Daiwa's View

Things to keep an eye on going forward

➢ (1) Awareness about the Delta variant and (2) comments about the pace of rate hikes

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The 10-year US Treasury yield declined by 1bp to 1.265%, reaching 1.22% at one point. Yields fell considerably when the market learned of a substantial undershoot in the New York Fed's manufacturing index (in the Empire State Manufacturing Survey). This seems to have reinforced news about the weak University of Michigan index. The Empire State Index does not attract much attention under normal circumstances, so the strong reaction to the index shows that an economic slowdown is serving as a market topic. (Yesterday, Chinese indicators were also weaker than market estimates across the board.)

That said, the 10-year US Treasury yield cut short its decline in the end, closing at 1.265%, after a temporary drop to 1.22%. Looking at closing levels, 5-year to 10-year yields declined in parallel by 1-1.5bp. Meanwhile, the 30-year yield was largely unchanged, showing that the decline in forward yields is approaching the limit vs. the longer-run projection for the federal funds rate. Also, with comments by Fed Vice Chair Richard Clarida acting as a check against a drop in the 5-year yield (with rate-hike pricing receding), an overshoot with long-term yields is being avoided. We see 1.25% as an approximate near-term lower limit for the 10-year yield, in our view.

Today, Fed Chair Jerome Powell is scheduled to make comments at an event, but no disturbance is anticipated. At this sensitive time ahead of the Jackson Hole conference and the release of the FOMC minutes amid an extremely complicated political situation regarding fiscal spending and the debt ceiling, he will be forced to make cautious remarks. (This may be reading too much into it, but the 4 August comments by Clarida may have been made with the Fed Chair's situation in mind.)

If our understanding of the above is solid, factors that could affect US yields, other than economic trends, are (1) changes in awareness about the Delta variant and (2) comments about the pace of rate hikes.

Economic Surprise Index (US, China)

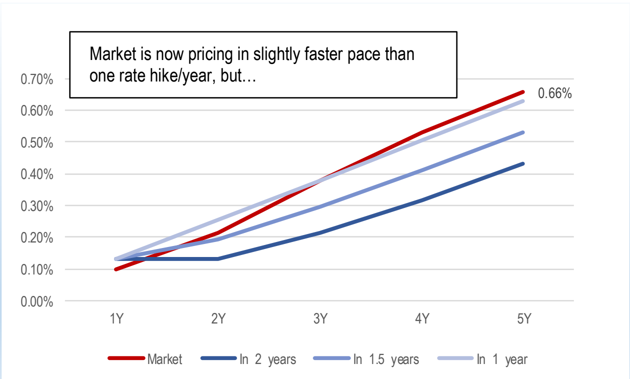
Source: Bloomberg; compiled by Daiwa Securities.

(1) Awareness about the Delta variant
At a press conference after the July FOMC meeting, Fed Chair Jerome Powell showed a stance in which he downplayed the impact, saying "it seems like a good going-in estimate would be that the effects will probably be less." We are seeing a glimpse of the Fed's intention to avoid delaying the process of tapering. However, the US is also facing more infections of the Delta variant than it was at the time of the July FOMC meeting. Therefore, his tone may become more cautious than in July. If he becomes more cautious about the Delta strain, this will be regarded as dovish. But if he downplays it, this will be regarded as hawkish. (I continue to forecast that it is a hawkish stance that the Delta variant will have no impact on the tapering processes.)

(2) Comments about the pace of rate hikes
Furthermore, the OIS curve is currently pricing in slow rate hikes—two rate hikes in the initial year and one rate hike per year thereafter. However, it is highly likely that the New York Fed's surveys of primary dealers will show faster rate hike forecasts than this. (Responses to the latest survey are to be released on 19 Aug.) In the survey before the June FOMC meeting, primary dealers estimated that the federal funds rate would be 0.38% at end-2023 and 1.25% at end-2024, assuming 3.5 rate hikes per year. However, reflecting the hawkish surprise at the June FOMC meeting, an upward revision is expected for the estimate at end-2023. The upcoming survey is likely to show new rate-hike forecasts among primary dealers.

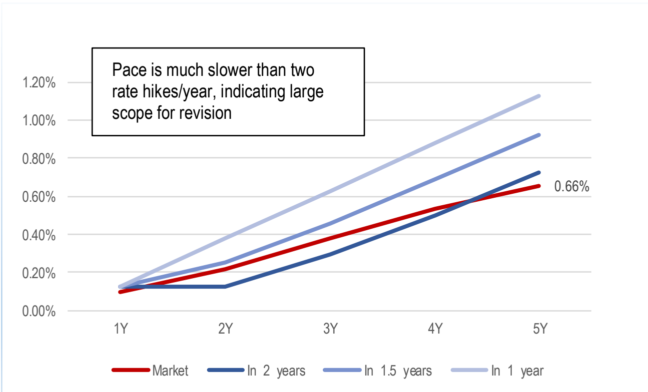
Moreover, dots for 2024 will be presented for the first time at the FOMC meeting to be held on 21-22 September. At the latest, by then the Fed's thinking about the pace of rate hikes from 2024 onwards will have been confirmed. For example, if the Fed assumes two rate hikes per year from 2024 onwards and thinks that the gap with current market pricing is too large, we may see more comments from Fed officials with respect to the pace of rate hikes during the month leading up to the September FOMC meeting. If so, it is fairly certain that short-term/intermediate yields will respond upwardly. The problem lies with long-term yields—if the market judges that an excessively hawkish stance will increase the possibility of policy mistakes, long-term yields may remain flat or decline.

Estimated OIS Curve Under Scenario of One Rate Hike/Year



Source: Bloomberg; compiled by Daiwa Securities.

Estimated OIS Curve Under Scenario of Two Rate Hikes/Year



Source: Bloomberg; compiled by Daiwa Securities.

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