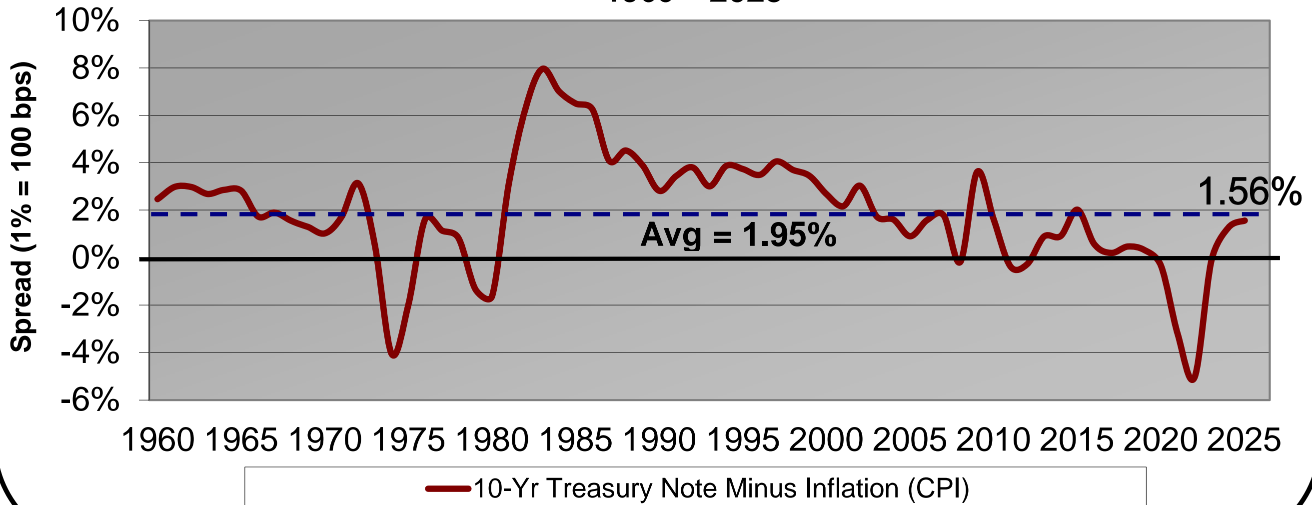

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DECADE	SPREAD AVERAGE	INFLATION (CPI) AVERAGE
1960s	2.3%	2.4%
1970s	0.3%	7.1%
1980s	4.8%	5.6%
1990s	3.5%	3.0%
2000s	1.9%	2.6%
2010s	0.6%	1.8%
2020s	-1.0%	4.0%

BOND YIELDS: REASONABLE EXPECTATIONS

Although the average yield spread for Treasury notes over the inflation rate has been approx. 1.9%, the average consists of periods that were above the average and periods that were below the average. Specifically, the 1960s reflected fairly modest inflation and a spread of 2.3%. The inflation-infected 1970s surprised bond investors and they were slow to adjust their required returns. By the 1980s, much like a battered insurance company that raises premiums, the inflation spread rose to near 5.0% to adjust to the newly-realized inflation risks. The current spread is 1.56%.

As Volker and Greenspan at the Fed maintained a campaign to tame and control inflation, the bond market began to calm its demand for an inflation-risk premium. By the 1990s, the inflation spread decined to 3.5%. For the 2000s, the spread averaged 1.9%. During the ZIRP and QE period, the spread was forced into negative territory. Going forward, the Powell Fed appears to be targeting inflation near 2% (although that commitment is somewhat uncertain). By adding a 2% or so inflation-risk and term spread, a yield near 4%-4.5% may be just about right for the 10-year note.

For an extended period, the Fed is expected to sustain *relatively* high short-term interest rates. Watch for reports about Conundrum II…similar but opposite of the period in 2005 when long-term interest rates (yields) remained relatively lower as the Fed raised short-term rates. As the Fed begins to lower rates, but with soft actions of conviction to control inflation, we should not be surprised if bond yields stay flat or even rise a bit.