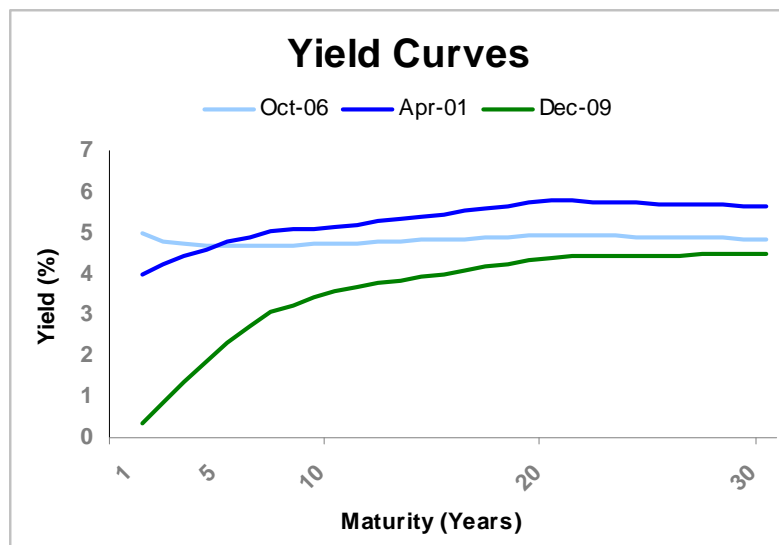


Fourth Quarter 2009 Knowledge College

Today's Yield Curve, a Slippery Slope?

In a 2006 Knowledge College titled "Inverted Yield Curve," we analyzed the inverted yield curve and its possible investment implications. A little over three years later, we have witnessed a dramatic shift as government intervention and market forces have pushed the slope of the yield curve to the opposite extreme. With the spread between 30-year and 2-year U.S. Treasuries at 3.62%, the yield curve is currently the steepest it has been in the last 30 years and one of the steepest since World War II.

The chart below shows an "inverted" yield curve as represented by October 2006, a "normal" yield curve as represented by April 2001, and a "steep" yield curve as represented by the present day yield curve.



Data Source: Federal Reserve.

A yield curve can be interpreted many ways. Because the yield curve reflects investors' economic expectations for interest rates, inflation and bond risk premiums, a steep yield curve is often considered a leading indicator of an economic upturn. The anticipation of an improving economy creates the expectation of higher interest rates, higher inflation, or both. Higher inflation negatively impacts bonds in the short-term, as investors demand higher interest rates to offset their potential loss of purchasing power.

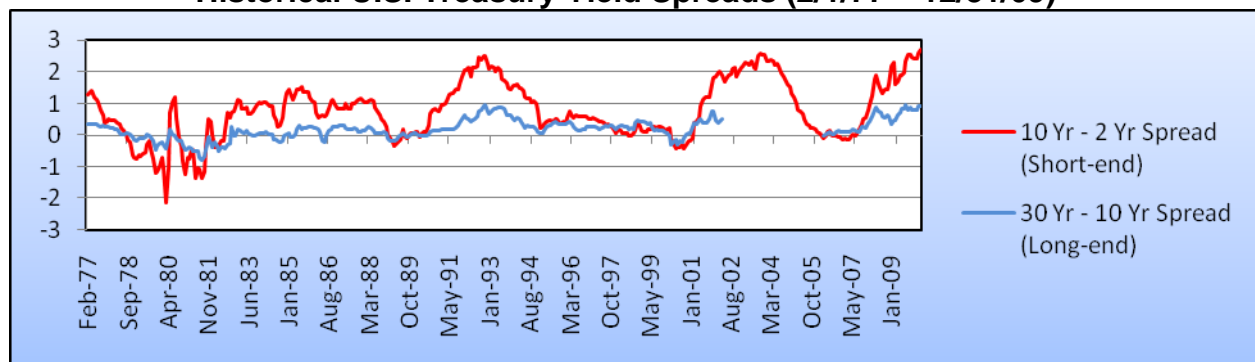
Historical Perspective

Short and Long End

Commonly, the yield curve is categorized by a 'short end' (between 10-year and 2-year rates) and a 'long end' (between 30-year and 10-year rates). Based on current spreads, the slope of the yield curve is extremely steep at both ends.

