Daiwa's View

Outlook for Japanese and US Yields in FY24 (as of 8 May 2024)

- Capture current trends, indicate central and alternative scenarios (soft-landing or hard-landing)
- Assume 10yr UST yield of 4.5% in Apr-Jun, 4.35% or 4.8% in Jul-Sep, 4.2% or 4.05% in Oct-Dec, and 4.0% or 3.3% in Jan-Mar 2025
- Assume 10yr JGB yield of around 1.0% in 1H FY24, then the lower 1.0% range or the upper 0% range in 2H

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We have never viewed the creation of bond yield projections as an easy task and this time the task seems particularly challenging. This is because the Fed, which was seriously behind the curve in the past, has changed its policy response functions to allow for backward-looking data. Moreover, the US economy looks very different depending on which data is used by the Fed.

Currently, uncertainty is increasing on many fronts. As such, forecasting scenarios with a high degree of certainty is not easy. Recently, former Fed Chairman Ben Bernanke explained that publishing both central scenarios and alternative scenarios is a forecasting approach that better captures the prevailing trends. Therefore, we will do the same in this report and, for the first time, explicitly identified a soft-landing scenario and a hard-landing scenario. Of course, even this is hardly a sufficient number of scenarios, but we see this is a better approach than presenting only one uncertain main scenario as a basis for discussion (tentative).

Outlook for 10yr US Yield and FF Rate (as of 8 May 2024)

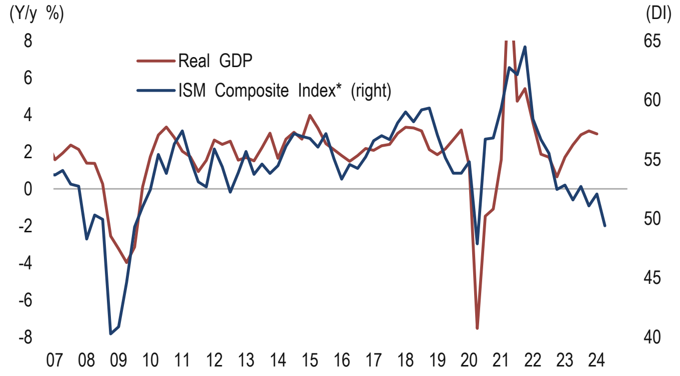
Soft-landing scenario													
(%)		May-Jun			Jul-Sep			Oct-Dec			Jan-Mar		
		Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
US	FF rate (upper limit)	5.50	5.50	5.50	5.25	5.25	5.25	5.00	5.00	5.00	4.75	4.75	4.75
	10y	4.15	4.85	4.50	4.00	4.70	4.35	3.80	4.60	4.20	3.50	4.50	4.00

Hard-landing scenario													
(%)		May-Jun			Jul-Sep			Oct-Dec			Jan-Mar		
		Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
US	FF rate (upper limit)	5.50	5.75	5.50	5.50	5.75	5.50	5.50	5.75	5.50	2.50	4.50	4.50
	10y	4.15	4.85	4.50	4.50	5.10	4.80	3.00	5.10	4.05	2.30	4.30	3.30

Source: Compiled by Daiwa

The US real GDP growth (GDP) and ISM Composite Index (ISM) are probably the best indicators in terms of presenting the current complex situation (see chart on next page). If, among these two data sets, we focus on GDP, additional rate hikes seem necessary to limit surprisingly strong growth despite the restrictive FF rate level setting. Meanwhile, in light of the ISM, which has shown that labor demand has clearly cooled down to the point where even the reading for the service sector, the main source of US employment, has finally fallen below 50, an "additional rate hike" that would further damage the US corporate sector seems to be out of the question. An early precautionary rate cut appears to be necessary to avoid labor market imbalances caused by rising unemployment.

US Real GDP, ISM Composite Index

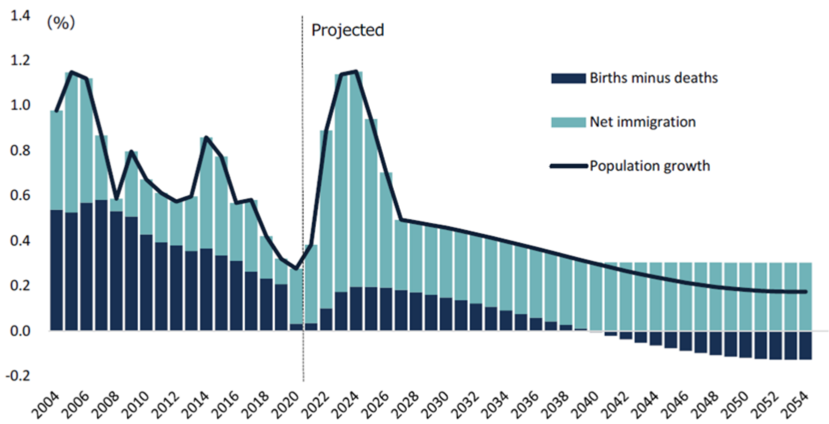


Source: US Department of Commerce, ISM; compiled by Daiwa.
**Total of ISM Manufacturing Index and ISM Services Index.*

