Stephens
Capital Management

FIXED INCOME STRATEGY

Quarterly Commentary | March 2010

Interest rates in the first quarter of 2010 showed no discernable direction as the ten-year Treasury ended the quarter one basis point lower than where it stood on New Year's Eve. Inflation likewise moved in a sideways pattern. The Consumer Price Index for the twelve months ending March 31st showed a gain of 2.4%, down slightly from the 2.8% change for all of 2009. However, when one strips out the effect of the decline in shelter costs, the rate of inflation for the remainder of the index rose a more ominous 3.8%, up from minus 1.3% one year ago.

Our proprietary model of future inflation correctly predicted both the onset and the end of deflation months in advance. This model, after forecasting a lull in inflation in the first half of 2010, is anticipating an acceleration in inflation in the second half of 2010 into the first half of 2011. This inflation would be the lagged result of the rise in the monetary base after the financial crisis response by the Fed. Most of the increased monetary base is still being held as excess reserves but a sufficient amount of it has been taken down by the banking system to cause a noticeable increase in inflation.

Bank loans have been in a decline since October 2008. Only bank investments have shown a positive trend as the banks purchased over $320 billion of government securities since the financial crisis began. If this were to reverse and loan demand begin to rise, the Fed's task of controlling inflation would become much more challenging.

The Fed basically has two choices to avoid higher inflation – they can begin liquidating the huge bond portfolio they acquired in 2009 in order to shrink the monetary base or they can start paying much higher interest rates on excess bank reserves to discourage the banks from making loans. The former should drive longer term rates up including fixed rate mortgages while the latter would cause all short term rates to jump including adjustable rate mortgages. Faced with two unappealing options, it is possible that the Fed will be reluctant to take either action until it is more obvious that inflation is becoming a problem. With unemployment still close to 10%, raising rates preemptively would be a politically unpopular decision. Because of the delayed reaction of monetary policy upon inflation, there is risk that inflation builds considerable momentum before any Fed policy moves can dampen it.

Inflation risk is the most dominant influence upon interest rates. In the current environment, the risk of higher inflation means that bond investors are at risk of substantial price declines. To mitigate this risk, we are maintaining the duration of our portfolios much shorter than our benchmark index.

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Important Disclosures

The views expressed in this commentary were those of the portfolio manager as of the publication date and are subject to change without notice. The performance data quoted does not reflect the deduction of advisory fees and other account expenses. Our advisory fees are available in Part II of our ADV or the appropriate brochure. Performance results represent past performance and do not guarantee future results. Market volatility can significantly impact short-term performance. Actual results of an investment made may differ from the composite results, depending on the size of your account, the duration of the account, the investment objectives and/or restrictions, the time at which your investments are made, and other factors.

William Tedford 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.

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