Daiwa Securities

Daiwa's View

US yields: Clearing up misinterpretation of current situation, pessimism about future

- Current US yield levels viewed as appropriate (short-term perspective)
- Attractive investment opportunities from real policy rate path (long-term perspective)
- Corporate bond yields suggest only limited additional upside for UST yields

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"The act of justifying price increases up to that point (and expect more to follow) always happens when the market is high, not when it is low. If looking for truly useful guidance, I would look to 'experts' who express cautious views during bull markets and disagree with pessimism when the market is down." (Howard Marks)

US yields: Clearing up misinterpretation of current situation, pessimism about future

Disagree with pessimism after affirming current conditions

In line with these words from Howard Marks, in this report we will try to "justify the current state of US debt (and expect more to follow)" and then try to "disagree with the excessive pessimism" (albeit, the author himself is not an "expert").

Considerations that justify current yield rise (and expectations for further rise)

◆ Current US yield levels generally appropriate (short-term perspective)

Some have described the current US bond market as "broken." However, we think that with the Fed's September FOMC's Summary of Economic Projections (SEP) presenting a view of the 2.5% real policy rate "world" and providing a de facto forward guidance of "high for long," we believe that current US yields are generally at levels viewed as appropriate.

5yr UST yield: The current 5-year maturity consists of (1) a 5-year breakeven inflation (BEI) rate of 2.29% based on stable medium-term inflation expectations (2% PCE ≒ 2.3% CPI), which indicates confidence in the Fed, and (2) a 5-year real rate of 2.37%, reflecting the propagation of the real policy rate of 2.5% through the "high for long" (de facto) forward guidance. The current level of 4.6-4.7% for the 5-year UST yield is viewed as reasonably appropriate under the current constraints. If we assume a slight margin between the BEI and real interest rates, a 5-year UST yield increase to just over 4.9% is well within the realm of possibility (we currently estimate that it is a little bit hard for the yield to reach 5.0%).

10yr UST yield: Currently, the 10-year UST yield is roughly around 4.5~4.6% (BEI in 2.3~2.4% range, real interest rate around 2.2%). We should note that the 10-year UST yield is now slightly lower than the 5-year UST yield due to inversion of the yield curve. When the yield curve becomes inverted, speculators can earn positive carry + roll-down income by building short positions. Of course, such short positions also have some inherent risks. The biggest risk is a surprise Fed rate cut (= return to normal upward sloping yield curve due to bull steepening), but that risk is now apparently blocked by the Fed's "high for long" forward guidance. If that is the case, under the current situation, shorting those maturities along the yield curve where the inverse yield is forming is the correct move in line with the Fed's intentions. On the other hand, it would be irrational for long-term investors to go against that approach (at least over the short term).

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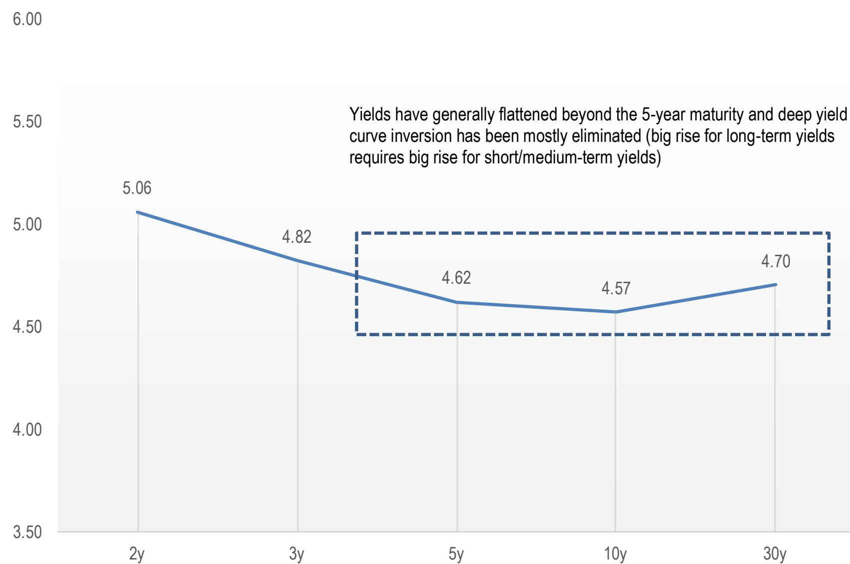
Inverted yields: Based on that discussion, if the 5-year yield were to rise significantly from here, the inversion of the yield curve would deepen and the 10-year yield could rise significantly as well, on increased shorting of the 10-year UST. That said, as the current 3-year yield is just over 4.8%, taking this level as a given, the hurdle for the 5-year yield to top 4.9% is high (→①return to normal yield curve, ②slight overshoot due to BEI + real interest rate). Therefore, in order for the 5-year UST yield to rise significantly from its current level, we expect that the 3-year UST yield would also need to rise significantly. That said, the current 2-year UST yield is 5.06%, so the hurdle for the 3-year UST yield to rise well above 5% is daunting. In other words, for the 3-year UST yield to significantly rise from its current level, the 2-year UST yield would also need to rise significantly. However, the Fed's SEP forecasts an end-2024 FF rate of 5.125%, so the hurdle is still high for the 2-year UST yield to move well above 5.2% under the current constraints. If we consider such a sequence, the current 10-year UST yield is appropriate for the most part and even if there is naturally room for another increase of just over 20bp, our current forecast is that a 5% 10-year UST yield is still unlikely.