Under the current situation in which economic perceptions expressed by the data are so varied, we are forced to conclude that "High for Long" (maintaining FF rate at 5.25-5.5%) will continue until there is sufficient data to provide more confidence. However, wouldn't that mean that the Fed is moving towards the "mistake of maintaining excessively high interest rates for a long time," which Fed Chairman Jerome Powell himself sternly warned against at the December 2023 FOMC meeting?

The background for this emergence of unprecedented and puzzling data is probably due to the large role played by the substantial US population growth due to the massive influx of immigrants that has swelled to an unprecedented scale. The data shows that the population growth rate increase appears to have resulted in an increase in the US potential growth rate (→r*). However, sustainability of that trend will depend on whether this immigrant influx is sustainable.

US Population Growth Rate: Sharp Influx of Immigrants



Source: CBO; compiled by Daiwa.

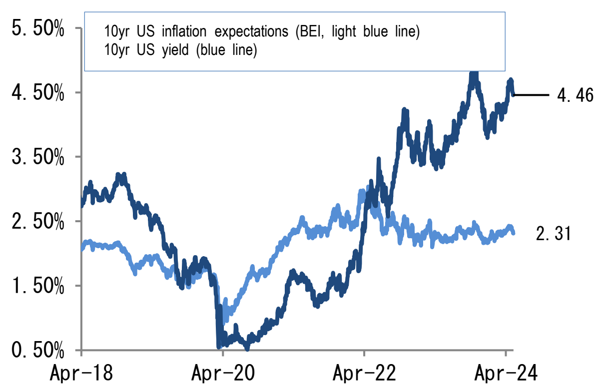
In any event, amid such conditions, we feel that in addition to the "soft-landing" scenario widely envisioned by the current market and most economists, we must also keep in mind the existence of a "hard-landing" scenario, which the market and most economists disregard. In the following section we discuss the image of our bond yield outlooks based on real yields (interest rates) and the breakeven inflation rate.

Outlook for US Monetary Policy (as of May 2024)

	Adjustment rate cut scenario (Soft-landing scenario)		High-for-long scenario (Hard-landing scenario)	
FOMC meeting	Policy rate (median of range)	Balance sheet reductions (QT)	Policy rate (median of range)	Balance sheet reductions (QT)
Jul-23	0.25% hike (5.375%) Terminal rate: 5.25%～5.50%		0.25% hike (5.375%) Terminal rate: 5.25%～5.50%	
Sep-23	—		—	
Nov-23	—		—	
Dec-23	—		—	
Jan-24	—		—	
Mar-24	—		—	
May-24	—	Slowdown in pace of balance sheet reductions (US Treasuries: $60bn/m → $25bn/m, MBS: $35bn/m) ※Portion exceeding MBS cap reinvested in US Treasuries	—	Slowdown in pace of balance sheet reductions (US Treasuries: $60bn/m → $25bn/m, MBS: $35bn/m) ※Portion exceeding MBS cap reinvested in US Treasuries
Jun-24	—		—	
Jul-24	0.25% cut (5.125%)			
Sep-24	—		—	
Nov-24	—		—	
Dec-24	0.25% cut (4.875%)		—	
Jan-25	—	Suspension of balance sheet reductions (Continuation of MBS roll-off)	0.50% cut (4.875%)	Suspension of balance sheet reductions (Continuation of MBS roll-off)
Mar-25	0.25% cut (4.625%)		0.50% cut (4.375%)	
May-25	—		0.50% cut (3.875%)	
Jun-25	0.25% cut (4.375%)		0.50% cut (3.375%)	
Jul-25	—		0.50% cut (2.875%)	
Sep-25	0.25% cut (4.125%)		0.50% cut (2.375%)	
Nov-25	—		0.50% cut (1.875%) Terminal rate: 1.75%～2.00%	
Dec-25	0.25% cut (3.875%)		—	
Jan-26	—		—	
Mar-26	0.25% cut (3.625%)		—	
May-26	—		—	
Jun-26	0.25% cut (3.375%)		—	
Jul-26	—		—	
Sep-26	0.25% cut (3.125%) Terminal rate: 3.00%～3.25%		—	

