T.RowePrice®
INVEST WITH CONFIDENCE

FINDING “FAIR VALUE” FOR US TREASURIES

MARCH 2018

Ken Orchard
Co-Portfolio Manager, Diversified Income Bond Strategy

There is constant speculation about the direction of US Treasury bond yields, particularly the 10-year. This is because US Treasuries are the global low-risk asset *par excellence*. Their liquidity, widespread ownership and benchmark status mean that they both influence, and are influenced by, global financial markets. Recently, the rise in yields of Treasury bonds has contributed to higher volatility in other bond markets and asset classes around the world, and investors are concerned about how much further Treasury yields will rise.

What’s often missing from the equation, however, is discussion about the fair value of Treasuries at a given point in time. Having an informed view on what a bond’s value “should” be is an important guide to decision making — especially if fair value is out of line with current market pricing.

Fair value of Treasuries can be estimated using a number of different approaches. One is to use fundamental economic data to generate the expected probability of a US recession in the coming years. This information is used to identify the likely path of short-term interest rates over the same period, and from that to calculate the fair value of Treasuries today. For example, by the third week of March after the US Federal Reserve meeting, this method was outputting a fair value of between 2.85% and 3.00% for the 10-year US Treasury. (US 10-years were trading around 2.85%, according to US Treasury data.)

Another method to estimate fair value is to compare what the Fed is likely to do over the next few years — as outlined in the Federal Open Market Committee (FOMC) members’ projections for the Federal Funds rate — with the 30-year Treasury yield. Over the past 25 years, 30-year Treasuries have been good at finding the peak of the Fed funds rate and 10-year yields in rising interest-rate cycles. By the third week of March, the Fed dot plot (which shows the interest-rate projections of the 16 FOMC members over various calendar years) was predicting that Fed funds would peak between 3.25% and 3.50%, while the 30-year Treasury yielded about 3.15%.

A third thing to look at is the breakdown of nominal yields into inflation breakevens (the difference between the yield of a nominal bond and an inflation-linked bond of the same maturity) and the real yield. After remaining below the Fed’s 2% inflation target for several years, 10-year inflation breakevens have recently pushed back above this mark, suggesting they are now around fair value. Real yields have also risen, but a 10-year yield at roughly 0.80% (as of 22 March) still appears slightly low compared with long-term potential GDP growth.

These and other methods can be combined to estimate a range of longer-term fair values of Treasuries of different maturities. This can give investors a good indication of what their investment approach to Treasuries and other fixed income sectors should be. The measures above imply that, while 30-year Treasury yields were within fair value range, 10-year yields were slightly below fair value — in other words, they were overpriced. This information would also keep us slightly cautious on sectors that are more sensitive to Treasury yields, such as investment grade credit.

For investment professionals only. Not for further distribution.

T.RowePrice®
INVEST WITH CONFIDENCE

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date noted on the material and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

DIFC - Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA - Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Switzerland - Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE and the Bighorn Sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc. All rights reserved.

201803-455853

For investment professionals only. Not for further distribution.