

Fear Drives U.S. Treasury Yields

Lingering concerns about the euro zone and unemployment raise fears about the prospect of a recession.

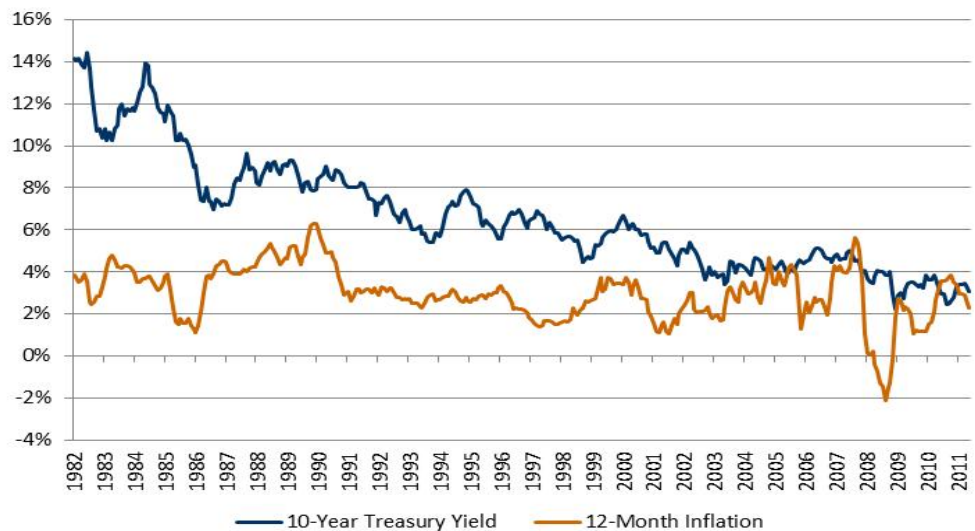
Yields that have been below the rate of inflation could cause investors to lose purchasing power.

With prospects for the euro zone becoming uncertain, many investors are bracing for a global recession. In a trend that some observers describe as a flight to safety, 10-year U.S. Treasury securities have experienced significant inflows, sending prices up and yields down.¹ As of May 31, 2012, the yield of 10-year U.S. Treasury securities was 1.59%, compared with 3.05% on May 31, 2011.²

Investors may increase allocations to U.S. Treasury securities when there is widespread belief that a recession or declines in global stock markets are imminent. In these scenarios, the backing of the U.S. government and a consistent yield until maturity enhances the appeal of a U.S. Treasury security. When large numbers of investors purchase U.S. Treasury securities, investors bid up prices and yields fall. The Federal Reserve also influences prices and yields when it buys and sells U.S. Treasury securities.

Losing Out to Inflation

Since May 2010, the yields of 10-year U.S. Treasury securities have frequently fallen below the 12-month rate of inflation as measured by the Consumer Price Index. If this situation continues, investors with large allocations to 10-year U.S. Treasury securities will lose purchasing power.



Sources: Bureau of Economic Analysis, the Federal Reserve. Twelve-month inflation is

represented by the Consumer Price Index, the 10-year U.S. Treasury yield by the yield at the start of the corresponding 12-month period.

What Investors Can Do

There are strategies that may help investors balance risk and return in an uncertain environment.

- An allocation to investment-grade corporate bonds could provide more attractive yield without too much additional risk. As of April 2012, the Moody's Seasoned Aaa Corporate Bond Yield was 4.94%.³ In contrast, the corresponding 12-month yield for 10-year U.S. Treasury securities was only 1.95%.
- Hold U.S. Treasury securities until maturity, when the U.S. government guarantees the face value. According to an analysis by Standard & Poor's Capital IQ Financial Communications, if a hypothetical investor purchased a 10-year U.S. Treasury security with a 1.7% yield at par value on May 30, 2012, and the market yield subsequently increased to 3.4% six months later, the market value of the bond would decline by 13.7%.⁴ Trading U.S. Treasury securities prior to maturity increases the chances of being caught off-guard by short-term volatility.
- U.S. stocks historically have not moved in tandem with U.S. Treasury securities.⁵ Balancing an allocation to U.S. Treasury securities with U.S. stocks or another asset that has not moved in tandem may help to cushion long-term portfolio volatility.
- Given the S&P 500's 6.3% decline in May 2012, investors may want to consider dividend-paying stocks.⁶ Although dividends are not guaranteed, a dividend's positive return can help offset declines in stock prices. Note that current favorable tax rates on qualified dividends are set to expire after December 31, 2012, unless Congress changes tax laws.

Events in the euro zone and concerns about possible contagion may lead to volatility in the financial markets for some time. When assessing 10-year U.S. Treasury securities, consider your risk tolerance, the rate of inflation, and opportunities for diversification.

¹Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, offer a fixed rate of return and fixed principal value.

²Source: The Federal Reserve.

³Source: The Federal Reserve.

⁴Sources: S&P Capital IQ Financial Communications, The Federal Reserve.

⁵Sources: S&P Capital IQ, Barclays Capital. U.S. stocks are measured by the S&P 500, 10-year U.S. Treasury securities by the Barclays Intermediate-Term U.S. Government Bond Index. This historical tendency of two assets to move in tandem is measured by correlation. Returns are for the 10-year period ending December 31, 2011. Past performance does not guarantee future results.

⁶Source: Standard & Poor's. You cannot invest directly in an index. Past performance does not guarantee future results.