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Economics Group

Interest Rate Weekly

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Trading Places: On the U.S/U.K. 10-Year Rate Spread

After years of offering a yield higher than, or roughly equivalent to, the 10-year U.S. Treasury, the 10-year U.K. gilt has consistently yielded less than its U.S. counterpart since late last year. What caused the switch?

A "Switcheroo" Across the Pond

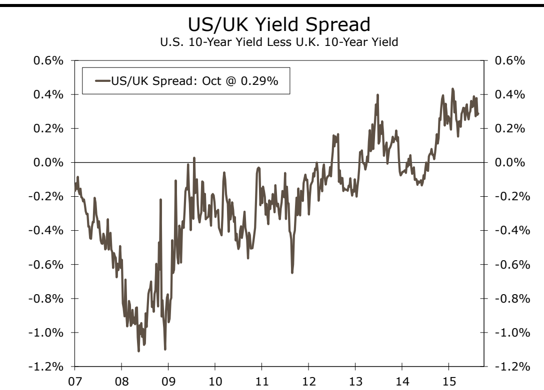
For much of the past decade, the U.K. 10-year government bond has offered a higher yield than the U.S. 10-year Treasury, at times even yielding a full 100 bps higher than its U.S. counterpart. However, since late last year, the 10-year Treasury has consistently traded 20-40 bps above the 10-year gilt (top chart). What factors have led to the switch?

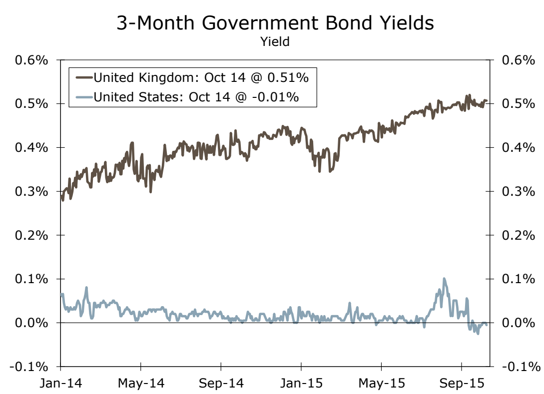
As we have written in the past, Treasury yields can be broken down into two components: the risk-neutral yield and the term premium. In theory, the risk-neutral yield should roughly equal the yield obtained from continuously rolling over short-term bonds. Meanwhile, the term premium reflects the marginal compensation investors receive for assuming the risk that short-term yields will evolve differently from expectations.

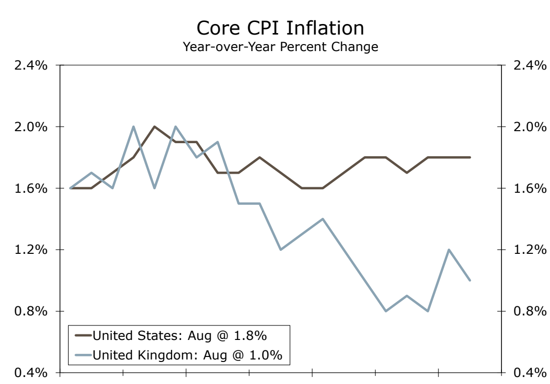
The middle chart shows the change in three-month government bond yields in the two countries since January 2014. The yield on the U.K. 3-month bond has clearly tracked higher over this time period, while the yield on the U.S. 3-month Treasury bill has held fairly steady. This implies that, while the risk-neutral yield on the U.S. 10-year has probably been little changed over the past two years or so, the U.K. risk-neutral yield has likely trended upwards. Yet, 10-year yields in both countries have moved lower on trend since last year, with the U.K. yield falling slightly further. Thus, we conclude not only that the declines in these yields are due entirely to declines in the term premiums, but also that the U.K. term premium has fallen further than the U.S. term premium.

Several hypotheses have been put forth in an attempt to explain the decline in Treasury term premiums. Broad-based global quantitative easing (QE), particularly by the European Central Bank (ECB) and Bank of Japan (BoJ), has been cited as one factor skewing the demand for government bonds.[1] Given the closer ties of the U.K. government bond market to the European market, it is possible that U.K. yields were disproportionately affected by the implementation of ECB QE. Indeed, expectations of the ECB's asset purchase program began to materialize around the same time that U.K. yields fell below U.S. yields on a consistent basis.

Another possible explanation relates to inflation developments in the two countries. The bottom chart shows that, while U.S. core CPI inflation has held fairly steady since last year, U.K. core inflation nosedived late last year and has subsequently recovered only modestly. Investors thus likely perceive less risk of unexpected inflation developments in the U.K. economy relative to the U.S. economy and subsequently require relatively less compensation for holding long-term bonds in lieu of rolling over short-term bonds. We suspect the relatively steeper decline in U.K. yields reflects both of these factors, although with the financial system constantly evolving and becoming more complex, other factors cannot be ruled out.







Source: Bloomberg LP, U.S. Department of Labor and Wells Fargo Securities, LLC

[1] Bernanke, Ben S. "Why are interest rates so low, part 4: Term premiums." (April 13, 2015). Brookings Institution.

Wells Fargo U.S. Interest Rate Forecast

	Actual			Forecast								
	2015				2016				2017			
	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	0.50	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.00
3 Month LIBOR	0.27	0.28	0.33	0.65	0.70	0.95	1.20	1.45	1.70	1.95	2.20	2.20
Prime Rate	3.25	3.25	3.25	3.50	3.50	3.75	4.00	4.25	4.50	4.75	5.00	5.00
Conventional Mortgage Rate	3.77	3.98	3.89	3.92	3.94	3.99	4.11	4.25	4.35	4.42	4.48	4.55
3 Month Bill	0.03	0.01	0.00	0.09	0.21	0.60	0.86	1.19	1.27	1.60	1.85	1.89
6 Month Bill	0.14	0.11	0.08	0.20	0.28	0.69	0.95	1.28	1.36	1.69	1.94	1.98
1 Year Bill	0.26	0.28	0.33	0.53	0.62	0.98	1.16	1.43	1.51	1.84	2.07	2.10
2 Year Note	0.56	0.64	0.64	0.85	1.01	1.28	1.55	1.80	2.01	2.28	2.35	2.40
5 Year Note	1.37	1.63	1.37	1.58	1.72	1.81	1.94	1.97	2.20	2.32	2.38	2.42
10 Year Note	1.94	2.35	2.06	2.08	2.10	2.15	2.25	2.37	2.45	2.50	2.54	2.59
30 Year Bond	2.54	3.11	2.87	2.89	2.88	2.90	2.92	2.94	2.96	2.96	2.98	2.98

Forecast as of: October 7, 2015

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

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.1	2.6	2.3
FOMC	2.0 to 2.3	2.2 to 2.6	2.0 to 2.4
Unemployment Rate			
Wells Fargo	5.0	4.6	4.4
FOMC	5.0 to 5.1	4.7 to 4.9	4.7 to 4.9
PCE Inflation			
Wells Fargo	0.8	1.9	1.9
FOMC	0.3 to 0.5	1.5 to 1.8	1.8 to 2.0

Forecast as of: October 7, 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: September 17, 2015

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

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