Daiwa Securities

# Daiwa's View

## US yield outlook for 2022

- With uncertainties high, we recommend preparing for various possibilities, with no specific scenario in mind

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.

### US yield outlook for 2022

*I say, "In investing, everything that's important is counter-intuitive, and everything that's obvious to everyone is wrong." — Howard Marks*

**With uncertainties high, we recommend preparing for various possibilities, with no specific scenario in mind**

As our main scenario, we expect the 10-year US Treasury yield to be 1.7% at end-2022. However, the difference in the probabilities of our main scenario and sub scenarios, which we discuss later, is minor, and the uncertainties seem higher than before. We would thus prepare for various possibilities.

**US Yield Forecasts for 2022** (%)

| UST | 5Y | 5Y5Y | 10Y |
|---|---|---|---|
| Current level | 1.24 | 1.77 | 1.49 |
| 1Y-forward yield | 1.56 | 1.88 | 1.72 |
| Main scenario for end-2022 | **1.55** | 1.85 | **1.70** |
| Upside scenario | **2.00** | 2.50 | **2.25** |
| Downside scenario | **0.50** | 1.50 | **1.00** |

Source: Bloomberg; compiled by Daiwa Securities.

Our initial end-2021 10-year Treasury yield forecast was 1.5%. We subsequently raised our 5-year yield forecast, after the expected timing of Fed rate hikes moved up on a pickup in inflation and the Fed's shift to a hawkish stance, but the 10-year Treasury yield looks likely to end up close to our original forecast of 1.5% (it was 1.493% on 23 Dec). Nevertheless, the 5-year Treasury yield has risen much more than we originally expected, and the 5-year forward 5-year (5Y5Y) yield has declined substantially. The breakdown we originally expected was a 5-year yield of 1.0% and a 5Y5Y yield of 2.0% (they are currently 1.24% and 1.77%, respectively).

◆ A rise in the 5-year yield and a decline in the 5Y5Y yield

It is clear why the 5-year yield has been higher than expected. With US inflation picking up and President Biden saying that "reversing this trend is a top priority for me," the Fed's hawkish stance has become acute. Its dot plot has quickly changed, indicating the first rate hike is likely to come in March 2022, rather than in 2024 (we expect four rate hikes in 2022). We think this move up of the expected timing of rate hikes led to a rise in short- and medium-term rates, which tend to react to policy rate expectations.

Important disclosures, including any required research certifications, are provided on the last page(s) of this report.

**Personal Probability of Fed's Initial Rate Hike**

| Scenario | Probability |
|---|---|
| Mar 2022 FOMC | 55% |
| May 2022 FOMC | 30% |
| Jun 2022 FOMC | 12% |
| Jul 2022 FOMC or later | 3% |
| Total | 100% |

*Source: Compiled by Daiwa Securities.*

Surprisingly, though, forward rates declined sharply twice following the June and November FOMC meetings, when the Fed strengthened its hawkish stance. Our 5Y5Y yield estimate of 2% is 50bps lower than the median 2.5% longer-run projection for the fed funds rate by Fed policymakers. However, the yield has declined to 1.75% (75bps lower than the median longer-run projection; a forward-rate decline). This forward-rate decline, the reasons for which we have outlined our views on a number of times, is likely to remain a central theme for the rate outlook for 2022.

**5Y-forward 5Y UST Yield**

*Source: Bloomberg; compiled by Daiwa Securities.*

◆End-2022 10-year Treasury yield forecast 1.7%

Based on an outlook for economic trends and monetary policy in line with the Fed's December Summary of Economic Projections as our main scenario, the Fed is likely to raise rates and the 5-year yield is likely to rise over time. We think the 5-year yield could reach 1.5-1.6% at end-2022, based on a starting point of 1.24% and the time until then. Based on this 5-year yield and the current 5Y5Y yield of 1.75%, the 10-year yield would be 1.65%. If we use a 5Y5Y yield of 2.0% (our estimate used in 2021), the 10-year yield would be around 1.75%. We use 1.7%, the average of these two figures, as our end-2022 main scenario forecast for the 10-year yield.

