

Over the course of the second quarter, interest rates rose in every maturity along the Treasury yield curve. This appeared to be caused by subsiding fears of financial collapse which had spread following the implosion of Bear Stearns and which had triggered a flight to quality into Treasuries. Spreads between Treasuries and investment grade corporate bonds also reflected this increased confidence by narrowing slightly.

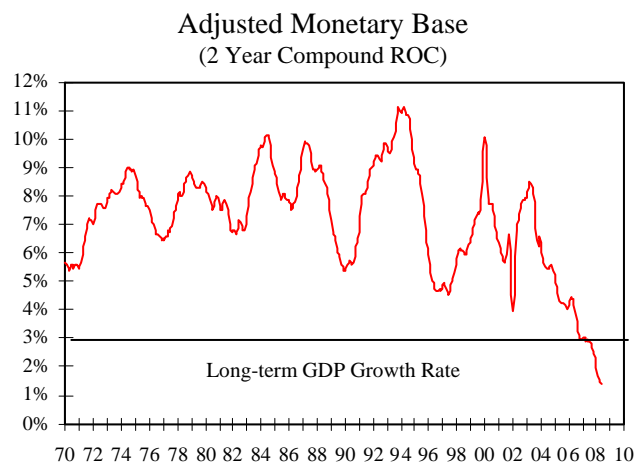
Date Range	Treasury Interest Rates			Agency Spreads *				Corporate Spreads*
	2 year	5 year	10 year	Fannie Mae		Freddie Mac		10 year
				5 year	10 year	5 year	10 year	
December 31, 2007	3.05	3.44	4.02	51.2	51.8	51.8	52.7	224
March 31, 2008	1.58	2.44	3.41	79.3	64.9	83.5	71.9	276
June 30, 2008	2.62	3.33	3.97	84.3	76.2	83.0	81.3	270
2Q '08 Change	1.04	0.89	0.56	5	11.3	-0.5	9.4	-6
YTD Change	-0.43	-0.11	-0.05	33.1	24.4	31.2	28.6	46

Source: Bloomberg

* Spreads displayed in basis points over comparable maturity Treasury

The large losses that have been surfacing relating to the declines in home prices should ultimately lead to a clarification of the government's "implied" guarantee of federal agency debt. In recent years the spreads between Treasury and agency debt have fluctuated from a low of 20 basis points to over 100 basis points. Thus far this year, the spreads of agency paper have widened out relative to Treasuries as the spillover from the decline in housing has brought into question the solvency of Fannie Mae and Freddie Mac. If, as we believe, the resolution will be on the side of a more explicit government guarantee, then the spreads should sharply contract again if not vanish altogether.

With oil reaching in excess of \$140 per barrel, inflation fears are being expressed daily in the financial press. This is especially true since the oil price run-up has been accompanied by a surge in food prices. But, in our opinion, what the pundits are missing is that the primary ingredient in the true inflation recipe is an acceleration in the growth rate of the monetary base which is nowhere to be found. In actuality it is the reverse – monetary base growth has been decelerating as the accompanying chart clearly demonstrates.



Source: Stephens Capital Management

June 30, 2008

As we have mentioned in prior commentaries, the surge in inflation that we are currently experiencing is primarily related to the 100% rise in the cost of oil over the last twelve months and its accompanying repercussions throughout the economy. In the short-term, large swings in oil prices (both up and down) can overwhelm the monetary component in the inflation equation. However, if oil were to just stay at these current levels for the next twelve months, then by definition its rate of change would be zero. In that instance, its impact on inflation would be eliminated and the primary determinant would again fall back to the growth rate of the monetary base. The June 25th statement from the Federal Open Market Committee stated that the Fed “expects inflation to moderate later this year and next year.” Our data shows that they have valid reasons for saying that.

While inflationary expectations are the primary determinant of interest rates in the long term, it can be overturned in the short run by the other component of nominal interest rates – real yields. If the Fed holds the Funds constant at 2% and inflation subsides as we predict, then the “real” Fed Funds rate will begin to rise. This could encourage some increase in real yields throughout the yield curve which could then cause nominal rates to firm up in the longer maturities despite less inflationary risk. For this reason we intend to keep our portfolio duration close to benchmark level in the near term while enhancing our returns by continuing to overweight government agency securities and including a small investment grade corporate bond component.



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.