Daiwa's View

Reconfirmation of fair value of US interest rate

➢ Fair value is 1.75-1.85% with an estimated range from 1.65% to 1.95%

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Daiwa Securities Co. Ltd.

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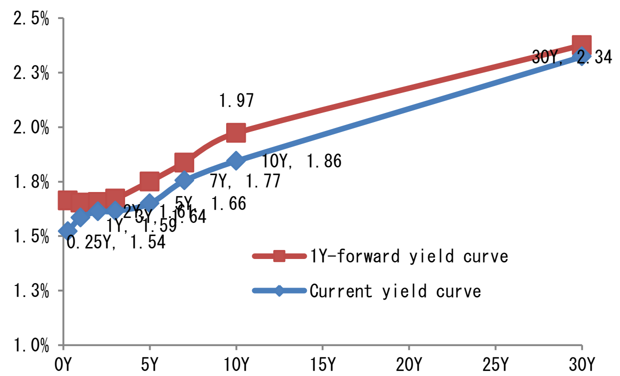
Yesterday, it turned out that the October US ISM non-manufacturing sector PMI exceeded the market consensus alongside continued optimism about US-China trade talks, pushing up the US long-term interest rate by 8bp. The cumulative rise over the two days reached as much as 15bp. As previously reported[1], we estimate that the near-term fair value of the 10-year US interest rate is 1.75-1.85% (with an estimated range from 1.65% to 1.95%). Although improvement in the US-China trade issue must be confirmed, we think the current interest rate level is relatively attractive in light of the fair value level discussed later in this report.

In forecasting the 10-year US interest rate, I am focusing on three factors: (1) longer-run projections for the federal funds rate, (2) the short-term interest rate, and (3) the differential between long-term and short-term interest rates (+ term premium). Regarding the first factor, longer-run projections for the federal funds rate tend to fall in the upper end of the 30-year US interest rate in terms of quality. In longer-run projections, a downtrend has been observed. In fact, a comparison of the dot charts in June and September 2019 shows a slight downward shift in dot distributions, although the median level was unchanged. Probably, the median of longer-run projections is likely to decline to 2.25% at some stage.

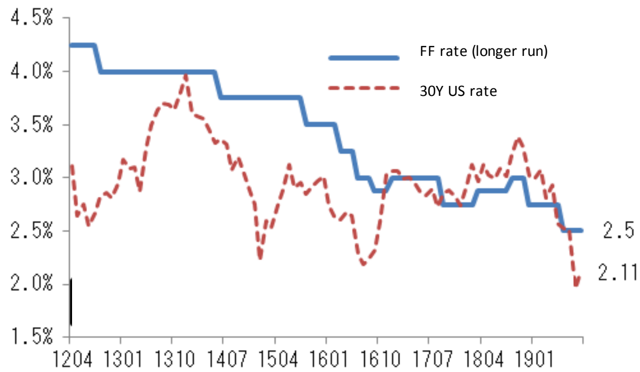
If longer-run projections for the federal funds rate are seen as being in the process of moving downwards from 2.50% to 2.25%, the point of reference for the appropriate level of the 10-year US interest rate would also be in the process of moving downwards from 2.00% to 1.75% (assuming the US 10-year/30-year spread is 50bp). Here, we estimate that the appropriate level of the 10-year US interest rate is 1.75% plus something extra.

Chart: US Treasury Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Longer-run Projection for FF Rate and 30Y US Rate



Source: Bloomberg; compiled by Daiwa Securities.

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[1] Refer to our 13 Sep 2019 report *Daiwa's View: Current level offers good opportunity to consider probe buying.*

Chart: Dot Chart (Jun 2019)

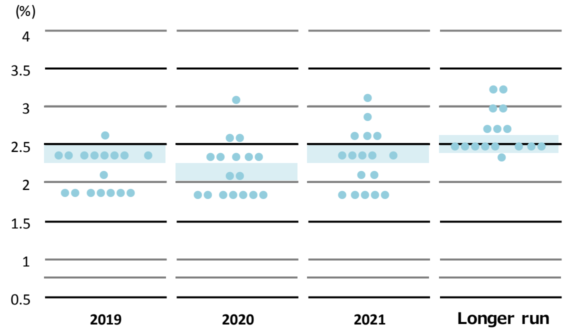
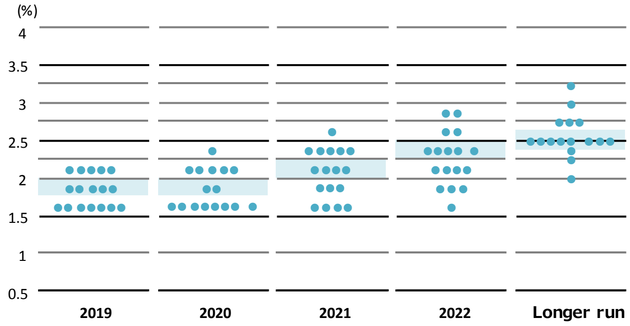


Chart: Dot Chart (Sep 2019)



Source: Fed; compiled by Daiwa Securities.

Besides the first factor, useful perspectives for judging the fair value of US interest rates are the short-term interest rate and the differential between long-term and short-term interest rates. With the completion of the process of preventive rate cuts, the Fed has lowered the target range for the federal funds rate to 1.5-1.75%. Going forward, as the hurdle is high both for rate cuts and rate hikes, the Fed is expected to maintain the current policy interest rate level.

The effective federal funds rate level established under the aforementioned target range for the federal funds rate is estimated at around 1.65%. Here, if we assume that the differential between long-term and short-term interest rates is 10-20bp, the point of reference for the 10-year US interest rate is calculated at 1.75-1.85%. For reference, if the 10-year US interest rate were to exceed 2.00%, the differential between long-term and short-term interest rates would need to be at least 35bp. Of course, we cannot deny the possibility that the rate could reach such a level in the short term, but the hurdles to maintaining that would be high.

Due to these factors, the fair value of the 10-year US interest rate is projected at 1.75-1.85% with an estimated range from 1.65% to 1.95%. Although we need to keep an eye out for surprises from the US-China trade talks, the hurdle for the 10-year US interest rate to exceed 2% is substantially high, as the upside is curbed by the longer-run projections calculated by FOMC members. It is possible that current US interest rates have reached an appropriate level for cautious probe buying.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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May 2018

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As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter's outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.

2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Nippon Healthcare Investment Corporation (3308), Japan Rental Housing Investments (8986).

3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.

4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of Y10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.

5) Daiwa Securities Group and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group is to acquire up to 5.01% of Credit Saison's total common shares outstanding (as of 31 Jul 2019), while Credit Saison is to purchase up to Y2bn worth of Daiwa Securities Group's common stock.

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* The amount of the trading commission 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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