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Capital Management

FIXED INCOME STRATEGY

Quarterly Commentary | December 2010

The second and third quarters of 2010 saw sharp declines in Treasury interest rates. Several factors combined during that time to trigger a flight-to-quality in the bond market. First, the European debt crisis raised investor's fears of default in several countries including Greece, Portugal and Ireland. Some analysis even predicted the eventual demise of the Euro as a currency. Secondly, American economic activity slowed prompting many forecasts of a possible double-dip recession. And finally, inflation declined renewing fears of possible deflation.

The latter two factors were instrumental in the Federal Reserve's decision to implement a second round of quantitative easing (QE2). Chairman Bernanke hinted in a speech in Jackson Hole, Wyoming on August 27th at the possibility of QE2. It is noteworthy that 30-year Treasury rates began to rise that day. When the Federal Open Market Committee voted to approve QE2 on November 3rd, the minutes reflected that, "Most participants judged that a program of purchasing additional longer-term securities would put downward pressure on longer-term interest rates…"

Between Bernanke's August 27th speech and the end of the fourth quarter, 10-year Treasury interest rates rose 75 basis points, 30-year rates rose 76 basis points and 10-year inflationary expectations rose 57 basis points. It would appear that the Fed seriously misjudged the response of the bond market to their new initiative.

Our model of future inflation had predicted a slowdown in inflation in the second and third quarters. However, our data also predicted that the slowdown would be short-lived and that the upward trend in inflation would re-emerge in the fourth quarter and continue through the first half of 2011. By the end of 2010, trailing 12-month CPI had risen to 1.4% from 1.1% in September. Importantly, the annualized inflation rate of the trailing six months of CPI increased from .59% to 3.09%.

When analyzing the CPI, it is important to note that the shelter component comprises almost one-third of the index (32.3%). The 12 month rate of change in shelter was negative for the better part of 2010 (ending the year at a slightly positive 0.04%). The net impact was to drag headline CPI lower. Computing the inflation rate excluding shelter, the CPI increases from 1.4% to 2.04%. Interestingly, if we annualize the latest three months of the shelter component, the rate of change rises to 1.19% from 0.04%. While that is still below headline CPI itself, the numbers suggest that the shelter component will be less of a drag on inflation in the new year. It is no wonder that the bond market came down with a case of the jitters in the most recent quarter.

Looking ahead to 2011 we expect interest rates to rise further. Bank loans are finally beginning to expand which means more of the monetary base that the Fed has created will begin working its way into the money supply creating more inflationary pressures over time. Commodity prices, historically a leading indicator of inflation, rose significantly in 2010 with several broad commodity indices rising 15% to 20%. Despite growing signs of potential inflation in the marketplace, the Fed is constrained from taking remedial action due to the high level of unemployment. To prevent the explosion of the monetary base created by QE1 and QE2 from causing high levels of inflation, the Fed, in our opinion, needs to begin shrinking its balance sheet. However, doing so would likely cause another surge in interest rates, including mortgages which could damage the still fragile housing market. The Fed's concerns about unemployment and housing will likely encourage them to maintain their current posture until evidence of inflation is irrefutable.

For bond investors, the dilemma faced by the Fed poses significant risks. Due to the long lag time between the implementation of Fed policy and its impact on inflation, there is serious risk that the Fed will ultimately overshooting its inflation target. We believe the prudent course for investors is to maintain short durations in their bond portfolios as the risk of higher rates and lower bond prices far outweighs the reward of reaching for the slightly higher income associated with longer maturity bonds.

Bill Tedford

Important Disclosures

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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.

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