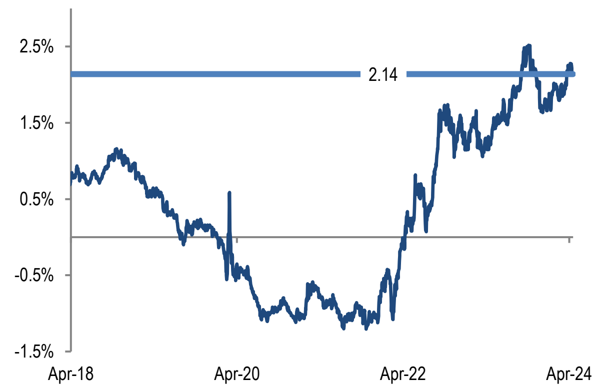
Source: Compiled by Daiwa
Note: Official schedule for FOMC meetings from Jan 2025 onwards undisclosed.

10yr US Yield, 10yr US Breakeven Inflation Rate



Source: Bloomberg; compiled by Daiwa.

10yr US Real Yield



Source: Bloomberg; compiled by Daiwa.

Apr-Jun: Mid-point of core range at 4.5% (4.15-4.85%)
As we have discussed several times in the past, the cruising level for the 10-year breakeven inflation rate (BEI) is considered to be 2.3%. Meanwhile, we think the BEI will land at a slightly higher level than the normal cruising level amid the current situation involving concerns about a rekindling of inflationary pressures and heightened tensions in the Middle East, which is a major factor in terms of setting energy prices. During the Apr-

Jun period, the BEI will likely hover around 2.25-2.45% (2.35% mid-point).

Next is the real yield, which basically depends on the Fed's intentions (degree to which a restrictive level is desired). On that point, Fed Governor Christopher Waller expressed some satisfaction last September when the 10-year real yield rose to a level of around 2%. Also, the 2024 real FF rate (FF - core PCE) in the March 2024 Summary of Economic Projections (SEP) was also about 2% (4.625 - 2.6%). Meanwhile, the Fed was dissatisfied with the disinflationary developments in Jan-Mar 2024 and reset monetary policy at the May FOMC meeting. That said, Chairman Powell was not overly hawkish, denying any additional interest rate hikes. Furthermore, taking into account the overall situation, including the Fed not defending the real yield, which rose to around 2.5% when the 10-year US Treasury yield broke through 5% around Oct-Nov last year, among other factors, we believe that the Fed's intended real yield is currently in the neighborhood of 1.9%-2.4% (2.15% mid-point).

Based on the above points, we assume that the image of the 10-year US Treasury yield by the end of June will be around 4.15-4.85% (4.5% mid-point). As a side note, this means that core inflation will increase by about 0.2% in the upcoming June SEP. Meanwhile, current expectations are for three rate cuts, but this will probably be reduced to one or two cuts during this year.

Jul-Sep: Mid-point of core range at 4.35% or 4.8%
After the Jul-Sep quarter, the Fed's actions will change for each assumed scenario. Under the soft-landing scenario, we assume the Fed will make a precautionary rate cut in the Jul-Sep period. At the same time, the economy and inflation are expected to remain firm. As such, any decline for the 10-year real yield will probably be modest (10-year real yield of around 2%). Meanwhile, under a hard-landing ("High for Long") scenario, we assume the need for an additional rate hike, rather than a rate cut, will again be discussed. Under the growing perception that the Fed cannot cut interest rates on a semi-permanent basis, we assume the US 10-year Treasury yield would again touch 5%.

Oct-Dec: Mid-point of core range at 4.2% or 4.05%
Under the soft-landing scenario, the US presidential election passes without incident (we want to discuss this point separately) and there is one more rate cut during the year (i.e., two rate cuts during the year). Still, only a modest decline for the 10-year real yield is expected as the economy remains strong at a restrictive level (10-year real yield of around 1.9%). Meanwhile, Under the hard-landing scenario, we assume that signs of "cracks" in the soft data will begin emerging and some market participants will become wary of a significant rate cut.

Jan-Mar 2025: Mid-point of core range at 4.0% or 3.3%
Under the soft-landing scenario, we expect a third additional interest rate cut to materialize, bringing the nominal interest rate to around 4% (real yield at roughly 1.7%). Meanwhile, under the hard-landing scenario, we assume a large interest rate cut of 1.0% (or more) in Jan-Mar 2025 due to a situation in which a further large rate cut is a certainty in order to stave off a recession. In that case, the 10-year Treasury yield could fall to 3.3% in nominal terms (real yield of 1.0%) or lower.

