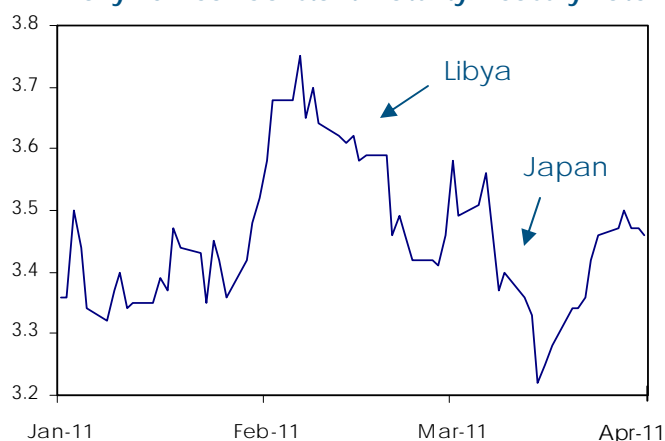


During the first three months of this year, interest rates on U.S. Treasury securities rose on average between 10-30 basis points. While the general direction of interest rates was higher, it was far from a straight line. The first quarter was dominated by overseas events, and their effects can be seen in the movement of the 10-year Treasury interest rate shown below.

Daily 10-Year Constant Maturity Treasury Rate



Source: Stephens Capital Management

Political turmoil erupted in North Africa and quickly spread to other countries in the Middle East as citizens grew tired of the corrupt and oppressive regimes that had ruled over them in search of a more democratic way of life. Regime change in Tunisia and Egypt, other uprisings in the region, and the escalation of the civil war in Libya rattled markets and confidence around the world. The second major event was a devastating earthquake and tsunami in Japan on the 11th of March. The situation appears to be moderating, although the long-term impacts of the earthquake and resulting nuclear risks remain unknown.

The other underlying story is the outlook for inflation. Inflation is of utmost importance to bond investors as it is the primary determinant of interest rates in the long-term. As readers of our past commentaries know, our inflation data has been indicating that inflation would bottom in the second half of 2010 and then trend higher through the first two quarters of 2011 as the impacts of past Federal Reserve actions begin to work their way through the economy. The consumer price index (CPI) bottomed last November at 1.10%, and is now up 2.65% over the 12 month period ending in March. The market has clearly written off deflation as a risk and is now beginning to worry about inflation, particularly as commodities of all types are flashing warning signs. Since last August, when Federal Reserve Chairman Ben Bernanke mentioned the prospect of additional easing by the Fed, the CRB Index (one of the longest running commodity indexes) is up over 41%, thus increasing the fear that the Fed is behind the curve in fighting inflation. As the table below reflects, the inflationary pressures appear to be increasing.

Consumer Price Index

Headline Inflation	Nov	Dec	Jan	Feb	Mar
12-Month ROC	1.10	1.36	1.60	2.15	2.65
6-Month ROC Annualized	1.86	3.03	3.21	3.81	4.74
12-Month ROC Excluding Shelter	1.65	1.99	2.07	2.81	3.46
12-Month ROC Excluding Energy	0.09	1.09	1.08	1.27	1.45
Core Inflation (excluding food & energy)	Nov	Dec	Jan	Feb	Mar
12-Month ROC	0.69	0.65	0.96	1.11	1.21
6-Month ROC Annualized	0.93	0.74	0.82	1.13	1.40

Source: Stephens Capital Management

One area of particular interest is the shelter component of CPI. Shelter accounts for almost 32% of the index. As recently as last November, the 12-month rate of change for shelter was a -0.06%. While this was higher than the -0.62% registered last May, shelter continues to have a depressing effect on headline CPI (reference the table above to see its effect – *CPI ex Shelter*). The shelter component has now turned positive, as of March albeit at a meager 0.92%. While still below the overall inflation rate, the amount by which it is weighing down the headline inflation should diminish as we proceed through the current quarter and possibly beyond.

QE2, the controversial second round of quantitative easing the Fed initiated last November, will be drawing to a close at the end of the coming quarter. With a stated goal to purchase a total of \$600 billion in longer-term Treasury securities to help spur the economy and raise inflationary expectations, the Fed has been a buyer of \$75 billion in Treasury securities each month over the past five months. There has been much speculation about what will happen to the markets—stock, bond, as well as commodities—when the Fed ends QE2 and the economy is left standing on its own without the added stimulus from the Fed. While the stock and commodity markets were clear beneficiaries of the stimulus, the bond market's reaction is less obvious. The day QE2 was started, the 10-year Treasury interest rate stood at 2.50%. Today it is closer to 3.50%.

Last summer investors were worried about the possibility of a renewed round of deflation. It now seems attention is turning to the potential for uncomfortably high inflation for the remainder of the year. While we are concerned about the Fed's inability to articulate a clear exit strategy, our data indicates that inflation will likely peak out this summer and begin a meaningful decline for the better part of a year. Therefore, after QE2 comes to a close and as we approach what we believe to be the near-term peak in inflation, our current intentions are to lengthen our duration and purchase longer-dated securities that should benefit from a decline in inflation. How much we raise our duration will be determined by how much interest rates rise between now and then.

These are historic times we are living through. With such unconventional monetary policy being utilized, the range of possible outcomes becomes that much more wide. We will continue to monitor the markets carefully, being ever mindful of protecting the assets you have entrusted to our care.



Important Disclosures

The views expressed in this commentary were those of the portfolio manager as of the publication date and are subject to change without notice. The performance data quoted does not reflect the deduction of advisory fees and other account expenses. Our advisory fees are available in Part II of our ADV or the appropriate brochure. Performance results represent past performance and do not guarantee future results. Market volatility can significantly impact short-term performance. Actual results of an investment made may differ from the composite results, depending on the size of your account, the duration of the account, the investment objectives and/or restrictions, the time at which your investments are made, and other factors.

William Tedford has developed and uses a proprietary model designed to forecast inflation. The model reflects past and historical relationships of inflation to monetary base and oil prices. The future behavior of inflation is influenced by many factors (many of which are themselves unpredictable) and will not necessarily continue to follow historical patterns. The model, by itself, cannot guide an investor as to what securities should be bought or sold nor as to when to buy or sell.

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