Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

MAY 19, 2014

WHAT'S GOING ON WITH THE 10-YEAR?

Almost everyone expected 2014 to bring higher interest rates. But the 10-year Treasury yield finished last week at its lowest level in almost a year. This sets up the mystery of 2014: what's going on with the 10-year Treasury? Taking the counsel of Albert Einstein, who suggested, "a man should look for what is, and not for what he thinks should be," we identify three possible drivers of the recent decline in US Treasury yields: the end of QE3, asset scarcity, and expectations of future fed funds rate hikes.

A curious, counterintuitive trend has appeared during each of the Federal Reserve's QE programs. In theory, bond buying puts downward pressure on interest rates, but in practice, as bond buying ramped up in QE1, QE2, and QE3, 10-year Treasury yields rose. Even more strange, as soon as the purchases stopped, the yield on the 10-year declined over the next three, six, and twelve months (see Chart 1).

We suspect this empirical oddity has to do with inflation expectations: when bond buying starts, investors ratchet up their inflation expectations and demand higher nominal yields. When the programs end with no inflation, the previous inflation premium departs (see Chart 2 below). Regardless of the cause, the pattern has persisted since the announcement that QE3 would wind down ("tapering"). *If* history is indeed a guide, yields could fall throughout 2014.

CHART 1: HERE'S HOW THE 10-YEAR TREASURY YIELD FARED UNDER QE1, QE2 AND QE3 (SO FAR)…

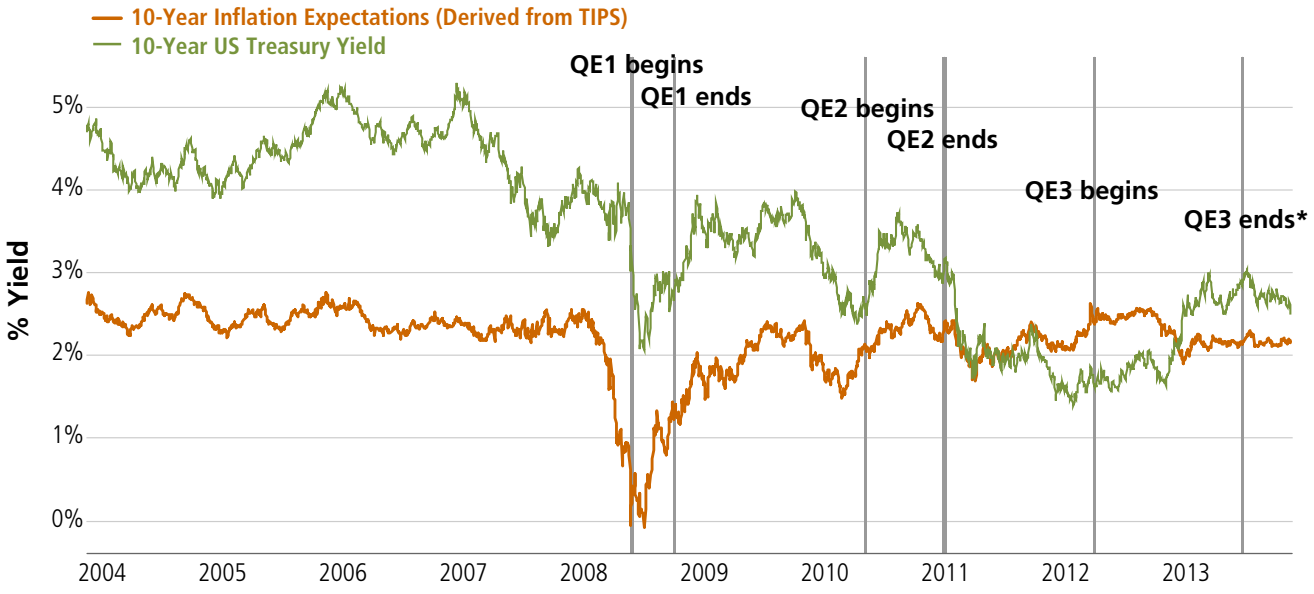
Yield Changes in percentage points (+/- = up or down)	QE1	QE2	QE3
Program Start-to-End	1.03	1.12	1.04
Three Months After Program End*	-0.88	-1.26	-0.10
Six Months After*	-1.3	-1.29	-0.35
1 Year After	-0.37	-1.51	??

