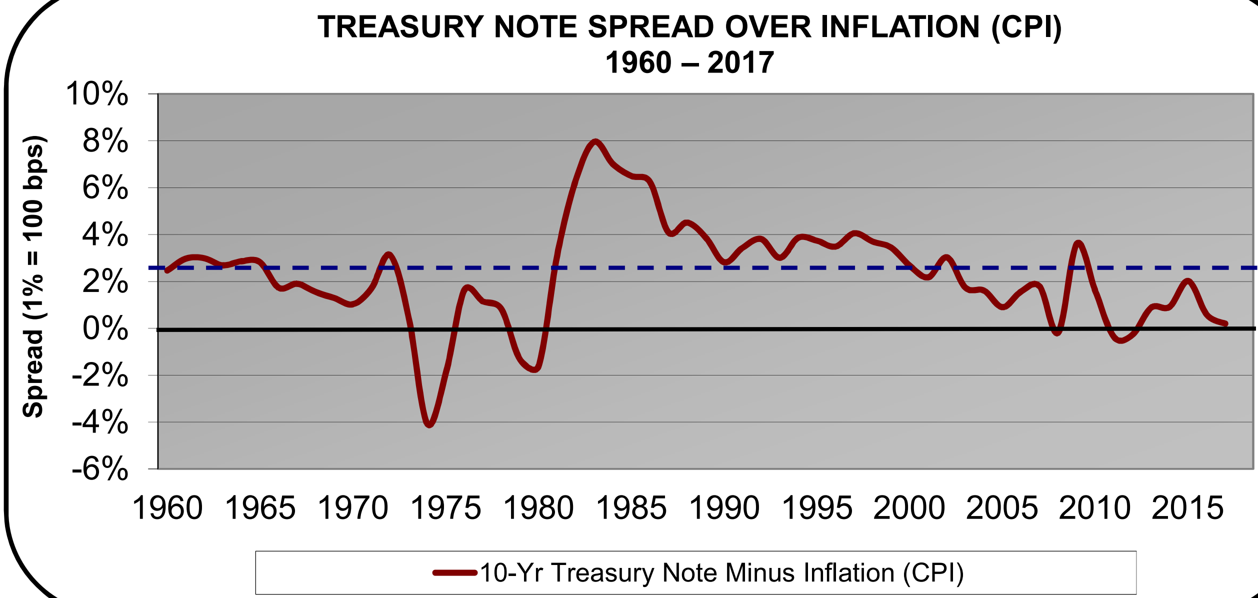

DECADE	SPREAD AVERAGE	INFLATION (CPI) AVERAGE
1960s	2.3%	2.4%
1970s	0.3%	7.1%
1980s	4.8%	5.6%
1990s	3.5%	3.0%
2000s	1.9%	2.6%
2010s	0.7%	1.7%

BOND YIELDS: REASONABLE EXPECTATIONS

Is 3% on a 10-year Treasury note high, low, or just about right? Although the average spread for Treasury notes over the inflation rate has been 2.4%, 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.

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%. In 2011, the spread declined due to a rise in the reported inflation rate. In the longer-run, the Bernanke Fed appears to be targeting inflation between 1% and 2% (although that commitment is quite uncertain). By adding a 2% or so inflation-risk spread, a yield of 3% or so may be just about right for the 10-year note.

During the next few years, the Fed is expected to begin raising short-term interest rates. Reports may begin soon about Conundrum II…the redux of the period in 2005 when long-term interest rates (yields) remained low as the Fed raised short-term rates. As/If the Fed again demonstrates its conviction to control inflation, we should not be surprised to see bond yields remain steady or even decline based upon historical spreads over inflation.