- ✓ As of December 2009, the short end spread of the curve was at 2.72%, eclipsing the previous high mark of 2.59% set in August 2003.
- ✓ The long end spread as of December 2009 was 0.90%, slightly off the all-time high of 0.94% reached in May 2009 and October 1992.

Historical U.S. Treasury Yield Spreads (2/1/77 – 12/31/09)



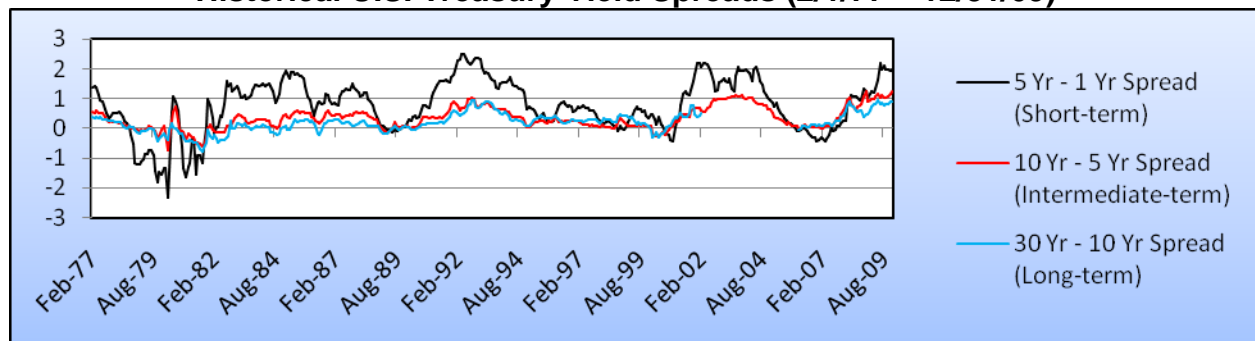
Data Source: Federal Reserve.

Maturity

Decomposing the current yield curve into three maturity sectors (short, intermediate and long) is also revealing.

- ✓ Short-term spreads are near the all-time high reached in May 1992 (2.50%).
- ✓ At 1.25%, the current spread between the 10-year and 5-year Treasury is at an all-time high.

Historical U.S. Treasury Yield Spreads (2/1/77 – 12/31/09)



Data Source: Federal Reserve.



Steep Yield Curves and the Markets

There were four periods between 1979 and 2009 where the spread between 10-year and 1-year Treasuries was greater than 2% (it is currently 3.22%). The following table looks at the S&P 500's performance prior to, during and after those periods.

Equity Returns Around a Steep Yield Curve

Steep Period (Month-End)	Duration (Months)	Annualized Return	Return 1-Year Prior	Annualized Return 3-Years Prior	Return 1-Year After	Annualized Return 3-Years After
Dec-84 - Oct-85	10	21.5%	6.3%	16.5%	33.2%	17.6%
Aug-91 - Apr-94	32	8.1%	12.8%	16.6%	17.5%	24.2%
Oct-01 - Sep-04	35	3.5%	-26.6%	2.0%	12.3%	13.1%
Oct-08 - ?	?	15.8%	-36.1%	-5.2%	?	?

The following table looks at the Barclays Capital U.S. Aggregate Bond Index's performance prior to, during and after those periods.

Fixed Income Returns Around a Steep Yield Curve

Steep Period (Month-End)	Duration (Months)	Annualized Return	Return 1-Year Prior	Annualized Return 3-Years Prior	Return 1-Year After	Annualized Return 3-Years After
Dec-84 - Oct-85	10	19.2%	15.2%	18.3%	17.8%	10.9%
Aug-91 - Apr-94	32	7.7%	14.6%	11.6%	5.8%	7.7%
Oct-01 - Sep-04	35	5.3%	14.6%	7.3%	3.9%	3.9%
Oct-08 - ?	?	11.4%	0.3%	3.6%	?	?

Conclusion

While a steep yield curve may indicate an upcoming positive economic environment, which would generally be positive for stocks and negative for bonds, the data is mixed. Therefore, a steep yield curve should not be viewed in isolation as an indicator to make significant tactical changes to a portfolio.

