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Economics Group

Interest Rate Weekly

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10-Year Treasury: A Closer Look at the Benchmark: Part II

Last week, we examined the historical record. This week, we take a snapshot of where we are today. Are we getting paid for the risk? At low rates, small changes have big implications for total return.

Are We Getting Paid? The High Price of One-Percenters

One immediate problem we have identified to investors over the past six months is that small increases in the 10-year yield, when 10-year yields were at or below two percent, would easily generate negative total returns in a portfolio. We also found forecasts of one percent for the 10-year Treasury as not credible.

As evidenced in the top graph, year to date through June 1, the total return for 7-10 year Treasury debt came in at 1.1 percent—a far cry from the nominal 2 percent yield frequently cited in the media as a benchmark for performance. What is also interesting is that both U.S. and European high yield fixed income outperformed longer-term Treasury debt.

Are We Getting Paid to Go Long?

While longer-dated U.S. Treasury yields appear attractive relative to short-dated Treasuries at first blush, there is also the question of duration risk. As evidenced in the middle graph, the incremental yield on U.S. government bonds an investor receives drops noticeably beyond five years.

Given the rapid rise in yields since the end of May, the incremental yield did not provide enough protection to provide a positive total return on the portfolio.

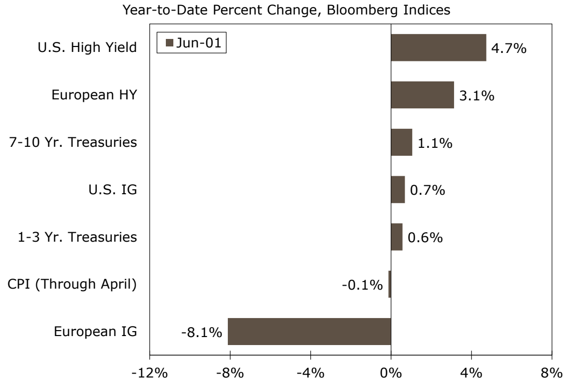
When we review the patterns for Germany, Spain and Italy as displayed in the middle graph, first, German yields pay very little incremental yield and so any significant rise in German yields would likely generate negative total returns. In contrast, for Spain the incremental yield actually rises and peaks at five years, but remains high through year nine. Only at the benchmark 10-year maturity does the incremental yield fall dramatically. For Italy, the incremental yield peaks at six years and then drops off but remains significant at years seven and eight. This quick review illustrates how varied the decision to go long can be influenced by the differences in incremental returns between sovereign debt opportunities.

Diminishing Returns to Go Long: Time to Rethink Allocation?

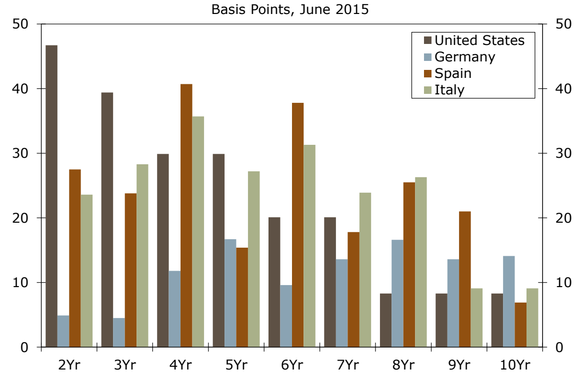
As illustrated in the bottom graph, the term premium on the 10-year Treasury has been steadily declining over the past 30 years. While the term premium rises in the early years of an economic recovery, this is a counter-trend move to the over-whelming secular decline in the premium. This premium, which measures the extra return a bond buyer demands to hold a longer bond rather than investing in a series of short-term securities, has declined over time as investors have put a reduced premium on the possibility of an upside inflation surprise.

For investors, this raises the fundamental question of what is the value of an allocation of long-term U.S. Treasury debt in a portfolio.

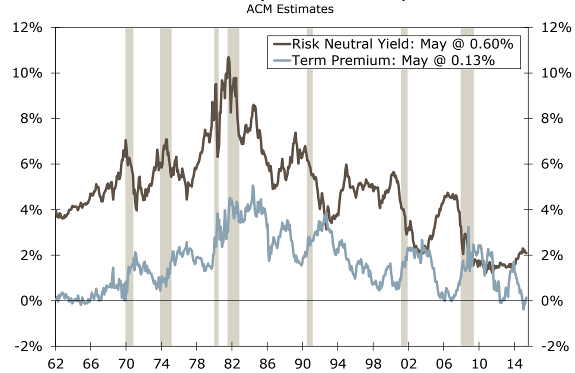
Fixed Income Total Return
Year-to-Date Percent Change, Bloomberg Indices



Government Bond 1-Year Roll
Basis Points, June 2015



10-Year Treasury Yield Decomposition
ACM Estimates



Source: Bloomberg, LP, Federal Reserve Bank of New York and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual					Forecast						
	2014				2015				2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.75	2.25
3 Month LIBOR	0.23	0.23	0.24	0.26	0.27	0.30	0.70	0.95	1.20	1.45	1.95	2.45
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.75	5.25
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.77	4.05	4.15	4.23	4.28	4.37	4.63	4.75
3 Month Bill	0.05	0.04	0.02	0.04	0.03	0.05	0.13	0.55	0.86	1.15	1.43	1.81
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.16	0.27	0.63	0.91	1.22	1.52	1.85
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.30	0.69	0.99	1.24	1.57	1.89	2.43
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.70	0.87	1.07	1.26	1.71	2.00	2.46
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.68	1.78	1.89	2.01	2.19	2.31	2.59
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.25	2.35	2.41	2.46	2.53	2.77	2.89
30 Year Bond	3.56	3.34	3.21	2.75	2.54	2.95	3.07	3.15	3.18	3.29	3.53	3.69

Forecast as of: June 10, 2015

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	1.7	2.9	N/A
FOMC	1.8 to 2.0	2.4 to 2.7	2.1 to 2.5
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.2 to 5.3	4.9 to 5.1	4.9 to 5.1
PCE Inflation			
Wells Fargo	0.8	2.0	N/A
FOMC	0.6 to 0.8	1.6 to 1.9	1.9 to 2.0

Forecast as of: June 10, 2015

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: June 17, 2015

Source: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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