**Program has yet to finish*

Second, asset scarcity remains a key factor in fixed income markets. As it turns out, even under tapering, the Fed continues to be a big buyer of US securities. In Chart 3 we calculated the new supply of US Treasuries net of Fed purchases. Over the last year, our measure of "net issuance" posted one of the smallest increases in the last decade. Fewer outstanding Treasury securities (due to an improving fiscal picture) in the face of rising demand due to global political and economic risk (Russia, China, a potential ECB asset purchase program, etc.) may have kept a lid on yields.

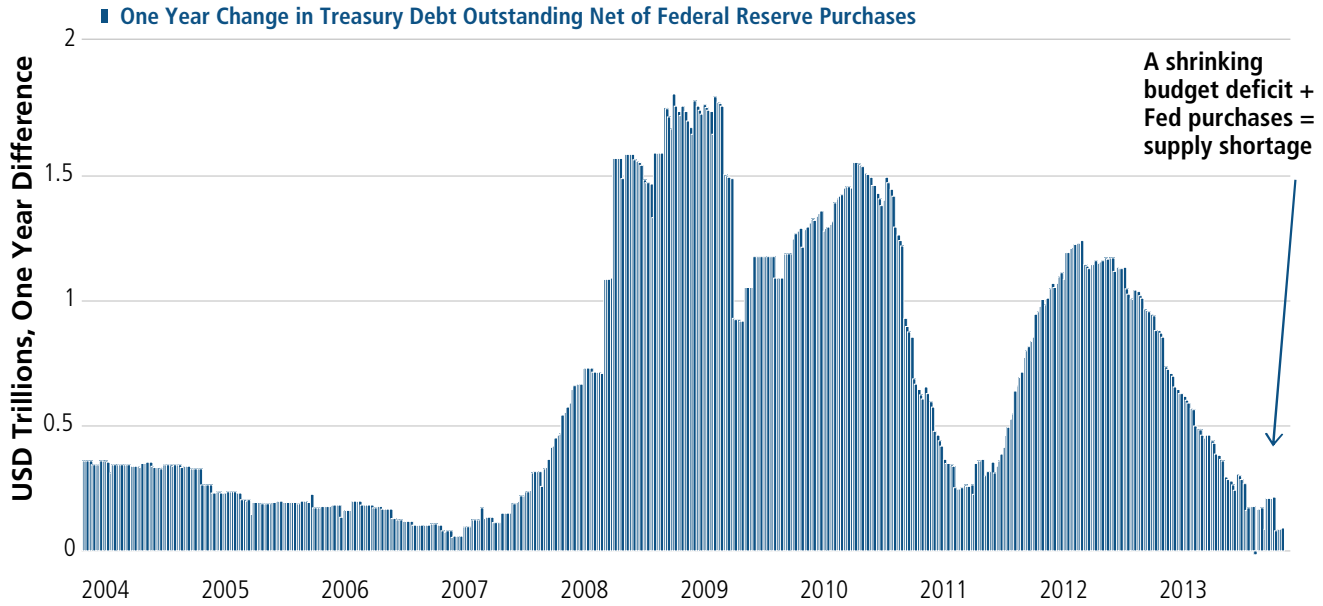
Finally, we suggest with the strongest conviction, expectations for rate hikes drive longer term interest rates. We've been showing the same chart for the last year which tracks a measure of the market's estimate of the number of months until the first fed funds rate hike

