Daiwa's View

US yield forecasts for 2H 2020

➢ Extraordinarily stable movements are expected with a core range of 0.60-0.75%

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Daiwa Securities Co. Ltd.

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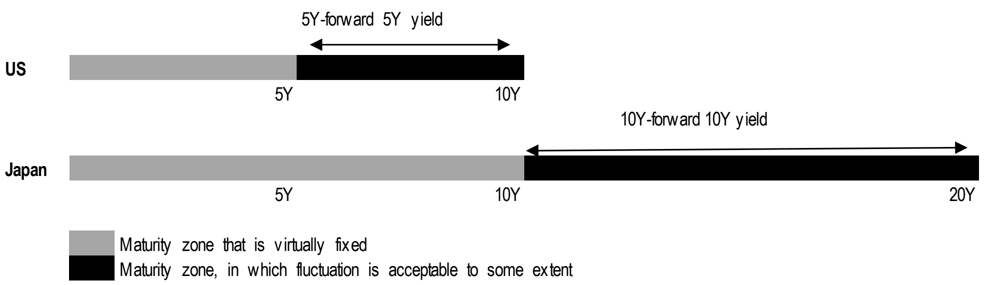
For 2H 2020, we anticipate extraordinarily stable movements of Japanese and US yields. We have been surprised by developments over the past six months, given our projections compiled half a year ago in the midst of the COVID-19 pandemic that yields would fluctuate extraordinarily.

This time around, we put more focus on the concept of "forward yields" than before, when forecasting the range for 2H. This is because the front-end of the yield curve has been stabilizing due to a series of measures by the Fed introduced since the outbreak of the pandemic. In this report, we begin by stating our forecast for the range of US yields.

For 2H 2020, we expect the 10-year US yield to range from 0.50% to 0.80% (with a core range of 0.60-0.75%). The two major reasons for this are because (1) the possibility of a rate hike was eliminated until core inflation reaches 2% in new forward guidance introduced at the September FOMC meeting and (2) Fed Chair Jerome Powell has committed to a policy that will remain highly accommodative until there is a moderate overshoot of inflation for some time even after the federal funds rate is lifted in the future.

There is little room for argument regarding the first reason. Since the market has been aware of the introduction of average inflation of 2%, the 5-year US yield has been virtually pegged at around 0.25%. We think the market interpretation that at least five years are needed before a rate hike is appropriate, given (1) the current core PCE level of far below 2% and (2) the timing of inflation reaching 2% implied by the Fed's economic projections. Therefore, the 5-year yield is expected to remain stable at around 0.25% in 2H.

Conceptual Diagram of Yield Fixation

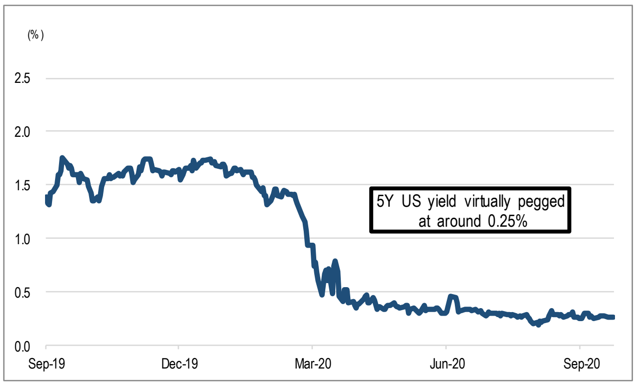


Source: Compiled by Daiwa Securities.

If the 5-year yield is pegged, variable factors for the 10-year yield are limited to the 5-year forward 5-year yield. From this perspective, the second reason given above regarding the remark by Fed Chair Powell deserves attention. This is because its implication that the Fed will maintain the federal funds rate below the neutral level of 2.5% (shown in dot chart) until inflation stays moderately above 2% for some time is expected to have a major impact on the 5-year forward 5-year yield.

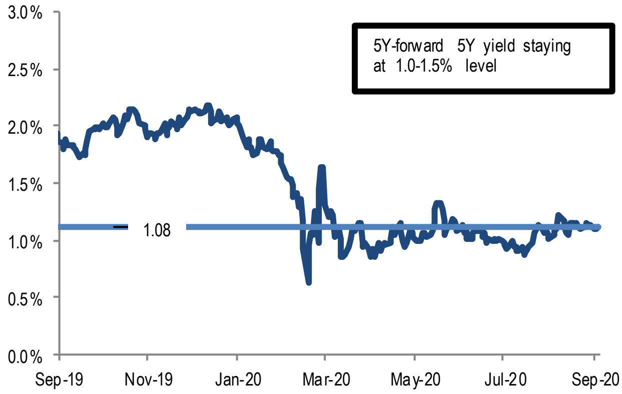
Even if we assume that a rate hike starts in five years in line with the current market consensus, the pace and level are likely to be more moderate than with previous hikes. There have been no remarks regarding a concrete rate hike pace under the new policy. However, it is safe to say that a more moderate pace can now likely be expected than the quarterly 0.25% rate hike seen in the period of former Fed Chair Janet Yellen. If we assume that a rate hike will take four years and that the final level reached will be around 2%, our rough estimations indicate that the point of reference of the theoretical value of the 5-year forward 5-year yield would be around 1.25%. In this case, if the level of the 5-year yield is assumed to be 0.25-0.30%, the level of the 10-year yield can be estimated at the upper 0.7% range.

US 5Y Yield



Source: Bloomberg; compiled by Daiwa Securities.

US 5Y-forward 5Y Yield



Source: Bloomberg; compiled by Daiwa Securities.

That said, the assumption of a steady US rate hike to 2% appears to be considerably optimistic. In fact, the currently observed 5-year forward 5-year yield is just around 1% in the market, implying that the Fed's fight with inflation will not be easy. If we assume that the preconditions for the rate hike are that it will start in five years and stop at 1% after two years from the inception, an appropriate level of the 5-year forward 5-year yield would be calculated at around 0.8%. In this case, if the level of the 5-year yield is assumed to be 0.20-0.25%, the level of the 10-year yield can be estimated at around the lower 0.5% range.

US Yield Forecast Scenario

(%)	5Y	5Y5Y	10Y
Current level	0.27	1.04	0.65
Upward scenario	0.28	1.25	**0.77**
Downward scenario	0.23	0.80	**0.52**

Source: Bloomberg; compiled by Daiwa Securities.

Of course, yields currently tend to face upward pressure because (1) the US economy is in a recovery cycle and (2) market participants are aware of additional issuance of Treasury bonds due to fiscal support. However, the new forward guidance and the aforementioned interpretation of the Fed Chair's remarks would lead to fixation of the 5-year yield and stabilization of the 5-year forward 5-year yield, which should constrain a rise in the 10-year yield.

If we see disappointment over fiscal support measures and risk-off moves when the US presidential election approaches, the 0.5% level may be tested in the absence of risk premium due to concerns about additional Treasury issuance. However, a decline of the 10-year yield to 0.0-0.5% would require the Fed to either (1) further extend forward guidance, or (2) consider negative interest rates. At the moment, there appears to be a low chance of either happening, preventing us from forecasting a scenario that the 10-year yield will decline to 0.0-0.5%.

If we forecast the yield level by zone based on forward yields, as described above, we can see that the movable range of US long-term interest rates has narrowed compared to previous ranges due to the Fed's new policy and series of communications. Extraordinarily stable movements are expected for the US long-term rate in 2H, with our core range forecast being 0.60-0.75%.

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[Standard & Poor's]

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1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies.
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), Daiwa Securities Living Investment Corporation (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%.

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