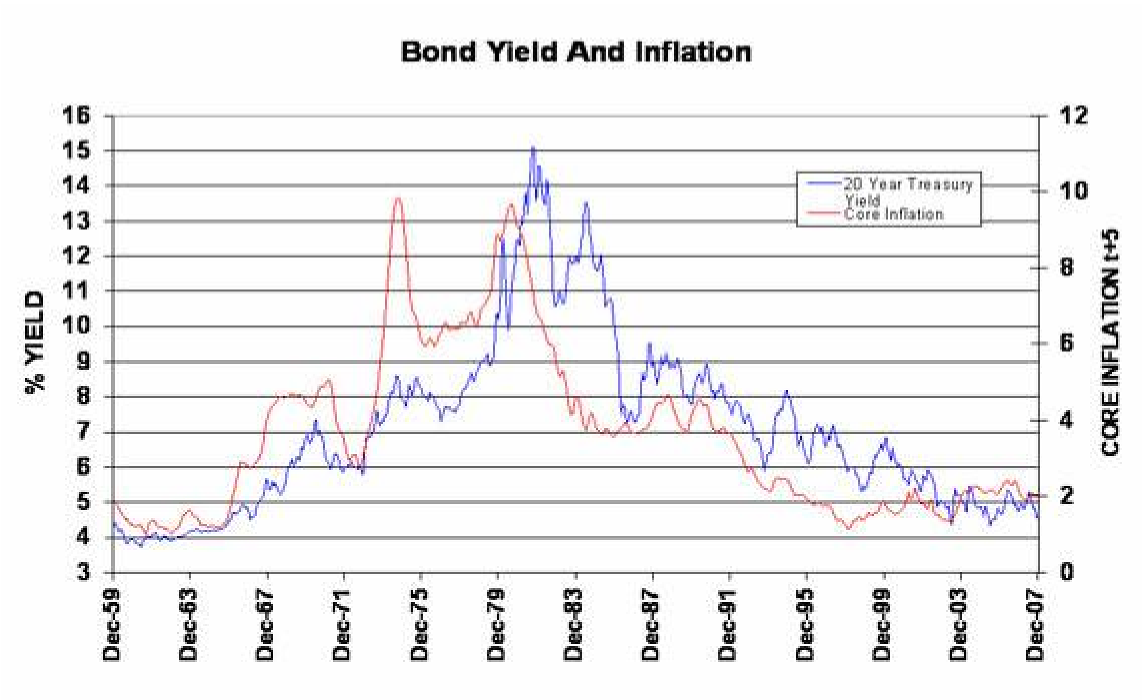
MARKET SLOW TO LEARN
WEB BUZZ 2010.03.29

One of the most consistent positive correlations in the financial world is between inflation and long-term government bond yields. Many other factors cause changes (noise) from time to time, but, in the final analysis, inflation is without a doubt the primary determinate. Please note the chart below.



Adapted from FinancialSense.com

Today we seem to be experiencing the reverse of a lag that took place during the 1970s. Note that inflation during the '70s erupted well in advance of the upward move in yields. That, we believe, was due to the lack of inflation during the 1950s and first part of the '60s. The market was slow to understand that the "dogs of inflation" had been unleashed by improper monetary and fiscal policy on the part of the federal government. Today there is a lag in realizing that this time the "dogs of deflation" are being unleashed by – you guessed it – improper monetary and fiscal policy. Inflation is now running at about 1%. If one were to add 2.5% for an inflation hedge (approximately that which has been demanded historically) then 3.5% should now be the yield on the 30-year government bond rather than 4.7%. In addition, the inflation premium will diminish as it will become apparent that deflation will be here to stay for an extended period of time. That's when a 2% interest rate could become a reality.