The uncertainties for this scenario are very high, though. Factors that could affect the 5-year yield and the 5Y5Y yield include (1) wage and inflation trends, (2) the Fed's balance sheet strategy (quantitative tightening), (3) a risk-off trend, (4) moves by other major central banks (the ECB and the BOJ), (5) the Biden administration's fiscal policies (such as the Build Back Better bill), (6) the midterm US elections, and (7) Covid-19 and other various factors that could cause disruptions.

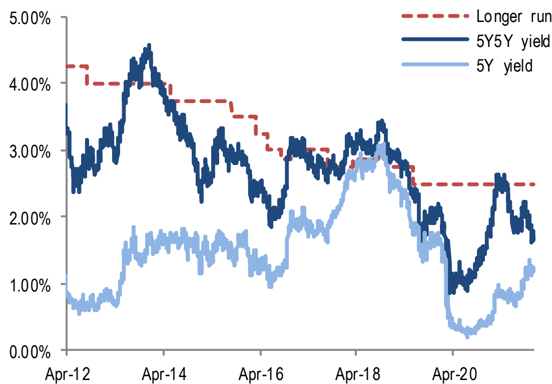
◆5-year yield forecast: Balance sheet strategy discussions have a major impact

If inflation and wages quickly cool off, the Fed would not need to raise rates sharply, and the 5-year yield would likely decline. However, if inflation and wages continue to rise, the Fed's balance sheet strategy, rather than rate hikes, regarding which a market consensus view has already developed, would become a key issue. Fed Governor Chris Waller said recently that the Fed "should start doing [some balance sheet runoff] by summer" so that the Fed would not "have to raise rates quite as much." The specific process is unknown, as it is to be discussed at the January and March FOMC meetings. However, the 5-year yield may not rise as much as we expect in our main scenario, depending on if the Fed moves up its planned balance sheet moves. If hasty balance sheet reductions lead to an adverse pattern of risk-off trends worldwide and the Fed having to pause its rate hikes, as in 2016, then the 5-year yield could fall below 1%.

◆ 5Y5Y yield forecast: The possibility of a rise

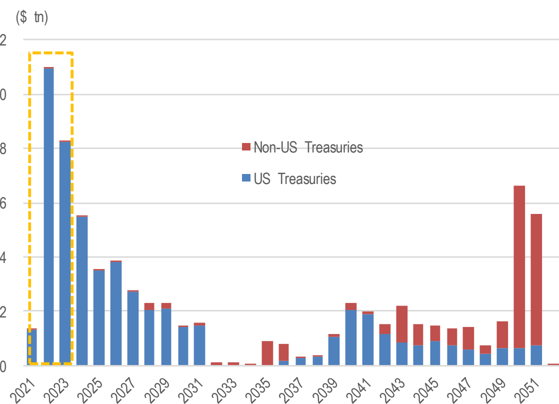
One issue is whether the 5Y5Y yield would rise if the Fed moves up its balance sheet reductions. A number of patterns are conceivable for this issue. No market consensus view has emerged yet, but an important example that should be noted is that the 5Y5Y yield has declined (contrary to what one would expect) after the Fed decided to taper. This happened in 2013, when Ben Bernanke was the Fed chairman. This example raises doubts about the simple, intuitive notion that balance sheet reductions lead to forward-rate increases.

