

Ten-year Treasury interest rates fell a modest 23 basis points during the third quarter despite an intensive effort by the Federal Reserve to drive rates down. (The Fed purchased over \$140 billion in government paper plus another \$230 billion in mortgage-backed bonds during the quarter.) However the net result for the calendar year is that ten-year rates have increased 94 basis points. Corporate bond rates have continued to narrow against Treasuries but still have not reached normal levels.

In their initial response to the financial crisis, the Fed made mostly short term loans to financial institutions and money market funds to get them through the liquidity shortage. But as these loans are maturing and being repaid, the Fed is purchasing assets that have extended maturities as part of their announced intention to drive rates lower. The result is that the Fed's balance sheet is not shrinking and their ability to shrink it later is being compromised because reselling these assets could cause a sharp spike in interest rates. With the economy functioning well below potential, such an increase in rates could abort the economic recovery.

The Fed has a new tool at their disposal with which conduct monetary policy. In late 2008 Congress authorized the Fed to pay interest on bank reserves. This will enable the Fed to establish a floor for short term rates without having to conduct open market operations to drive the Fed Funds rate upward. However, raising rates in that manner means that they will not simultaneously be shrinking their balance sheet and thus the monetary base. This will set up a conflict between interest rates and the money supply for the control of inflation. The risk of a policy error that allows inflation to rise to unacceptable levels is apparent.

Our model of future inflation implies that the low point for inflation on a trailing twelve month basis was probably reached during the summer. This model is forecasting that CPI inflation will turn positive in early 2010 and continue rising into 2011. Evidence of that trend is already starting to appear when the past year's results are carefully analyzed.

ANNUALIZED INFLATION			
	Latest 12 Months	Oct 08 - Mar 09	Apr 09 - Sept 09
CPI	-1.32%	-5.38%	2.91%
CPI Core	1.51%	1.16%	1.85%
CPI ex energy	1.24%	1.11%	1.36%
CPI ex food	-1.50%	-6.37%	3.63%
Average	-0.02%	-2.37%	2.44%

Source: Stephens Capital Management

September 30, 2009

For the latest 12 months, the CPI shows a net decline (deflation) of -1.32%. However, if the past year is divided into two six month sections, the results are surprising. For the first six months the annualized rate of inflation for the CPI was a negative 5.38%. But the second six months showed a positive rate of inflation of 2.91%. The same pattern was observable in other measures of inflation.

Thus it appears that the deflationary forces are waning and the return to inflation is at hand. However, the breakeven inflation rate embedded in the ten-year Treasury Inflation Protected Securities indicates an expectation of future inflation of only 1.8% per year for a decade. We feel that the bond market's complacency about inflation will be tested in 2010 and 2011. In preparation, we are maintaining our portfolio duration below our benchmark index.



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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.