Daiwa's View

US yield outlook (28 Sep revision)

➢ Reflects significant increase in real rates

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Reflects significant increase in real rates

We revised our outlook for the US 10-year Treasury yield. Our new outlook places this yield at 3.65% for end-2022 and at 3.05% for end-FY22. Our revised outlook emphasizes (1) expected policy rate path, (2) inflation expectations (BEI), and (3) the "restrictive real rate level" stance presented by the September FOMC "dot chart" and Federal Reserve Chairman Jerome Powell's press conference.

In our previous outlook (revised on 28 Jun), our main scenario[1] assumed that the Fed's "unconditional" commitment would lead to a decline in US inflation expectations (BEI) to the low 2% range, which in turn would cause the US 10-year Treasury yield to peak. Actually, inflation expectations subsided as anticipated, but real rates have risen significantly, with the US 10-year Treasury yield currently at 3.92%. One of the main reasons is the perception that, having witnessed a persistently stronger-than-expected US economy (employment), a more restrictive real policy rate (Higher for Longer) in terms of both "level" and "duration" is now needed to quell inflation.

This development clearly shows that the real rate outlook will dominate the rate outlook under stable inflation expectations (BEI) brought about by the "unconditional" commitment. In this regard, Fed Chairman Powell mentioned during his press conference following the September FOMC meeting specific real rate levels needed to control inflation. This serves as an important foundation for our new Treasury yield outlook.

Also, since the market tends to factor in the next anticipated phase, in this report we consider the timing for (1) slowdown for interest rate hiking pace, (2) end of rate-hiking phase, and (3) start of corrective rate cuts, which will act as key catalysts for US 10-year Treasury yield trends. In particular, since (2) and (3) require the fulfillment of inflation conditions [annualized value of core PCE deflator decelerates to +2.5~+3.0% m/m for several months] and [core PCE deflator's annualized value declines to +2.0% m/m] (Fed acknowledgement), the specific actions of the Fed are expected to have a significant impact on the US 10-year Treasury yield. In terms of timing for these three conditions, we think December 2022 for (1), February 2023 for (2), and September 2023 for (3) are likely. Reflecting this point, we assume that by the end-FY22 (March 2023), when the Fed's rate hike suspension trigger is expected to be activated, the US 10-year Treasury yield may fall substantially from the current level toward 3%.

1 Our lower-end scenario level was 1.9% assuming an early emergence of recession fears and risk-off sentiment, while our upper-end scenario level was 3.75% assuming a terminal rate hike to 5% amid persistently high inflation. The level as of 28 September was close to the upper end scenario level.

Outlook for Monetary Policy and Balance Sheet Reductions (QT) as of 27 Sep

FOMC meeting	Policy rate (median of range)	Balance sheet reductions (QT)
Sep-22	0.75% hike (3.125%)	Maximum roll-off cap of $95bn/m (US Treasuries: $60bn/m, MBS $35bn)
Nov-22	0.75% hike (3.875%)	
Dec-22	0.50% hike (4.375%) Terminal rate: 4.50%～4.75%	
Feb-23	-	Possibility of start of discussions on MBS sales (actual sales are not anticipated)
Mar-23	-	
May-23	-	
Jun-23	-	
Jul-23	-	
Sep-23	0.25% cut (4.375%) Mid-cycle adjustment	Suspension of balance sheet reductions (Continuation of MBS roll-off)
Nov-23	0.25% cut (4.125%)	
Dec-23	0.25% cut (3.875%)	
Jan-24	0.25% cut (3.625%)	
Mar-24	0.50% cut (3.125%)	
May-24	0.50% cut (2.625%)	
Jun-24	0.50% cut (2.125%)	
Jul-24	0.50% cut (1.625%)	
Sep-24	0.25% cut (1.375%) Terminal rate: 1.25%～1.50%	

Source: Compiled by Daiwa Securities.
Note: Official schedule for FOMC meetings from Mar 2024 onwards undisclosed.

◆1.0~1.5% target for real rate over roughly next two years

Powell stated that the FOMC will determine the rate hike size at each meeting until the policy stance tightens "sufficiently" after adjusting for inflation, and he stressed that the restrictive level would be maintained until the Fed was "very confident" that inflation would fall to 2%. As a hint to the specific level of that "sufficiently restrictive" policy rate (terminal rate), we considered Powell's comment that by using the SEP (Summary of Economic Projections) inflation projections, "We want to get real rates positive across the entire yield curve."

Also, when another reporter asked a similar question about how restrictive is a 4.6% rate (median for end-2023), Powell said, "Assuming that we're doing our jobs appropriately, we will have a positive (real) Federal Funds Rate, at that point, which could be 1% or so." Furthermore, as seen even in SEP, the plan is to break through the tenacity and persistence of inflation by maintaining a policy stance that would raise the real policy rate to about "1.5%" over the next two years or so.

