

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	-2.2%	4.5%	

BOND YIELDS: REASONABLE EXPECTATIONS

Although the average spread for Treasury notes over the inflation rate has been 2%, 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 near 2% (although that commitment is somewhat uncertain). By adding a 2% or so inflation-risk spread, a yield near 4% may be just about right for the 10-year note.

During the next few years, the Fed is expected to sustain relatively high short-term interest rates. Watch for reports about Conundrum II...the redux of the period in 2005 when long-term interest rates (yields) remained relatively lower as the Fed raised short-term rates. If the Fed continues its conviction to control inflation, we should not be surprised to see bond yields increase much less than the change in short-term rates.