

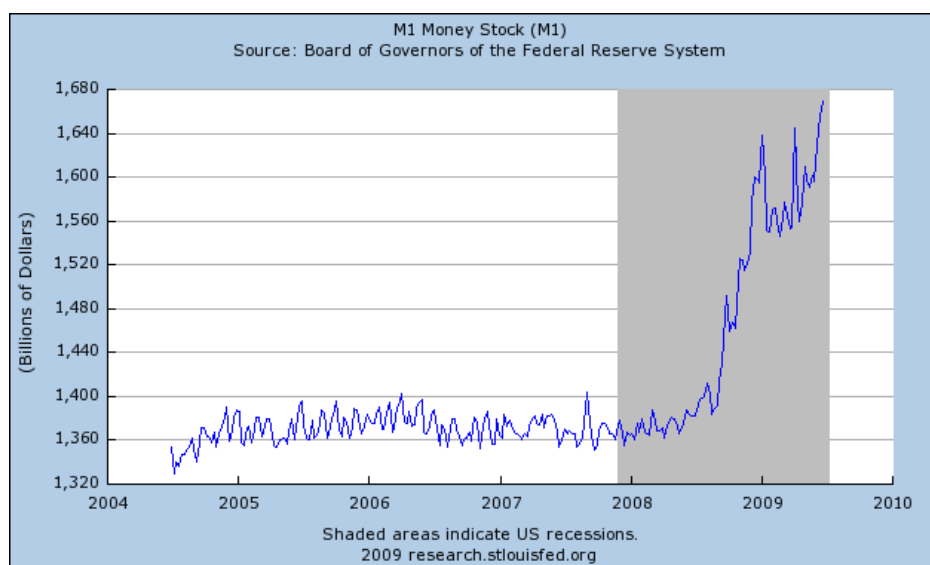
Storm Clouds

On March 18, 2009, the Federal Reserve Open Market Committee stunned the bond market by announcing that they intended to purchase up to \$750 billion in agency mortgage-backed securities and up to \$300 billion of longer-term Treasury securities. The intent of these actions, they said, was to “provide greater support to mortgage lending and housing markets” and “to help improve conditions in private credit markets”, i.e. to cause interest rates to decline.

The strategy worked beautifully but only for 24 hours. Upon that announcement, the ten-year Treasury yield fell from 3% to below 2.5%. But subsequently that same rate began to rise as the Fed began to actually implement its strategy. The rate touched 4% in early June before pulling back to 3.53% by the end of the month. We feel this is an ominous development for the Fed. Despite repeated assurances from the Fed that inflation is a distant worry that can be dealt with later, the bond market is now beginning to price in the rising risk of inflation.

The Fed’s theory, which has been adopted by many other economists, is that inflation will not rise so long as there is sufficient slack in the economy – what it terms the “output gap”. We and a few others have attempted to back test that theory and have been unable to substantiate its validity. Meanwhile, our own inflation model, which has a long history of relative reliability, is forecasting that the current deflation (-1.4% CPI for 12 months through June) will bottom out over the summer and that the U. S. will return to meaningful inflation in 2010 and beyond. As our quarterly commentaries from last year reflect, this model correctly predicted the deflation we are experiencing in 2009 well before the financial crisis developed.

The M1 money supply has risen to 18.9% above its level twelve months ago (see chart below). The demand deposit component of M1 is up 43.1%. The monetary base, which enables the money supply to expand, is up 97.5%.



Source: Federal Reserve Bank of St. Louis

In order to prevent a surge in inflation, the Fed, in our opinion, needs to shrink its balance sheet promptly; but, with the economy in such fragile condition, there would appear to be almost no chance of that occurring. That is especially true when the Fed believes that inflation is years away. Furthermore, it has been reported that a key part of the Fed's exit strategy will be to raise short term interest rates by arbitrarily raising the rate that they can now pay on bank reserves without the usual action of reducing the monetary base (by selling securities). This would have the effect of leaving the excess money supply in circulation as they raise rates (simultaneously stepping on the brake and the accelerator). To our knowledge, this is an untried and unproven theory to control inflation. Mark us down as skeptical.

Our strategy for the remainder of the year will be a continuation of a process we initiated in 2008. Our thesis has been three-pronged:

1. **Shorter Duration vs. Benchmark**- We took this position in mid-December as we became convinced that interest rates were unjustifiably low as a result of the economic chaos of last fall. We expect the trend toward higher rates to continue as the bond market begins to price for the risk of future inflation. The year-to-date increases in interest rates are illustrated in the table below:

	12/31/2008	6/30/2009	Change
3 Month	0.08	0.18	+0.10
6 Month	0.26	0.34	+0.08
1 Year	0.34	0.48	+0.14
2 Year	0.76	1.11	+0.35
3 Year	0.97	1.62	+0.65
5 Year	1.55	2.56	+1.01
10 Year	2.21	3.53	+1.32
30 Year	2.68	4.33	+1.65

2. **Agencies over Treasuries**- This is another thesis that we have been proponents of for some time. In the first half of 2008, we increased our allocation to Agencies at the expense of Treasuries as we were confident that the Federal government would stand behind the "implied guarantee" of Fannie Mae and Freddie Mac. As the housing situation continued to worsen, investors began to worry about the solvency of the two mortgage giants. As a result, Agency spreads over Treasuries widened out to historic levels. However, after some volatile months, the spreads have indeed narrowed to more normalized levels. We have included for your review a copy of the five-year Fannie Mae spread over Treasuries encompassing the past 12 months.

Five-Year Fannie Mae Spread over Treasuries
June 30, 2008 - June 30, 2009



Source: Bloomberg

While the majority of the spread tightening is behind us, we will continue to favor Agency debt as the additional yield is still 12% higher than a Treasury (in the five year maturity range) for what we believe is comparable credit risk.

3. **Corporate Bonds**- For those accounts that allowed for us to include a corporate bond component, we added these last year as well as the spreads widened out to levels not seen since the Great Depression. Earlier this year, we added to this position as we believed that the worst of the economic turmoil was behind us. Thus far, the spreads for investment grade bonds have declined meaningfully this year as the chart below demonstrates.

Ten-Year Investment Grade Corporate Bond Spreads over Treasuries
December 31, 2008 - June 30, 2009



Source: Bloomberg

June 30, 2009

As the economic picture becomes more settled, we anticipate that these spreads will continue to tighten even more in the months ahead.

Without question, these times ahead will be full of challenges as we attempt to navigate the fixed income markets on your behalf. We will continue to do our best for you to take full advantage of the opportunities we see before us. Thank you as always for your continued confidence.



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.