Daiwa's View

FICC Research Dept

US long-term yield declined to the 3.8% level: Considering the next threshold levels

- The next thresholds for US long-term yield are 3.4% and 2.9%
- Corresponding 10-year JPY swap rates are 0.7% and 0.5%
- Unless BOJ reduces JGB purchase operations, 10-year JGB yield could decline below 0.5%, with a risk of it falling to 0.3%

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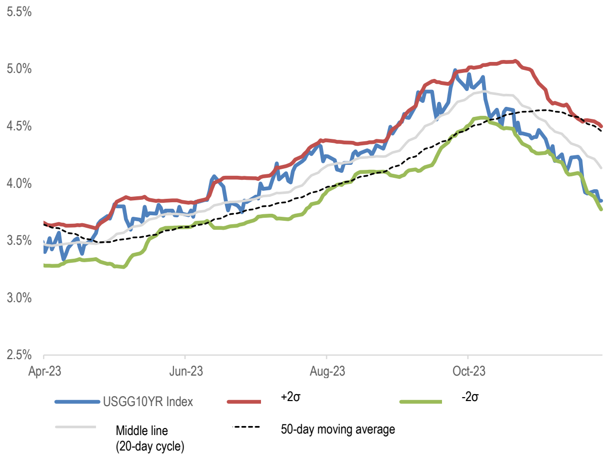
Amid the continued downtrend in global yields, the US long-term yield declined to 3.85% yesterday. It wasn't just US yields that broke through threshold levels. Yesterday, the 10-year German and JGB yields fell to the 1.9% level and the 0.5% level, respectively.

With the US long-term yield having reached the 3.8% level, one of its benchmarks (approximately equal to inflation target + potential growth rate) with surprising speed, in this report, we would like to confirm what could be the next threshold levels using remarks by Fed officials and the Summary of Economic Projections (SEP) indicated at the December FOMC meeting. Inevitably, once a point of reference for the US yield is determined, that for the 10-year JGB yield is also determined as a matter of course. With a 10-year JGB yield of 0.8% having already become far off, a level of 0.5% has become realistic. Unless the BOJ reduces its JGB purchase operations (I anticipate a reduction), there is a risk of the 10-year JGB yield falling to the 0.3% level in line with next year's rate cuts by the Fed.

US Long-term Yields



Source: Bloomberg; compiled by Daiwa.

Point of reference for upper limit: 4.2%
The SEP at the December FOMC meeting indicated a real policy interest rate (calculated using the difference between core PCE inflation and the federal funds rate) of 2.2% for both 2023 and 2024, 1.4% for 2025, and 0.9% for 2026. Assuming that next year's real policy interest rate of 2.2% will be maintained for ten years due to the Fed's "High for Long" strategy, a value of 4.2% is obtained by adding inflation of 2% to this real interest rate of 2.2%. This level corresponds to the level of the long-term yield when Fed Governor Christopher Waller commented on 5 September that Treasury yields were probably about where they should be. As fundamentals are largely in line with remarks by Fed officials, this level of around 4.2% is likely to be a near-term point of reference for the upper limit.

3.4%
The SEP indicates a real policy interest rate of 1.4% for 2025. When we add 2% inflation to this, the long-term yield is calculated at 3.4%. Of course, this is currently lower than the level "before the middle of the year" (around 3.7%), which is regarded as a benchmark by Fed Governor Waller. Therefore, this is somewhat low as a realistic target at this point. However, as this would be a realistic point of reference after the start of actual rate cuts in March-July 2024, we would like to begin viewing this as the threshold level indicated by fundamentals. In short, the yield is expected to largely return to the level it was at around the beginning of the fiscal year.