◆Forecast 3.65% at end of year (4% for 5-year, 3.3% for 5-year, 5-year forward)

Based on these comments from Powell, apparently a real rate between 1.0~1.5% is being planned for the time being (= do not assume more than 2% or less than 1%). Also, the real policy rate, calculated backwards from SEP, is 1.5% for 2023-24, 0.8% for 2025, and 0.5% for the longer run. The assumed 5-year real rate based on this point is 1%, and the 5-year, 5-year forward real rate is 0.5%.

Normally, these figures could be used as is, but under these circumstances in which Powell declared that "We want to be at a place where real rates are positive across the entire yield curve," it seems appropriate to add a certain amount of stress (premium) to the above level. Considering that the Fed's envisioned real rate of 1.0% to 1.5%, we add 0.5% to the level obtained by calculating backwards from SEP and our main scenario assumes a 5-year real rate of 1.0% and a 5-year, 5-year forward real rate of 0.5%.

Factoring the above real rate assumptions into the stabilization of inflation (BEI) brought about by the "unconditional" commitment, a 5-year rate of 4% (5-year BEI of 2.5%, 5-year real rate of 1.5%) and a 5-year,5-year forward rate of 3.3% (5yr5yr BEI of 2.3%, 5yr5yr real rate of 1.0%) are assumed. Based on these levels, we assume the US 10-year Treasury yield will land at 3.65% at end-2022 (BEI 2.4%, real rate of 1.25%). Meanwhile, for the upper-end scenario, we want to assume a 10-year real yield of 2%, which the Fed has not assumed. For the lower-end scenario, we would like to assume a 10-year real yield of 0.5%, the same as the longer run.

US Yield Outlook at end-2022 (main scenario)

	End-2022		
(%)	Yield	BEI	TIPS
5y	4.00	2.50	1.50
5y 5y	3.30	2.30	1.00
10y	**3.65**	2.40	1.25
2y 10y	-0.60		

Source: Bloomberg; compiled by Daiwa Securities.

US Long-term Yield Outlook at end-2022 (incl. upper-end and lower-end scenarios)

	End-2022		
(%)	10y	BEI	TIPS
Upper-end	4.55	2.55	2.00
Lower-end	2.75	2.25	0.50
Main	**3.65**	2.40	1.25
Current levels	3.92	2.32	1.60

Source: Bloomberg; compiled by Daiwa Securities.

◆Assume 3.05% at end-FY22 (activation of "(2) end of rate-hiking phase" trigger)

As mentioned at the beginning, in this report we consider the timing for (1) slowdown for interest rate hiking pace, (2) end of rate-hiking phase, and (3) start of corrective rate cuts, which will act as key catalysts for US 10-year Treasury yield trends. In particular, (2) and (3) require the fulfillment of inflation conditions [annualized value of core PCE deflator decelerates to +2.5 ~ +3.0% m/m for several months] and [core PCE deflator's annualized value declines to +2.0% m/m], the specific actions of the Fed can easily trigger a decline for the US 10-year Treasury yield (more likely to encourage price formation based on trust in SEP's real rate outlook).

In our current forecast, which assumes that the trigger for "(2) end of rate-hiking phase" is activated by the end of FY22, we expect real rates (Treasury Inflation Protected Security) will decline to the level described in SEP (1% for 5-year rate and 0.5% for 5-year,5-year forward rate). When combined with inflation expectations (BEI), our main scenario calls for levels of 3.4% for the 5-year rate, 2.7% for the 5-year, 5-year forward rate and 3.05% for the 10-year yield. The upper-end scenario sees the 10-year yield at 4.55%, same level as that for end-2022 (trigger for ending rate-hiking phase not activated). The lower-end scenario assumes a real rate decline to 0% due to worsening recession fears early into the crisis with a 2.25% level for the 10-year yield.

US Yield Outlook at end-FY22 (main scenario)

	End-FY22 (Mar 2022)		
(%)	Yield	BEI	TIPS
2 y	4.10	-	-
5y	3.40	2.40	1.00
5y 5y	2.70	2.20	0.50
10y	**3.05**	2.30	0.75
2y 10y	-1.05		

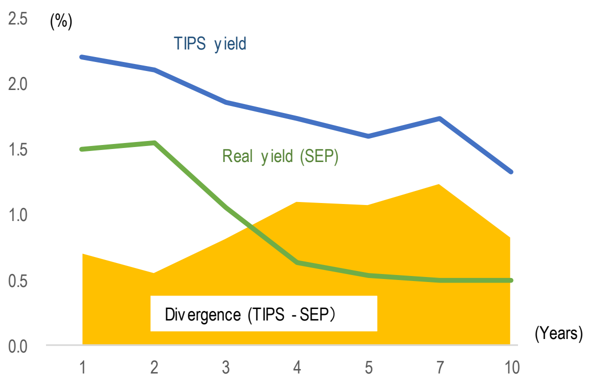
Source: Bloomberg; compiled by Daiwa Securities.

