Chart of the Month

May 2016

10-YEAR U.S. TREASURY YIELD

The U.S. economy suffered from stagflation – a term that was first coined in 1965 by a British politician during a period of stagnation and inflation – and escalating interest rates throughout the second half of the 1970s.

Paul Volcker was appointed the Chairman of the Federal Reserve in August 1979 and immediately chose to combat inflation by tightening monetary policy and raising the fed funds rate all the way to 20% in June 1981. The yield on the 10-year Treasury peaked three months later at 15.82%.

Inflation subsequently fell from a high of nearly 15% in March 1980 into the 3s by 1983. The Consumer Price Index has averaged between 2 and 2.5 percent over the past quarter of a century and remains stubbornly low at just under the Fed's 2% target. This decrease in the rate of inflation – also known as disinflation – has been the catalyst for the downward trend in interest rates over the past 35 years.

As shown in the graph, the yield on the 10-year Treasury has been channel bound with lower highs and lower lows for the past three decades. While Treasury yields won't decline forever, it is important to understand that the current rate of 1.75% is well above those in Germany (0.12%), Netherlands (0.34%), France (0.47%), Hong Kong (1.17%), Canada (1.29%), United Kingdom (1.37%), Italy (1.47%), and Spain (1.59%), not to mention the negative (yes, *negative*) rates in Japan (-0.12%) and Switzerland (-0.35%). Swiss, Japanese, and German investors earn an additional 2.10%, 1.87%, and 1.63%, respectively, by buying U.S. Treasury Notes over their government bonds.

Going back to the last recession, we have been resolute in our belief that interest rates will remain "lower for longer" and still contend that the combination of sluggish growth, low inflation, and demand from foreign investors as well as an aging population seeking income will keep yields in the low single-digits for the next few years.

Our fixed-income strategy continues to favor corporate bonds as a means of picking up one to two percentage points – and sometimes as much as three – over comparable short- to intermediate-term maturities on U.S. Treasury Notes. Given our outlook for interest rates, it would be tempting to extend our durations in the search for even higher yields but we generally view bonds as the defensive segment of balanced portfolios. As such, we are more than satisfied to earn higher rates of return on our corporates than 10-year USTN despite maturities that are typically four-to-eight years shorter.

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