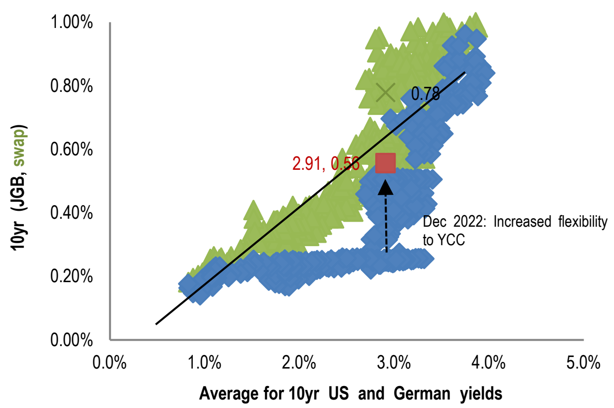
2.9%
The SEP indicates a real policy interest rate of 2.6% for 2026. When we add 2% inflation to this, the long-term yield is calculated at 2.9%. This largely corresponds to the upper limit of "2-3%," which has often been mentioned by Fed Chair Jerome Powell when he touches on the longer-run federal funds rate. The longer-run rate, which is currently shown in the dot plot at 2.5%, may rise to 2.75-3%, and 2.9% is close to this level. Therefore, this is a point of reference if progress is made in returning to neutral. Of course, this value is too low at this point. However, if we confirm rate cuts progressing to 2.875% at the end of 2026 as indicated by the SEP, this may turn into a realistic target.

10-year JPY swap rate: 0.9%, 0.7%, and 0.5%
As a rule of thumb, 200bp is a point of reference for the upper limit for the US/German long-term yield spread. When applying this 200bp to the US long-term yield, the averages for US and German yields are calculated at 3.2%, 2.4%, and 1.9%, respectively. As previously reported, JPY long-term/superlong yields are very highly correlated with the averages for 10-year US and German yields. Therefore, the 10-year swap rates corresponding to the US and German average yields of 3.2%, 2.4%, and 1.9% are calculated at just above 0.9%, slightly below 0.7%, and around 0.5%, respectively.

10-year JPY Swap Rate, Average for 10-year US and German Yields

Source: Bloomberg; compiled by Daiwa.

10yr Swap Rate, JGB Yield, 10-year JPY Swap Rate, Average for 10-year US and German Yields

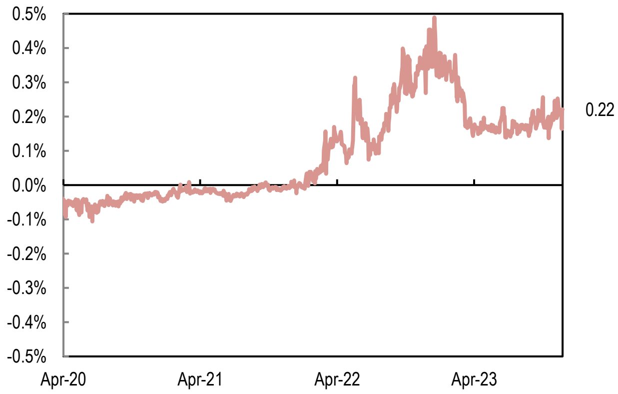


Source: Bloomberg; compiled by Daiwa.

10-year JGB yield: 0.7%, 0.5%, and 0.3%?
If we apply the recent JGB/swap spread of around -20bp to the abovementioned figures, the corresponding 10-year JGB yields would be calculated at 0.7%, 0.5%, and 0.3%, respectively.

Of course, the recently observed JGB/swap spread of -20bp has been seen since March 2022. Once negative interest rates are eliminated together with a substantial reduction in JGB purchase operations, mean reversion towards 0% is expected. Therefore, a JGB yield of 0.3%, which is derived simply by applying the JGB/swap spread that is formed based on the current large-scale *Rinban* operations, is not a realistic target.

JGB/Swap Spread (10yr)



Source: Bloomberg; compiled by Daiwa.

However, due to the recent decline in US yields, the 10-year JPY swap rate of 1% has become quite far off, and a decline in the swap rate to 0.7% has become a realistic possibility. These are unavoidable facts. Based on the current JGB/swap spread of around -20bp, it can be said that a 10-year JGB yield at the 0.5% level has become realistic, with a level of 0.8% having become quite far off. I expect the swap spread to tighten due to a reduction in *Rinban* operations by the BOJ after negative rates are eliminated. Therefore, after the 10-year JGB yield falls below 0.5%, the pace of the downtrend in JGB yields is expected to slow compared to US yields and JPY swap rates (which would serve as appreciation pressure on the yen). However, I cannot deny that there is a risk that if, contrary to my expectations, current large-scale *Rinban* operations were to continue even after the elimination of negative interest rates, the swap spread would be maintained, and therefore, the 10-year JGB yield could fall substantially below 0.5%, and approach 0.3%.

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