These are our current yield forecasts for FY24. However, as we mentioned at the beginning of this report, making a highly accurate central forecast is not easy as uncertainty is currently increasing on various fronts. Even providing two separate scenarios may not suffice. Still, we believe providing multiple scenarios is a better approach than offering a single main scenario as the basis for discussions.

(Tani)

JGB yield outlook (Kawahara)

We anticipate a core range for the 10-year JGB yield of around 1.0% in 1H FY24. In 2H FY24, we forecast it in the lower 1.0% range in the case of a soft-landing scenario in US or in the upper 0% range in the case of a hard-landing scenario in US.

1H FY24: Core range around 1.0%
JGB yields are currently facing upward pressure emanating from abroad, backed by a solid US economy. The BOJ is expected to implement additional rate hikes in the Jul-Sep quarter at the earliest. However, as the market has already factored in the possibility of early rate hikes, such hikes are unlikely to have a strong impact on the level of the long-term yield. When forecasting the long-term yield, the focus of attention is on trends with inflation expectations. In his post-meeting press conference in April, BOJ Governor Kazuo Ueda stated that inflation expectations were at the mid-1% level on a weighted average basis. Inflation expectations are expected to rise in anticipation of achieving 2% in the second half of the projection period. However, we think the market may factor in 2% inflation expectations in 1H FY24 at the earliest. If so, from the standpoint of fundamentals, the level of the long-term yield is expected to be around 1% (natural rate of interest at 0% + inflation expectations at 2% + stock effects at -1%).

2H FY24: Core range in lower 1.0% range (soft landing scenario in US)
If the US economy remains solid in 2H, the BOJ is expected to implement a second rate hike in the Jan-Mar period. In that case, we think the 5-year yield could rise to a level pricing in a terminal rate of around 1%, with the market assuming further rate hikes from FY25 onwards. We anticipate a long-term yield at the mid-1.0% range or the lower 1.0% range if the market factors in 2% or 1.5% inflation expectations, respectively. That said, stock effects, which have reined in a rise in yields thus far, are likely to persist. However, in a world factoring in a terminal rate of 1% and inflation expectations of 2%, stock effects are expected to diminish in anticipation of QT in the future.

2H FY24: Core range in upper 0.0% range (hard-landing scenario in US)
If the US economy were to fail to bear monetary tightening and enter a recession from the 2H, the BOJ would likely abandon a second rate hike. While the US economy would initially be solid in the Oct-Dec period, with the market factoring in additional rate hikes by the BOJ, similar to the soft-landing scenario, and this would be expected to lead to a rise in the 5-year yield to a level that factored in a terminal rate of around 1%, with the long-term yield anticipated to move at the lower 1.0% range, once the US economy worsened, the situation would change substantially. JGB yields would be expected to decline in line with lower US yields. Amid falling inflation expectations, speculation about additional rate hikes by the BOJ would be expected to diminish. We anticipate that the long-term yield would decline to the upper 0.0% level.

Addendum: Lower limits in each scenario
Currently, the lower limit of the long-term yield from the standpoint of fundamentals is around 0.5% (natural rate of interest at 0% + inflation expectations at 1.5% + stock effects at -1%). However, this assumes inflation expectations of 1.5%. It is possible that inflation expectations will be lower than 1.5% in a hard-landing scenario in the US. If we assume inflation expectations of 1.0% in that case, we can calculate that the lower limit would be around 0.0% (natural rate of interest at 0% + inflation expectations at 1.0% + stock effects at -1%). However, we are not anticipating a decline to that extent in this report, because, if there were a substantial drop in yields, in addition to abandoning additional rate hikes, the BOJ could reduce JGB purchases in its operations in order to avoid flattening of the yield curve. In September 2016, the BOJ changed the framework of monetary policy for similar reasons. This time, a similar situation is anticipated. We also do not anticipate the lower limit declining to 0.5% in a soft-landing scenario in the US. Even if inflation expectations rise at a more moderate rate due to a delay in the recovery of Japan's economy, we think that hopes for a rise in inflation expectations to 2% in the future will not disappear as long as the US economy remains solid and financial conditions remain accommodative.