**5Y UST Yield, 5Y-forward 5Y UST Yield, Longer Run**




*Source: Bloomberg; compiled by Daiwa Securities.*

**Redemption Amount of Securities Held by New York Fed** (SOMA portfolio)




*Source: Bloomberg; compiled by Daiwa Securities.*

The high likelihood that the Fed will shrink its balance sheet through runoffs (no longer replacing Treasury securities and agency MBS that mature) should limit the impact on forward rates. A runoff could enable the Fed to shrink its balance sheet fairly quickly because a large amount of the bonds in its System Open Market Account (SOMA) are ones that mature within two years. However, bonds whose outstanding amounts would decline as they reach maturity are unlikely to have as much impact to raise a term premium as expected, owing to the reduction of their outstanding amounts and the bonds' durations of close to 0. If hasty balance sheet reductions lead to risk-off trends, forward rates could decline further as investors flee to quality. This latter pattern (hasty balance sheet reductions plus risk-off trends) would bring about greater rate declines. For our downside scenario, we forecast a 10-year yield of 1% (a 5-year yield of 0.5% and a 5Y5Y yield of 1.5%).

If the forward yield rises to the Fed's median longer-run projection (as the market expects), both the 5-year yield and the 5Y5Y yield would have much leeway to rise. The forward yield has been in the range of 1.50-1.75% in the recent market, but if the rate hike ceiling is raised to 2.5%, the 5-year yield would rise to 2%[1] and the 5Y5Y yield to 2.5% (many US investment banks' main scenarios are based on this optimistic perspective). We think this scenario is not that likely but cannot be completely ignored, as it is what the Fed's dot plot suggests. For our upside scenario, reflecting deference to the Fed, we forecast a 10-year yield of 2.25% (a 5-year yield of 2.0% and a 5Y5Y yield of 2.5%). The table below summarizes these scenarios.

**US Yield Forecasts for 2022** (%)

| UST | 5Y | 5Y5Y | 10Y |
|---|---|---|---|
| Current level | 1.24 | 1.77 | 1.49 |
| 1Y-forward yield | 1.56 | 1.88 | 1.72 |
| Main scenario for end-2022 | **1.55** | 1.85 | **1.70** |
| Upside scenario | **2.00** | 2.50 | **2.25** |
| Downside scenario | **0.50** | 1.50 | **1.00** |

*Source: Bloomberg; compiled by Daiwa Securities.*

[1] If the market's estimate for rate hike ceiling is raised from the current 1.5-1.75% to 2.25-2.5%, 5-year yield could rise to around 2% at end-2022.

◆ Rising likelihood of downside scenario

We have so far discussed mainly the US situation, but global financial market trends are closely linked to it. Major central banks are likely to withdraw their easing at about the same time because they have eased to an unprecedented extent, in tandem, during the pandemic to address circumstances common worldwide. If the ECB and the BOJ, the major central banks other than the Fed that have much influence on financial conditions worldwide, drastically turn hawkish, a fallacy of composition could develop and global financial conditions might tighten drastically. Overall, we think the likelihood of the downside scenario for 2022 is greater than it used to be.

Lastly, we discuss warnings raised by former US Treasury Secretary Larry Summers. The Fed's dot plot cannot be ignored, but we think it is worthwhile giving consideration to what he says, as he did better than the Fed did in forecasting the pickup in inflation during the pandemic. His warning that the Fed is behind the ball on reducing inflation and that secular stagnation may lie ahead, after a recession, is consistent with the recent sharp flattening of the yield curve.

**Former Treasury Secretary Lawrence Summers** (23 Dec 2021)

**Summers Sees Risk of Recession Soon, 'Secular Stagnation' Later** (Bloomberg: 23 Dec 2021)

・That's why my fear is that we are already reaching a point where it will be challenging to reduce inflation without giving rise to recession

・(He said the central bank was still too confident in projecting sustained low unemployment alongside receding inflation). It doesn't seem to me that it is the most intuitive reading of our macroeconomic history.

・I'm certainly not confident that we're going to have sustained excess demand for many years. … Secular stagnations are a real risk looking out a few years.

## IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

**Ratings**
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

**Target Prices**
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

**Disclosures related to Daiwa Securities**
Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

**Explanatory Document of Unregistered Credit Ratings**
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:
https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf

## Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* 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.
** The ratio of margin requirements etc. to the amount of the transaction 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.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association