Daiwa Securities

Daiwa's View

Factors behind yield declines and consensus on rate-hike path

- Yield declines were led by term premium, as expected
- Unresolved gap in perceptions is likely to cause market turbulence in the future

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

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Yield declines were led by term premium, as expected

◆ Breakdown of factors behind yield declines

A substantial drop in long-term yields since the June FOMC meeting was mentioned in the "Developments in Financial Markets and Open Market Operations" section of the minutes of the July FOMC meeting, and it was described as follows.

Minutes of July FOMC meeting (18 Aug 2021)

・Longer-term yields fell notably over the period, with the declines concentrated in far-forward rates. A significant portion of these movements seemed to reflect changes in term premiums.

In its July surveys of primary dealers and market participants regarding this issue, the New York Fed asked respondents to provide factors for the 30bp drop in the 5-year forward 5-year yield during the intermeeting period by decomposing them into four components. The responses indicate that (1) primary dealers attributed around half of the drop to the term premium while (2) market participants attributed about two-thirds of the decline to the term premium.

Viewing the responses by dividing them into inflation and real yields, we found that the total of two inflation-related components—the "expected average inflation rate" and "inflation risk premium"—was about –15bp in both groups (primary dealers and market participants). It is interpreted that around half of the plunge in yields since the June FOMC meeting came about via an inflation-related channel.

Respondents attributed lower yields to a 4 to 7.8bp drop in the "expected average real policy rate" and an 8 to 11bp drop in the "real term premium." It is interpreted that half of the decline in yields came about via a real yield channel. For reference, supply/demand factors such as short covering are included in the "real term premium" component. These results are largely consistent with the current situation, in which long-term yields have not returned to their former levels, even after short-covering has played out.

New York Fed's Jul Surveys (factors behind decline in 5Y-forward 5Y yield, bp)

	Risk neutral yield		Term premium	
	Expected average real policy rate	Expected average inflation rate	Real term premium	Inflation risk premium
Primary dealers	-7.8	-8.3	-7.9	-6.0
Market participants	-4.0	-7.4	-11.0	-7.7

Source: New York Fed; compiled by Daiwa Securities.

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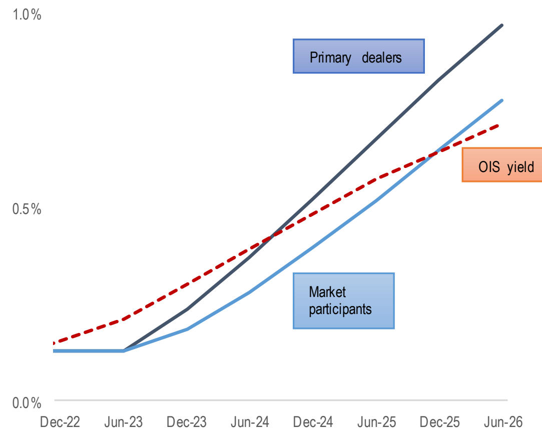
Unresolved gap in perceptions is likely to cause market turbulence in the future

◆ Rate-hike path

In these surveys, the results of questionnaires about the rate-hike path were also announced. From the standpoint of policy rate projections, we already made reference to this in our 23 August report. However, what should be noted from the standpoint of market participants is the fact that the July surveys still show a large gap between pricing in the OIS yield market and the rate-hike path estimated by primary dealers and market participants.

Path of Estimated Average FF Rate in New York Fed's Jul Surveys, OIS Yield Curve



Source: New York Fed; compiled by Daiwa Securities.

New York Fed's Jul Surveys (estimates for FF rate level, %)

Jul surveys	End-2022	End-2023	End-2024	End-2025	End-2026	End-2027
Primary dealers	0.13	0.63	1.38	2.00	2.38	2.38
Market participants	0.13	0.38	1.06	1.63	2.13	2.13
Change from previous survey	End-2022	End-2023	End-2024	End-2025	End-2026	End-2027
Primary dealers	0.00	0.25	0.13	0.00	0.25	0.00
Market participants	0.00	0.00	0.18	0.00	0.00	0.00
No. of rate hikes	End-2022	End-2023	End-2024	End-2025	End-2026	End-2027
Primary dealers	-	2.0	3.0	2.5	1.5	0.0
Market participants	-	1.0	2.7	2.3	2.0	0.0

Source: New York Fed; compiled by Daiwa Securities.

As the chart above clearly shows, primary dealers and market participants estimate an approximate rate-hike pace of at least two rate hikes per year during 2024-2026. However, pricing in the OIS market during this period is close to a pace of one rate hike per year. This gap in perceptions will have to be resolved in the future. If we see a pattern in which the rate-hike path estimated by primary dealers and market participants declines towards OIS yields, this will have no impact on the market. However, if we see a pattern in which pricing in the OIS market approaches primary dealers' projections, the 5-year US Treasury yield is expected to jump by as much as 30bp.

In any case, the only thing we can say now for a fact is that this substantial gap could cause market turbulence in the future. This may appear to be a circular argument, but such a surge in short-term/intermediate yields would cause dollar appreciation and risk-off sentiment, which could push the Fed into a situation in which rate hikes at the pace of twice a year were not possible. It will be a while before we see how this ends.

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