(Kawahara)

Outlook for JGB Yields (Soft landing scenario)

(%)		Soft-landing scenario											
		May-Jun			Jul-Sep			Oct-Dec			Jan-Mar		
		Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
Japan	IOER	0.10	0.10	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50
	2y	0.20	0.40	0.35	0.25	0.50	0.40	0.25	0.60	0.45	0.25	0.75	0.60
	5y	0.40	0.60	0.50	0.40	0.70	0.55	0.40	0.80	0.60	0.40	0.90	0.75
	10y	0.75	1.05	0.90	0.70	1.10	0.90	0.70	1.20	0.95	0.75	1.40	1.10
	20y	1.50	1.80	1.65	1.50	1.80	1.60	1.45	1.80	1.55	1.35	1.80	1.60
	30y	1.80	2.10	1.95	1.80	2.10	1.90	1.70	2.10	1.85	1.60	2.10	1.85

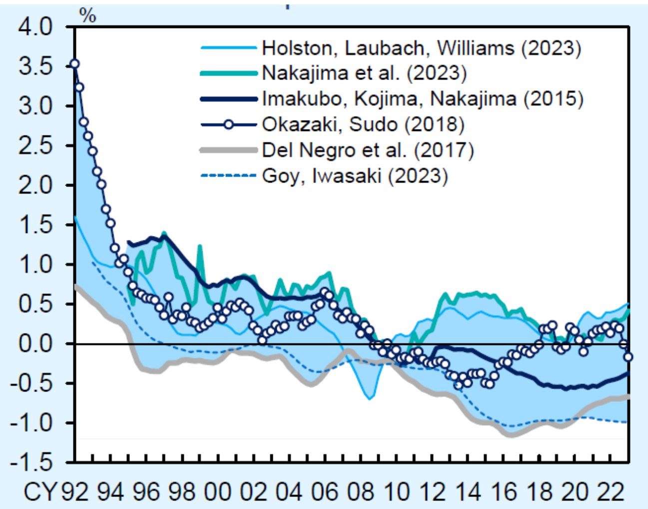
Source: Compiled by Daiwa

Outlook for JGB Yields (Hard landing scenario)

(%)		Hard-landing scenario											
		May-Jun			Jul-Sep			Oct-Dec			Jan-Mar		
		Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
Japan	IOER	0.10	0.10	0.10	0.10	0.25	0.25	0.10	0.25	0.25	0.10	0.25	0.25
	2y	0.25	0.50	0.35	0.25	0.60	0.45	0.20	0.70	0.40	0.15	0.50	0.30
	5y	0.45	0.60	0.50	0.45	0.70	0.60	0.30	0.80	0.45	0.20	0.60	0.40
	10y	0.85	1.00	0.90	0.85	1.25	1.05	0.60	1.15	0.80	0.50	1.00	0.70
	20y	1.60	1.80	1.65	1.60	1.90	1.75	1.05	1.90	1.45	0.90	1.50	1.20
	30y	1.90	2.10	1.95	1.90	2.25	2.05	1.30	2.20	1.70	1.20	1.75	1.50

Source: Compiled by Daiwa

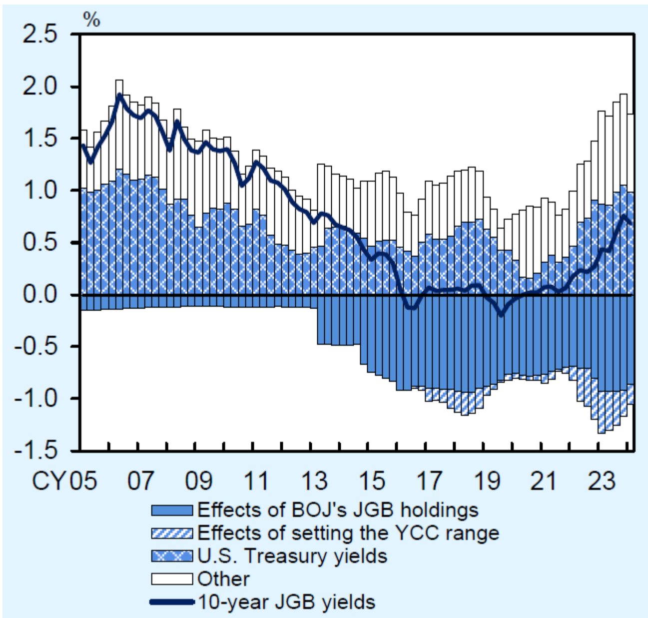
Estimates of Natural Rate of Interest for Japan



Sources: Bank of Japan; Ministry of Finance; Ministry of Health, Labour and Welfare; Cabinet Office; Ministry of Internal Affairs and Communications; Bloomberg; Consensus Economics Inc., "Consensus Forecasts."

Source: BOJ's Outlook for Economic Activity and Prices (Apr 2024).

Stock Effects



Sources: Bank of Japan; Ministry of Internal Affairs and Communications; Bloomberg; LSEG Eikon.

Source: BOJ's Outlook for Economic Activity and Prices (Apr 2024).

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** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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