

# Weekly Interest Rate Comment ... For Bond Portfolio Managers

## United Bankers' Bank Safekeeping

The table below shows the average bond portfolio yield and total return for all banks at United Bankers Bank.

Date	Yield	Total Return
1Q '03	4.74%	6.96%
2Q '03	4.05%	6.53%
3Q '03	4.29%	5.52%
4Q '03	4.23%	5.43%
1Q '04	4.12%	5.00%
2Q '04	4.12%	3.29%
3Q '04	4.14%	4.81%
4Q '04	4.29%	4.34%
1Q '05	4.41%	3.26%
2Q '05	4.44%	4.56%
3Q '05	4.41%	3.67%
4Q '05	4.49%	3.16%
1Q '06	4.52%	2.84%
2Q '06	4.61%	1.87%
3Q '06	4.78%	3.86%
4Q '06	4.96%	3.59%
1Q '07	5.01%	4.37%
2Q '07	5.02%	3.43%
3Q '07	4.78%	4.00%
4Q '07	5.18%	5.37%
1Q '08	5.13%	6.11%
2Q '08	5.02%	4.17%
3Q '08	5.01%	4.23%
4Q '08	4.97%	5.15%
1Q '09	4.73%	4.81%
2Q '09	4.58%	4.69%
3Q '09	4.57%	6.16%
4Q '09	4.30%	4.94%
1Q '10	4.13%	4.95%
2Q '10	4.08%	5.66%
3Q '10	3.94%	6.28%
4Q '10		

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## Lower Interest Rates Does Not Necessarily Translate Into a Stronger Economy.

### Economy, Inflation & Unemployment

GDP growth for 2Q2010 was revised downward from 2.4% to 1.6%, the second consecutive quarterly decline.

Year over year CPI inflation for July was 1.1% down from 2.7% last December. Core CPI, which excludes food and energy, continues its disinflationary trend and is down to 0.9%. Unemployment for August edged higher from 9.5% to 9.6% and remains well above the 4.9% level at the start of the recession in December 2007. Only once in post-war history, in the 1982 recession, has the unemployment rate been higher.

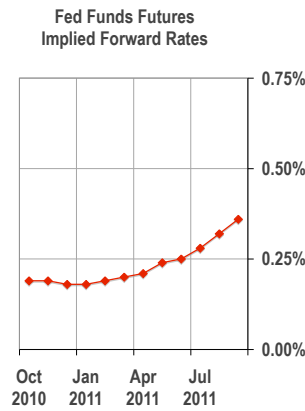
The Federal Reserve eased the fed funds rate 75 basis points to 0.25% on 12/16/08 and the funds rate now floats between 0.00% and 0.25%. Since March 2009, the Fed has indicated that "economic conditions are likely to warrant exceptionally low levels for the federal funds rate for an extended period."

Fed Funds Futures are not pricing in any Fed tightening for at least the next twelve months.

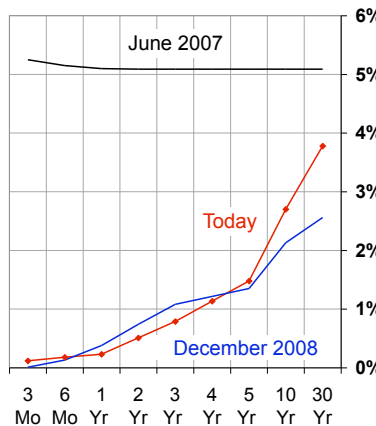
### Treasury Yield Curves

Today's positive yield curve stands in contrast to the last peak in rates and the inverted yield curve of 2007. Since December 2008 long term rates have moved higher while short rates through four years have recently moved to slightly new lows.

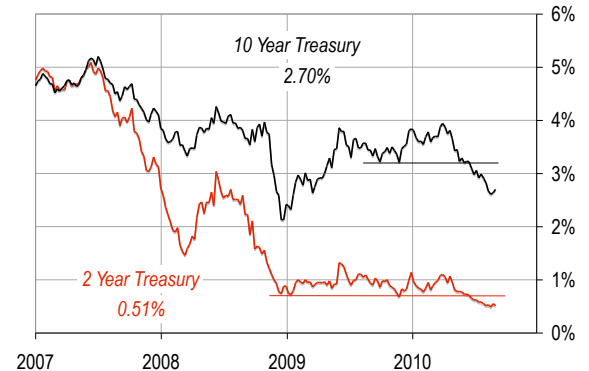
Quarter	GDP	Core CPI	Unem- ployed
4Q2009	5.0%	1.8%	10.0%
1Q2010	3.7%	1.3%	9.7%
2Q2010	1.6%	1.1%	9.6%
3Q2010	1.0%E	0.9%	9.6%



### U.S. Treasury Yield Curves



Comment... Further evidence of a weakening economy was the revision in 2Q2010 GDP from 2.4% to 1.6% and economists are busy lowering growth forecasts for the second half of the year. Fed officials were clearly caught off-guard by the extent of the slowdown but are still sticking to the line that growth will accelerate next year and the risk of deflation is considered to be "quite small." In a recent speech, Fed Chairman Bernanke still insisted that all the preconditions are in place for a more vigorous recovery, which should be here by next year. However, with the unemployment rate holding stubbornly near double-digit levels, businesses and households do not have the confidence to spend and invest. In the current environment, consumers have been focused on saving and paying down debt, making monetary policy a lot less effective in boosting economic activity. In other words, "you can lead a horse to water but you can't make him drink."



The bond market is not yet convinced that lower rates will promote economic recovery. The Fed Funds Futures chart in the previous column indicates the market is not expecting any Fed tightening in the next 12 months. The move towards lower long term rates is the repricing of long-term growth expectations and disinflation in the economy. Long term 10 year Treasury rates as shown in the chart above have been dropping since April and reflect the fact that an "extended period" of low interest rates and low growth is our reality. Bond funds have attracted a \$382 billion inflow in the past 12 months, in contrast to the \$18 billion outflow from equity funds. Perhaps this is not the best bet in the world but it is hardly irrational when the alternatives have been a shaky stock market, falling real estate prices and a nearly zero return on cash. A healthy sign would be for bond yields to begin rising but for that we need more tangible evidence of sustainable, broad-based economic recovery.

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