CHART 2: INFLATION EXPECTATIONS RISE AND FALL AS QE BEGINS AND ENDS



Source: U.S. Treasury Department

CHART 3: CHANGE IN OUTSTANDING TREASURY DEBT (NET OF FED PURCHASES) IN USD TRILLIONS



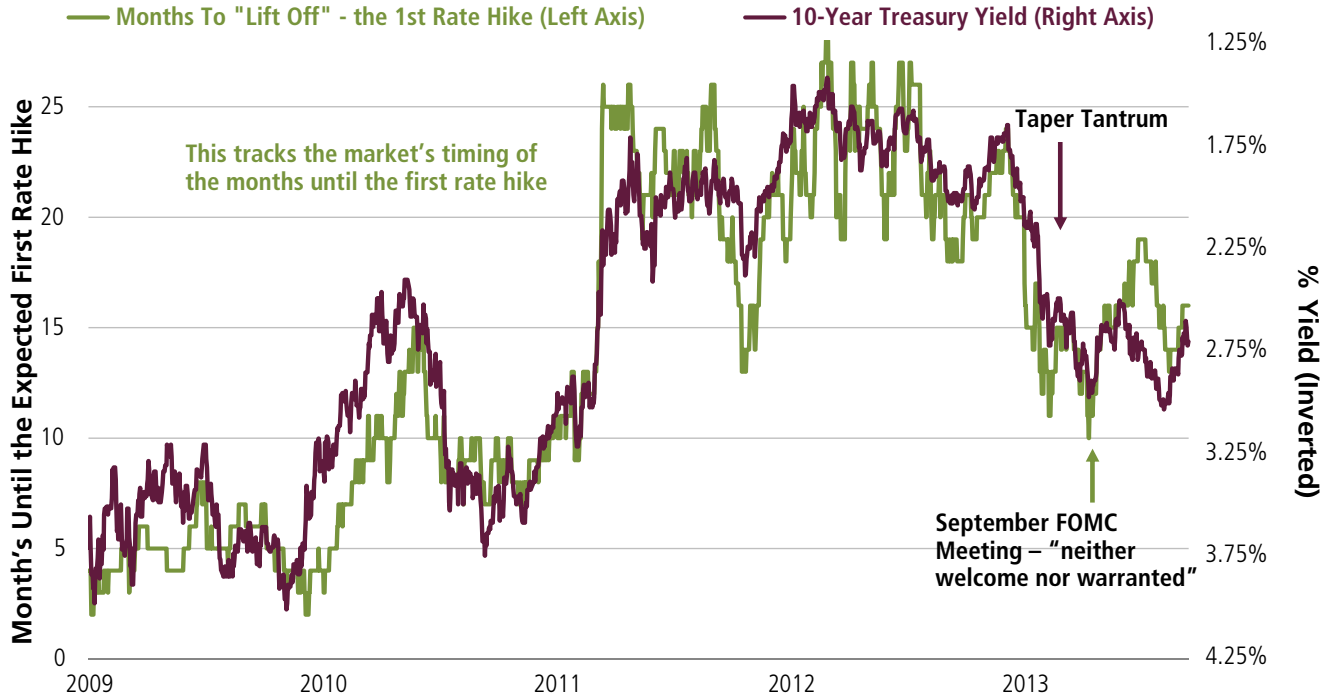
Source: U.S. Treasury Department

(see Chart 3). When the market expectations for the first rate hike move further into the future, longer-term Treasury yields move down. When market participants think the first interest rate hike will arrive sooner, longer-term Treasuries re-price and yields shoot up.

Simple though it may be, this chart has proved a powerful tool for understanding interest rates in the last five years of zero interest rate policy. This gauge explains the sharp move from sub-2% yields to 3% yields in short order during 2013. Again in 2014, as market expectations for a rate hike "just around the corner" diminished, Treasury yields fell. More to the point, it appears that surprises about the timing of the first rate hike cause the most interest rate volatility.

So where are we headed next? Einstein would remind us that just because investors think interest rates should push higher due to a pick-up in economic growth and a slow healing in the labor market doesn't necessarily mean they will. Instead, look beyond the traditional macro data for clues. Since we expect QE3 to taper off and for the asset scarcity to persist, it may be a surprise on the rate hike timing that tilts the balance one way or the other. We still think the first interest rate hike arrives in late 2015 rather than early 2015 or 2014.

CHART 4: MARKET PRICING OF FIRST RATE HIKE (# OF MONTHS AHEAD) DRIVES LONGER-TERM INTEREST RATES



Source: Payden Calculations, Bloomberg
**Readings Taken From Fed Funds Futures Market*