US Treasury Yield Curve (%)



Source: Bloomberg; compiled by Daiwa Securities.

Real policy rate: Of course, if the Fed were to present the view of a 2~3% real policy rate "world," naturally, the 10-year UST yield could rise to a cruising level above 5%. For example, if the Fed does not raise interest rates further this year (such as in the December SEP), but presents a dot plot that suggests no rate cut in 2024 or just one more rate hike in 2024, the real policy rate could be raised another notch. In light of the recent conditions in which yields rose immediately and sharply, reflecting the 2.5% real policy rate indicated at the September FOMC meeting, the real interest rate still depends on the Fed's intentions, which will be determined by future data. We cannot yet conclude that upside for yields is limited going forward.

◆ Disagree with excessive pessimism

However, we must be wary of spreading pessimism and focusing solely on bad news at a time when the market is nearing a bottom (risk is something that can always be found if we look for it). Indeed, Howard Marks said, "*Fear is overdone concern that prevents investors from taking constructive action when they should*." In the following section, we want to dispute the view that yields will continue to rise significantly.

Attractive investment opportunities from real policy rate path (long-term perspective)

Real policy rate path: Currently, the market's view of the 2.5% real policy rate "world" is spreading across the yield curve. While the propagation of the real policy rate through the "high for long" de facto forward guidance is generally appropriate, we should not overlook that the current market is downplaying the trajectory of the real policy rate indicated by the Fed's dot plot.

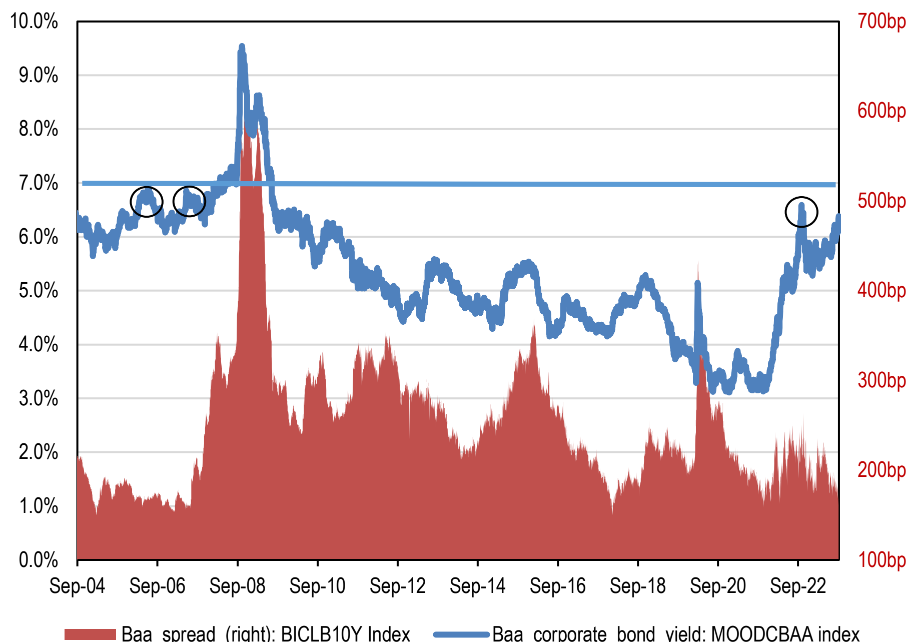
The real policy rates (end-year FF rate – core PCE) as indicated by SEP are 2.5% for 2024, 1.6% for 2025, 0.9% for 2026, and 0.5% for the longer run. Even if the 0.9% rate for 2026 is extended and applied to 2027 and beyond to avoid awkward discussions about the longer run FF rate, the real policy rate would still be 1.36% on a simple average over the next five years and 1.11% on a 10-year average, a downward deviation of more than 1% from the current real rate level observed in the market. If we are confident in the real policy rate path indicated by the Fed's SEP, a "significant decline" for the 10-year UST yield could be expected from a slightly longer perspective. If shorting among speculators increases and the yield curve approaches a flat (horizontal) shape, that could provide investors with a good opportunity to enter the market from a long-term perspective.

