Daiwa Securities

Daiwa's View

Overshoot correction or full-scale uptrend?

➢ Highly likely that current rise will be within overshoot correction range

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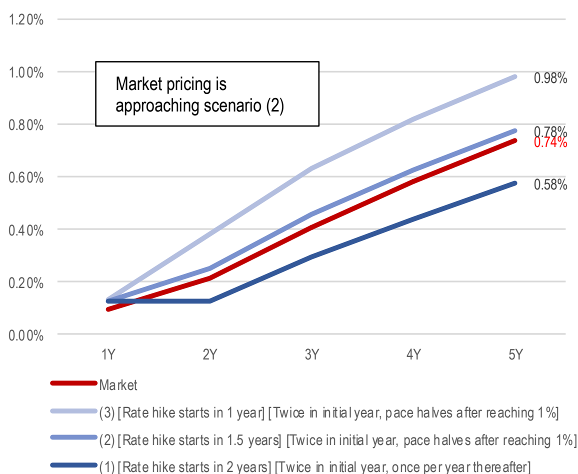
◆ A rebound from the overshooting range

The 10-year US Treasury yield rose to the 1.3% level, surfacing from a range below 1.25%, which I view as an overshoot. The 10-year yield declined to 1.12% at one point, balanced between a 5-year yield of 0.6% and 5-year forward 5-year yield of 1.75%. However, it appears that the trend has finally reversed course, reflecting the following two factors: (1) comments by Fed Vice Chair Richard Clarida that won't allow rate-hike pricing to recede excessively and (2) the satisfactory jobs report.

That said, an important point is whether (1) this reversal will be within the range of an overshoot correction or (2) we will see a resurgence of momentum for a full-scale uptrend (aiming for a 10-year yield of 2%) due to reflation expectations. Unfortunately, I think the former is likely under the current circumstances.

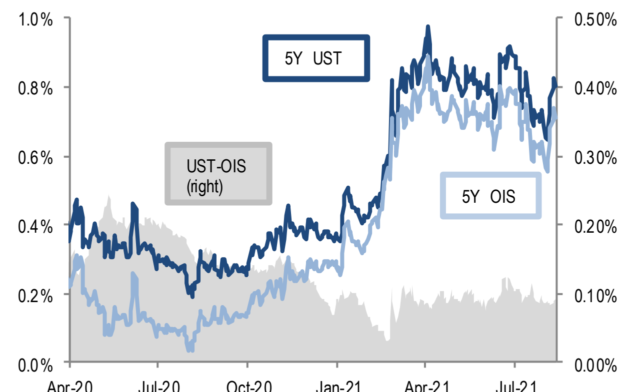
The 5-year OIS yield has now risen to 0.74%, which is close to an OIS curve estimated assuming a rate-hike trajectory with the first rate hike in early 2023, two rate hikes in the first fiscal year (50bp), and one rate hike per fiscal year thereafter (25bp, Scenario 2 in chart below). While it would be difficult for the rate-hike timing to be moved up substantially beyond the current timing, the comments by Clarida act as a check against significant delays in the timing. The consensus regarding rate-hike timing is likely to stabilize around where it is now—somewhere between end-2022 and the first half of 2023. Therefore, it is highly likely that the 5-year yield level will also be stable.

OIS Yield Curve, Simulation by Rate-hike Scenario



Source: Bloomberg; compiled by Daiwa Securities.

5Y OIS Yield, UST Yield



Source: Bloomberg; compiled by Daiwa Securities.

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UST Yields (%)

UST	5Y	(5Y OIS)	5Y5Y	(5Y5Y OIS)	10Y	(10Y OIS)
Current level	0.81	0.74	1.97	1.58	1.33	1.14

Source: Bloomberg; compiled by Daiwa Securities.

If the upside potential for the 5-year yield is not large, a full-scale uptrend in the 10-year US Treasury yield would require a significant rise in the 5-year forward 5-year yield. However, as I describe below, we think the chance of seeing such a rise soon appears small, given (1) the longer-run projection and (2) stock effects.

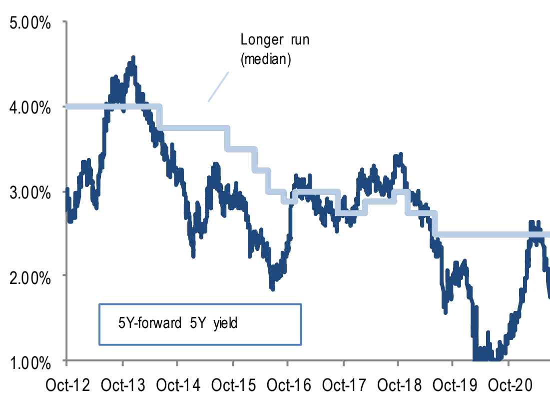
The market estimate for the longer-run projection, which is a benchmark of the 5-year forward 5-year yield, is 2-2.25%, which justifies the rise in the 5-year forward 5-year yield from 1.75% to 1.97% over the past several days (a rebound from the overshoot). Meanwhile, these market estimates for the longer-run projection mean that it would be rather difficult to see a continued rebound at a similar pace.

Looking at forward OIS yields, as well, the rebound in 3-month OIS yields with 5-year forward inception thereafter is surprisingly small. This implies that a holdover from the widespread pattern of "secular stagnation" during the pre-pandemic period has not been eliminated even after the latest jobs report, which is one factor behind the decline in forward real yields. The difference is clear when compared to the Jan-Mar 2021 period when the potential growth rate was expected to be boosted by promotion of a policy for a high-pressure economy.

We also mustn't overlook central banks' holdings of government bonds and stock effects, which were the focus of yesterday's *Daiwa's View*. While tapering suspends further increases in the outstanding amount of government bonds held, that doesn't mean a decrease of holdings accumulated via monetary easing thus far (the latter means balance sheet reductions, i.e., quantitative tightening). In *Daiwa's View* reports, we have put an emphasis on stock effects as one factor behind the excessive decline in yields. Therefore, viewing short-covering as the only reason for recent strong demand for US Treasuries is wrong, in our view.

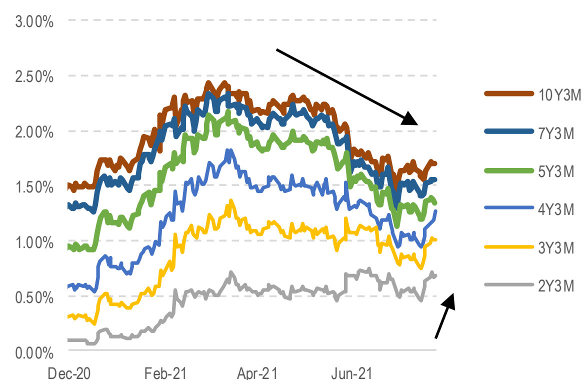
It is highly likely that stock effects will continue to constrain long-term yields going forward. It would be better not to expect a return to the reflation market that was seen in the Jan-Mar period.

US 5Y-forward 5Y Yield, Longer Run



Source: Bloomberg; compiled by Daiwa Securities.

Forward 3M OIS Yields



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