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THE WEEKLYVIEW

Bond Yields: A Pushmi-pullyu

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On the back of stronger US employment data, US bond yields have risen, and most maturities have returned to beginning of the year levels. For example, 10-year Treasury yields were 2.1% on January 2, fell to 1.6% by the end of the month, and are back to 2.0%. We think US 10-year Treasury yields will stay in a trading range between 1.6% and 2.4% until German 10-year bond yields, currently 0.28%, return to at least 1%.

Fans of Dr. Dolittle may remember the two headed 'pushmi-pullyu' portrayed in the movie by the front ends of two llamas joined together, facing in opposite directions. For US bonds, the 'push' higher in yields comes from a domestic economy that has been expanding for five years. The recent rise in yields was triggered by January's strong employment data with its significant upward revisions to prior months. The counterweight is the downward 'pull' of global yields (represented by Germany in our charts), where the yield difference is at 25-year highs (see chart on page 2). Relative inflation rates (shown below) help explain the differential in yields.

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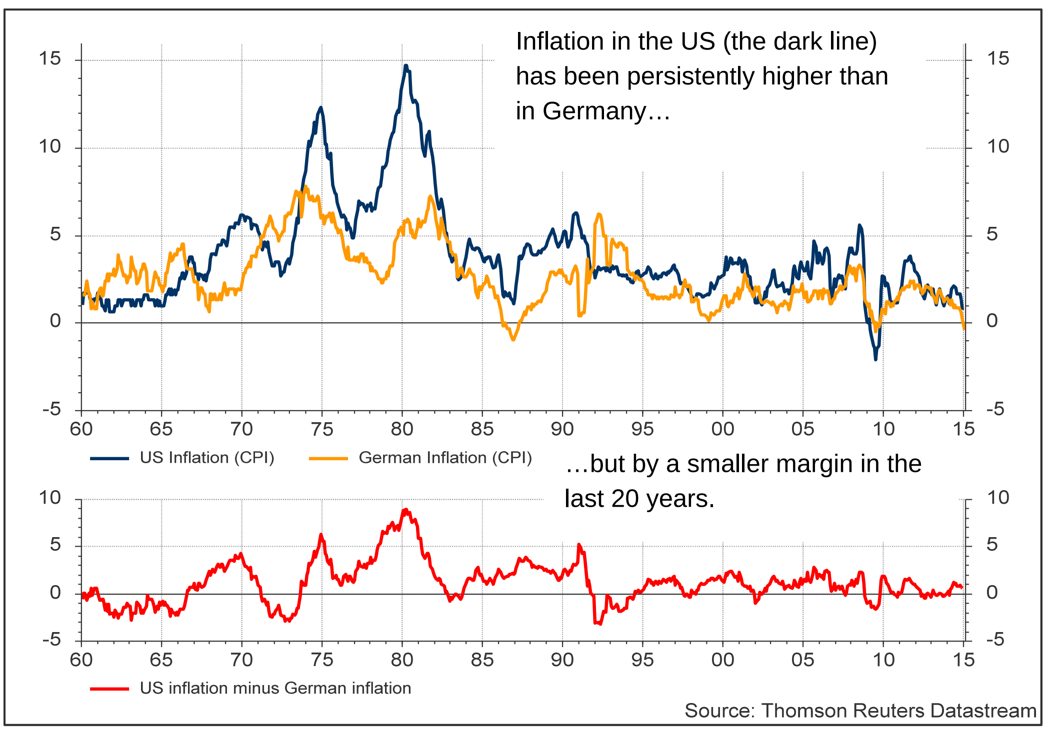

US inflation was one to two percentage points higher than Germany's from 1995 until 2007, but that gap has narrowed since the 2008 recession, as shown in the bottom panel of the chart above. Prior to 1990, the situation was different. Inflation rose considerably more in the US than in Germany during the oil shocks in the

1970s and early 1980s, so US bond yields also rose to higher levels. The first Persian Gulf War and German unification in the early-1990s caused German inflation to exceed US inflation, but in the last 20 years the relationship has been stable.

Interest rates are global: We believe it will be difficult for US 10-year yields to rise significantly while German rates remain near record lows, since the spread, shown in the bottom panel below, is already at 25-year highs. We continue to believe a 2% return is inadequate compensation for a 10-year loan to the US Treasury when the Federal Reserve's inflation target is 2%. For now, US yields will likely be capped by extremely low European interest rates, especially in Germany, and the European Central Bank 's (ECB) commitment to ramp up their bond purchases in March.

THE WEEKLY CHART: US BOND YIELDS PULLED DOWN BY GERMANY

In 2014 German interest rates collapsed (see oval in top panel) as growth in both Germany and the rest of Europe slipped towards recession and headed for deflation. The anticipation and eventual announcement of a bond-buying program by the ECB only exacerbated the trend. We believe this was a major force pulling US interest rates lower as global bond investors were attracted by higher US yields and a strengthening dollar. Despite this, the spread between US and German yields (the bottom clip) widened to 25-year highs. With spreads this wide, we think higher US rates are dependent on higher rates in Germany.