Corporate bond yields suggest only limited additional upside for UST yields

7% corporate bond yield: Government bonds yields serve as the foundation of fund procurement in the private sector. As such, any base rise will push up corporate bond yields. What is the highest corporate bond yield level that can be tolerated?

Looking at past Baa-rated 10-year corporate bond yields, those yields peaked at 6.6% in Oct-Nov 2022, when the market reached a climax (230bp corporate bond spread). Also, except for during the fallout from the global financial crisis triggered by the collapse of Lehman Brothers, when corporate bond spreads were exploding, the highest recent corporate bond yields were 6.8-6.9% just before the global financial crisis (10-year UST yield of more than 5% + corporate bond spreads in 100bp range). From these examples, it appears that a corporate bond yield of roughly 7% is one guide.

Baa-rated 10yr US Corporate Bond Spread (vertical axis), **S&P500 Index** (horizontal axis)

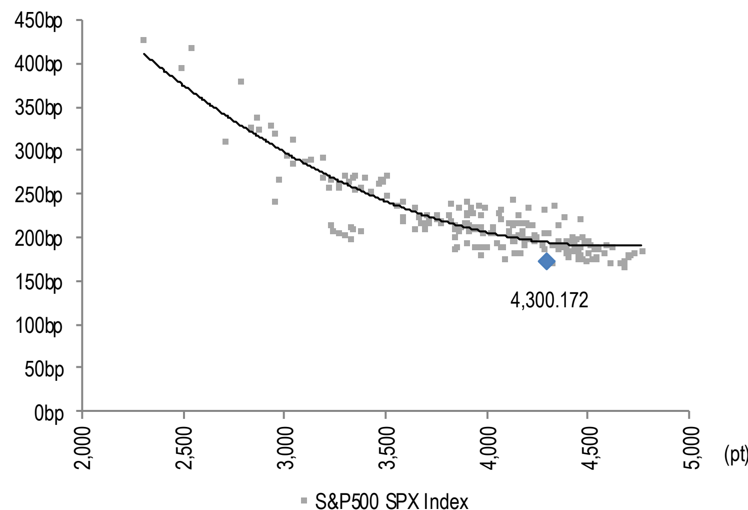


Source: Bloomberg; compiled by Daiwa Securities.

The current yield on Baa-rated 10-year corporate bonds is roughly 6.3-6.4%. As corporate bond spreads fell to around 170bp in 1H FY23, mainly due to rising expectations that the US economy will make a soft landing, corporate bond yields are currently lower than in Oct-Nov of last year, despite the significant rise for the 10-year US Treasury yield. Given this tight current spread, a backward calculation of the 10-year US Treasury yield at which corporate bond yields would reach the same level as in Oct-Nov of last year would be roughly 4.8-4.9%, and the level in line with the peak just before the global financial crisis would be 5.1-5.2% (+0.2-0.3% and 0.5-0.6% from current level, respectively).

Note that the above points assume the continuation of the current corporate bond spread of 170bp (nearing lowest level for this century), but the assumption that the current tight spread will continue is somewhat aggressive. Corporate bond spreads tend to widen (in a nonlinear fashion) during periods of falling stock prices. The spread between the S&P 500 and the 10-year US Baa since the pandemic is roughly 210bp when the S&P 500 is at roughly 4,000, 250bp when it is at around 3,500, and 300bp when it is at about 3,000 (see chart provided below).

Baa-rated 10yr US Corporate Bond Spread (vertical axis)**, S&P500 Index** (horizontal axis)



Source: Bloomberg; compiled by Daiwa Securities.

This means that, assuming the current 10-year UST yield of 4.6%, corporate bond yields will approach the level of last October when the S&P 500 approached the 4,000 level, and corporate bond yields will surpass 7% when approaching the 3,500 level (level before global financial crisis was around 3,700-3,800). Since the actual corporate bond yields are determined by two factors—increase in the base interest rate and a widening of the corporate bond spread—if the 10-year UST yield rises significantly from the current level of around 4.6% in the future, we calculate that a more modest widening of the corporate bond spread will be required to reach such corporate bond yield levels.

If the 10-year UST yield were to rise to 5%, it would only take a normalization of corporate bond spreads to around 200bp below the average level at normal times to bring corporate bond yields to the milestone of 7%. With such a pattern, if the Fed fails to quickly withdraw its "high for long" forward guidance, a risk-adverse market would likely gain real traction. Whether it is the withdrawal of the "high for long" forward guidance or the realization of a hard landing due to higher corporate bond yields, the 10-year UST yield is expected to decline in the case of either pattern.

It would be ironic if the Fed's high growth forecast of 1.5% for 2024, which is a decisive soft landing in the September FOMC SEP, and the aggressive dots that are based on this forecast, conversely raise concerns about a hard landing.

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