US Long-term Yield Outlook at end-FY22 (incl. upper-end and lower-end scenarios)

	End-FY22 (Mar 2022)		
(%)	10y	BEI	TIPS
Upper-end	4.55	2.55	2.00
Lower-end	2.25	2.25	0.00
Main	**3.05**	2.30	0.75
Current levels	3.92	2.30	1.62

Source: Bloomberg; compiled by Daiwa Securities.

Real Yield Curve (TIPS, Summary of Economic Projections)

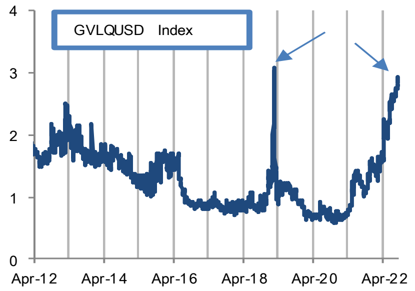


Source: Fed, Bloomberg; compiled by Daiwa Securities.

◆Points to keep in mind: Low liquidity, recession (5th phase)
Finally, we want to share a few points that should be kept in mind at this time. As evidenced by the recent sharp fluctuations in global bond markets originating from the UK, bond market liquidity has been severely reduced and market functioning is likely being lost. Indeed, liquidity for US Treasuries has deteriorated to near the worst phase of the pandemic. During the pandemic, the Fed introduced a flurry of measures to restore bond market liquidity, including the Primary Dealer Credit Facility, and also used QE to provide liquidity to the market. Meanwhile, currently, under the mandate of containing inflation, central banks (other than the BOJ) are faced with extremely high hurdles to providing such needed support to the market. In fact, if the Bank of England does indeed sell government bond holdings outright on the market next week as planned, the global bond market liquidity decline may become even more pronounced next week.

Note: After I wrote this report, the BOE announced during European trading hours on 28 September that "the Bank's Executive has postponed the beginning of gilt sale operations that were due to commence next week. The first gilt sale operations will take place on 31 October and proceed thereafter."

Bloomberg US Govt Securities Liquidity Index



Source: Bloomberg; compiled by Daiwa Securities.

Under such circumstances, bond market price fluctuations can no longer be expected to serve as a mirror of the macro-economy, at least over the short term, and it is possible that the supply-demand noise, which is usually only a few basis points in magnitude, has swelled tens of basis points. The situation is literally critical, but each investor must decide on their own whether to use this situation as a reason to hold back or to look at the fundamentals and view the overshoot as an opportunity.

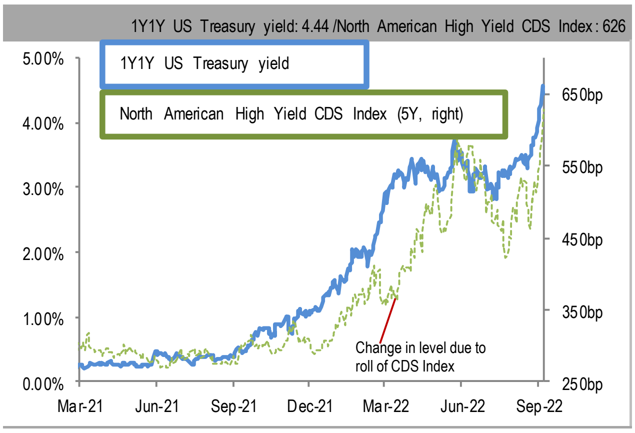
Not sure whether this is an appropriate example, but when the Nikkei Stock Average plummeted from 20,000 to such key marks 19,000, 18,000, 17,000, and 16,500 in the early stages of the pandemic, did investors consider buying when the index was in the 17,000's? Looking back over a larger span of time, clearly that level was a good buying opportunity. Meanwhile, at the time of the initial sharp decline, investors were reluctant to invest, convinced that the market would keep falling. In fact, over the span of a few days, that was the correct assessment. However, when dust had settled, the Nikkei Stock Average held at the 17,000 level for only a few business days, and it had risen from that level just two business days after hitting bottom. Also, if we ask whether investors who (rightly) passed on investing at the 17,000 level, believing that the price would still fall, were able to build up a sufficient position at the 16,000 level, the answer is probably "No." From this perspective, we can see that a decision that is correct over the span of just a few days (speculator's perspective) can be the exact opposite of that which is correct or incorrect from the perspective of a phase (long-term investor's perspective).

