

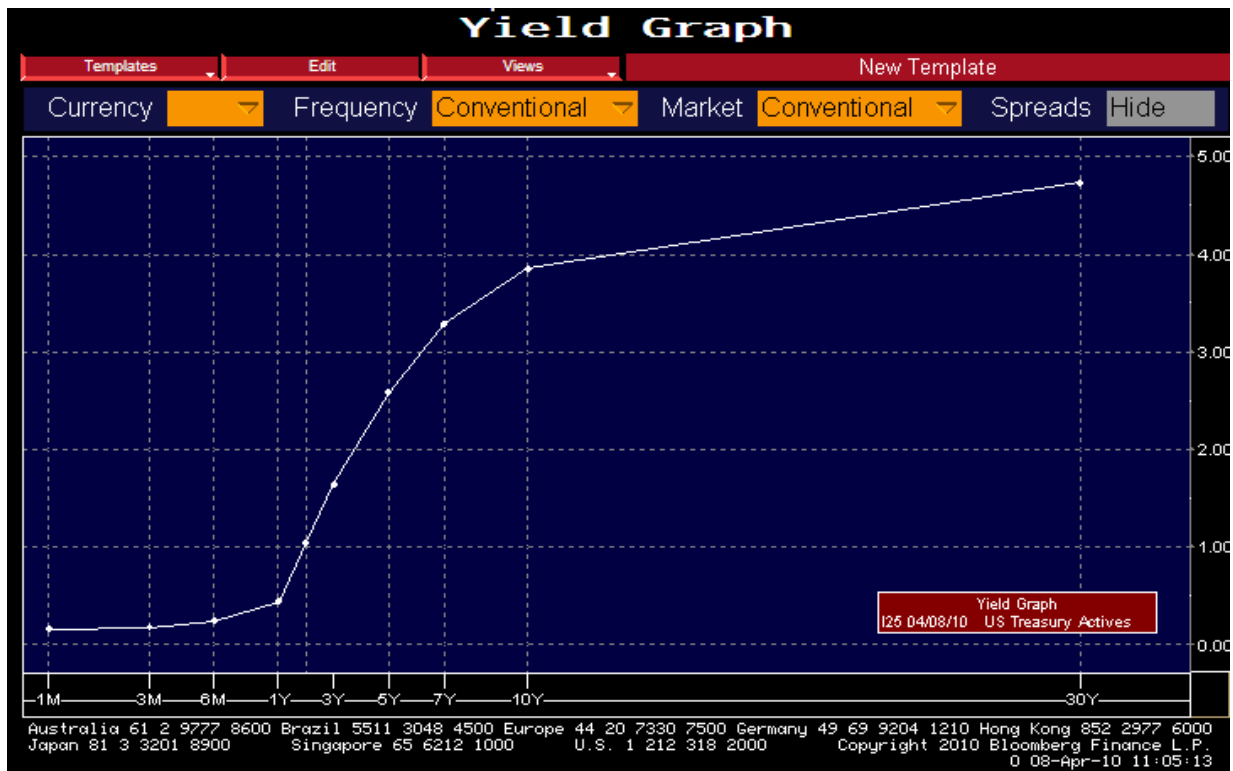
# Signs from the Yield Curve

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Trying to determine market direction by analyzing economic data can be an exceptionally difficult task. The data has become increasingly open to interpretation and it seems every economist sees the same data in slightly different ways. I'm not sure what I would do if the entire society of economists interpreted the same number the same way.

Instead of relying on fickle date interpretation, try looking at some black-and-white, indisputable numbers. I'm talking about the yield curve.

The yield curve is the relationship in yield between short-term debt instruments and long-term debt instruments. A common yield curve I look at is the 3 month Treasury bill out to the 10 year Treasury note. The difference in yield between these two instruments can be measured every day, all day long. The 3 month T-Bill is currently yielding 0.175% and the 10 year T Note is yielding 3.84%, making the difference between these two is 3.665%, or 366.5 basis points. As you can see in the chart below, the relationship creates a steep sloped line between the 3 month and the 10 year.



A normal yield curve is one where yields move incrementally higher as the maturities get longer. This is a very steep yield curve.

So, how is this relevant to market direction? Let's take a look at the five major asset classes (equities, bonds, international equities, commodities and real estate) and their performance during various yield curve scenarios. These numbers are the returns from 1973-2009, courtesy of the Cambria Investment Research group.

	<u>% of Time</u>	<u>SP500</u>	<u>EAFE</u>	<u>Bonds</u>	<u>GSCI</u>	<u>REIT</u>	<u>Gold</u>
<b>All</b>	<u>100%</u>	<u>10.88%</u>	<u>11.24%</u>	<u>9.38%</u>	<u>11.13%</u>	<u>10.52%</u>	<u>9.49%</u>
<b>&lt; 0%</b>	<u>12.87%</u>	<u>1.26%</u>	<u>-1.12%</u>	<u>-0.35%</u>	<u>29.40%</u>	<u>6.02%</u>	<u>39.82%</u>
<b>0-1%</b>	<u>20.54%</u>	<u>14.49%</u>	<u>10.50%</u>	<u>10.32%</u>	<u>12.34%</u>	<u>0.26%</u>	<u>8.99%</u>
<b>1-2%</b>	<u>21.67%</u>	<u>10.98%</u>	<u>9.15%</u>	<u>5.87%</u>	<u>16.81%</u>	<u>6.44%</u>	<u>2.69%</u>
<b>2-3%</b>	<u>27.99%</u>	<u>12.00%</u>	<u>14.72%</u>	<u>15.78%</u>	<u>2.51%</u>	<u>15.95%</u>	<u>5.27%</u>
<b>&gt; 3%</b>	<u>16.93%</u>	<u>12.25%</u>	<u>19.32%</u>	<u>6.41%</u>	<u>4.59%</u>	<u>24.10%</u>	<u>5.69%</u>

\*Cambria Investments, 2009

When the yield curve is less than 0% (the yellow line), which is almost 13% of the time, the best performing asset classes are commodities and in particular, gold. When the yield curve is less than 0%, or negative, it indicates a recessionary environment. All stock and bonds are historically poor performers during this period. The last recessionary period we had was from the end of 2007 to early 2009 and remember how stocks did?

Our current environment with a yield curve at 3.665% (the green line) happens nearly 17% of the time. All asset classes are positive but real estate and stocks (in particular, international stocks) are the only asset classes outperforming their long-term averages. We should remain in this category for a while longer but the situation will eventually change. The Federal Reserve will begin to raise the short-term rates, putting pressure on the yield curve to flatten over time. As it does, the concentration of portfolios will begin to change but not too drastically.

While there are many other variables involved in the management of an investment portfolio, using the current state of the yield curve is always a good starting point.

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