

The benchmark 10-year Treasury note ended the year yielding 3.84%, up 53 basis points in the fourth quarter and 162 basis points for the year. The rise in rates for the year was particularly impressive when one considers that the Fed embarked upon their “quantitative easing” program in March and since that time have purchased over \$1.3 trillion in fixed income securities in an attempt to suppress interest rates.

The result of this program has been to bloat the Fed's balance sheet, ballooning the monetary base in an unprecedented fashion since the Fed pays for its purchases with newly printed monetary base. Thus the monetary base rose by 21% in 2009 following 97% increase in 2008.

In our opinion, the Fed did a remarkable job in backstopping the financial crisis that developed in the latter part of 2008 and early 2009. But, as that crisis abated, the proceeds that the Fed had advanced began to be repaid. This repayment process would have promptly reduced the monetary base, returning it close to its pre-crisis levels and thus reducing the risk of an inflationary outbreak. However, quantitative easing reversed that outcome. Now the Fed is faced with an extraordinary challenge of how to keep the huge monetary base from fueling future inflation.

To date most of the growth in the monetary base is being held as excess reserves by the banking system. It would have been impossible for banks to lend such a giant increase in reserves in that space of time. In the current environment, consumers are paying down debt, the slow economy has suppressed corporate demand for credit and lenders have raised their lending standards. However, during 2009, the Federal Government was an insatiable borrower and the banks lent over \$250 billion to the government by purchasing Treasuries. Through this transmission, the monetary base has begun to work its way into the economy. Once the requisite time lag has passed, inflation will be the likely result.

To prevent the monetary base from flooding into the economy, the Fed basically has two choices: they can resell the securities they purchased (which would almost certainly send interest rates higher) or they can pay the banks enough interest on the reserves that the banks will decline to lend them at risk. Unfortunately the latter would cause short-term rates to rise which would have negative implications for the weak economy and would cause variable rate mortgages to adjust upward putting more downward pressure on the housing market. It appears to us that the likely course for the Fed is to stand pat until clear signs of inflation begin to emerge at which time the Fed can justify the need to increase interest rates. For bond investors this increased risk of inflation has negative implications as inflation is the primary driver of interest rates.

For all of 2009, the Consumer Price Index (CPI) rose by 2.82%. Core inflation, (CPI less food and energy) increased by 1.79%. Both of these appear to substantiate our position that the risk of deflation is behind us. Going forward, our worry is how much inflation we and the bond market will face. Our model is not encouraging as it foresees increasing inflationary pressure, particularly in the second half of 2010 and into 2011. Thus our investment strategy will be driven by our expectation for rising interest rates.

Now that the calendar has turned over to a new year, we thought it might be instructive to go over what our strategy was for 2009. As you may recall, our investment thesis consisted of three core ideas:

I. Interest Rates to Rise: In December of 2008, we positioned the portfolios in a defensive posture as we became concerned that interest rates were too low (despite the fact that we were calling for a brief bout of deflation) as a result of the preceding financial panic. As we mentioned above, the 10-year Treasury interest rate rose 162 basis points for the year. In fact, all interest rates of longer than 6-months rose as the accompanying table demonstrates.

U. S. Treasury Yield Curve

	12/31/08	12/31/09	Change
3 MONTH	0.076	0.048	-0.0284
6 MONTH	0.259	0.186	-0.0732
1 YEAR	0.340	0.435	0.0948
2 YEAR	0.764	1.135	0.3712
3 YEAR	0.969	1.676	0.7075
5 YEAR	1.549	2.679	1.1299
7 YEAR		3.384	
10 YEAR	2.212	3.837	1.6246
30 YEAR	2.676	4.641	1.9652

Source: Bloomberg

II. Agency Debt Spreads to Tighten: We continued our overweight to Agency debt as we believed that their spreads over Treasuries would tighten. In our view, the credit risk is essentially the same, and as such, there should be little to no difference between the two in their yields. While the spread has not gone away entirely, the spread has tightened substantially. The above chart is the five-year Fannie Mae spread over a comparable Treasury for 2009.



Source: Bloomberg

III. Corporate Bond Spreads to Tighten: As we started 2009, the corporate bond market was still priced for a depression. While we were not forecasting a rosy economic climate, we did not think we were heading over the cliff. Consequently, we maintained our conviction that, as corporate bond holders, we were getting more than adequately compensated for the risk we were assuming. As the year progressed and the economic fears subsided, the spreads of investment-grade corporate bonds declined by over 260 basis points (from 470 basis points over Treasuries to 208 basis points to end the year)! In order to grasp the amount of panic that was in the bond market to start the year, we have included a chart of the 10-year investment-grade spread over 10-year Treasuries going back to December 30, 1994. As you can see, while we have not quite returned to "normal", we have indeed made substantial progress on this front. We expect to continue to own this position through 2010.

10-Year BAA Corporate Bond Spread over 10-Year Treasuries



Source: Bloomberg

Government bonds had their worst year in over 15 years. In fact, this was the first negative year for our benchmark index (-0.32%) since 1994. Due to the positioning of your accounts, as discussed above, we were able to post a positive year of performance in an otherwise difficult environment.

Thank you as always for the opportunity to work on your behalf and we wish you the best for a happy and prosperous new year.

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.