As for the bottom line, guessing the exact bottom is impossible, and investors can become too caught up in the immediate fear of a further decline. In that case, even if the guess is correct from the short span of a speculator, investors may miss an opportunity (Nikkei Stock Average in a zone below 18,000 in previous example) that is possible over a longer phase. Bond prices tend to jump in situations involving reduced liquidity (real buying opportunity always comes when most investments are stuck, so the case is always low liquidity), but if an FF rate of more than 4% is unlikely to last ten years, even if it rises above 4% in the near term, 4% for ten years is a good buying opportunity from the above-mentioned perspective. In low-liquidity situations, simple considerations can sometimes lead to the right decision.

It should be noted that loss of liquidity in the bond market may hasten the onset of a recession to a greater extent than previously expected. We should recognize that "The events in the life of a cycle shouldn't be viewed merely as each being followed by the next, but – much more importantly– as each causing the next." (Howard Marks, investor)

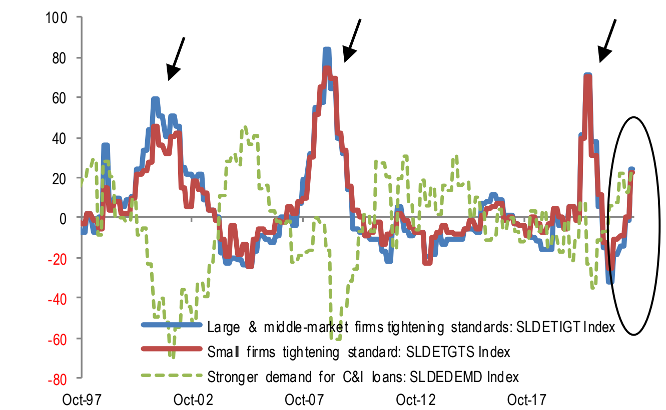
Amid the loss of government bond market liquidity up to this point, there is no need to again mention what could happen to the liquidity of dollar/euro-denominated corporate bonds and emerging market government bonds. Can loans replace financing? We have already seen a surge in loan demand, while bank lending attitudes (Senior Loan Officer Opinion Survey on Bank Lending Practices) have been deteriorating rapidly at a pace similar to that seen during the bursting of the IT bubble, the Lehman crisis, and the coronavirus outbreak. We can easily imagine the results of the next survey, which will reflect the Fed's terminal rate hike, the sharp drop in stock prices, and the current turmoil in the bond market.

1Y1Y US Yield, High Yield CDS Index



Source: Bloomberg; compiled by Daiwa Securities.

US Commercial & Industrial Loans: Net % of Domestic Respondents Tightening Standards



Source: Bloomberg; compiled by Daiwa Securities.

Somehow the fate of the fifth phase (following the four financial normalization phases) taking the form of a "recession" and a "cut in the FF rate to an accommodative level" appears to be largely settled. This situation could manifest as early as around the release of corporate earnings guidance next month or as late as around the release of such guidance in January 2023. At that time, the market will start reflect that situation in earnest. This is a factor that increases the probability that the lower-end scenario for the yield outlook will be realized at the end of March 2023.

Four Phases of Fed's Monetary Policy Normalization

	1st phase	2nd phase	3rd phase	4th phase
Image	"Expeditious" phase	"Purposeful" phase	"For some time" phase	"Adjustment" phase
Action	Rate hikes to long-term neutral rate level	Rate hikes to "sufficiently restrictive" policy rate level	Maintaining "sufficiently restrictive" policy rate level	"Adjustment" rate cuts toward long-term neutral rate level
Policy rate level	～2.5%	Around a bit over 4%	Around a bit over 4%	～2.5%
Time frame	Mar 2022-Jul 2022	Sep 2022-end-2022 or beginning of 2023	Several quarters (at least two quarters) Through 2023?	Around one year
Requirements to move next phase	-	Slowdown of core PCE deflator to +2.5-3.0% (m/m, annualized) for several months	Confirmation of core PCE deflator consistently staying at +2.0% (m/m, annualized)	-
Balance sheet policy	Start of QT	Continuation of QT	Continuation of QT	Suspension of QT

Market at entrance of first phase, began factoring in "second phase" ahead of time

Market at entrance of second phase (the present), factoring in "third phase"

Next, will market begin factoring in "fourth phase" once it reaches "third phase"?

Strong possibility of recession during "fifth phase"?

Source: Compiled by Daiwa Securities.

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