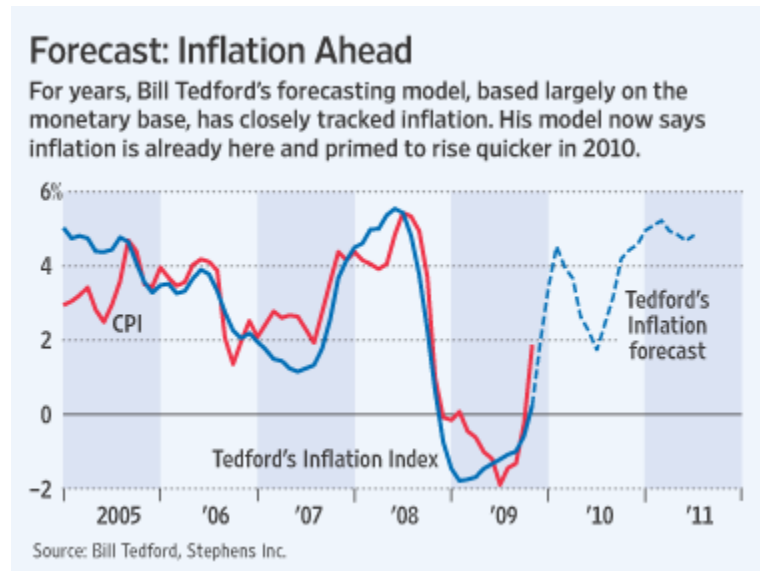
In the wake of the U.S.-inspired global financial crisis, the nation's monetary base has ballooned to more than \$2 trillion at the end of November from less than \$850 billion in August 2008, before the crisis began, according to Federal Reserve data. Even subtracting the more than \$1 trillion in excess reserves, the nation's monetary base has grown by more than 11% in the past 15 months, "one of the highest changes I've ever measured." Mr. Tedford says.

U.S. GDP during that period shrank by about 2%.

"The weight of that sharply increased monetary base points to significant inflation in 2010 and into 2011," he says.

His model "anticipates that trailing 12-month CPI goes positive by the end of this year, up to 3% or 4% by the end of 2010, and then toward 5% or 6% by mid-2011." And if some of the excess

reserves start leaking into the banking system, as Mr. Tedford thinks is happening, "inflation could go much higher."



At an investment conference in September, Mr. Paulson, the hedge-fund manager, told attendees the monetary base has enlarged at a historic rate, and that his play is to own gold, which is likely to rise even more than it already has if inflation takes off.

Though there is a gap between a rising monetary base and inflation, Mr. Paulson told the crowd that the economy can't grow fast enough to absorb all the money now in the system and, thus, inflation is the most likely result. A spokesman for Mr. Paulson declined to comment.

Already, Mr. Tedford says, inflation is apparent. While the unadjusted year-over-year CPI reading for October showed prices sank by 0.2%, the year-to-date change since January indicates prices are up more than 2.3%.

Not all economists buy into Mr. Tedford's thesis. "You cannot simply look at monetary base and come to a conclusion about inflation," says Sung Won Sohn, economics professor at California State University Channel Islands. Though the monetary base is up, Dr. Sohn notes the velocity of money—the rate at which currency circulates in an economy—is down, meaning price pressures are low because money is changing hands more slowly.

Andrew Tilton, senior economist at Goldman Sachs, says that while monetary base can play into inflation, "it's banks' willingness to lend, and private-sector demand for credit" that drives money in circulation. "The bottom line is that it takes a long time for monetary base to translate into inflation, and by then the Fed will be in tightening mode."

To be sure, Mr. Tedford's model has had its disappointments. In summer 2004 it foresaw inflation as the Fed began raising interest rates from around 1%. Yet Treasury bonds acted squirrely and fell rather than rose, as they had historically done.

For two years Mr. Tedford's bond portfolio trailed its benchmark by as much as 1.2 percentage points—"a very painful period for us," he says. "The model was right about inflation, but the interaction between inflation and interest rates didn't follow the norms."

Nevertheless, he says the model "has been extraordinarily accurate in the last 20 years [and] is responsible for our track record against the benchmark."

In his own portfolio, Mr. Tedford has begun shorting 30-year Treasuries, expecting the prices to fall as interest rates begin to rise. For clients, however, Stephens is encouraging the use of exchange-traded funds to own exposure to real assets. Mr. Tedford says a 5% or 10% position overall "is big enough to protect a larger portfolio."

Among ETFs, Stephens likes the U.S. Gasoline Fund, the iShares Dow Jones U.S. Oil & Gas Exploration & Production Index, SPDR Gold Trust, PowerShares DB Base Metals Fund and the PowerShares DB Agriculture Fund. The firm also likes Plum Creek Timber Co.

Though Treasury inflation-protected securities, or TIPS bonds, would seem a natural bet, Mr. Tedford says his group just this month sold off its TIPS investments. Real yields on TIPS are barely above 1% now and Mr. Tedford expects those yields will increase as inflation mounts, hurting prices, which move in the opposite direction.

The likely result: "The return on your TIPS could fall 10% or 15%," basically wiping out the bond's inflation protection.

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*Bill Tedford, an Executive Vice President of Stephens Inc. and Chairman of the Fixed Income Management Committee and Portfolio Manager of SCM, has developed and uses a proprietary model designed to forecast inflation. The model reflects past and historical relationships of inflation to monetary base and oil prices. The future behavior of inflation is influenced by many factors (many of which are themselves unpredictable) and will not necessarily continue to follow historical patterns. The model, by itself, cannot guide an investor as to what securities should be bought or sold nor as to when to buy or sell.*