Daiwa's View

FICC Research Dept

Better-than-expected US PPI lifts US 10yr Treasury yield to upper end of range

- Strong PPI reduces rate cut expectations; US 10yr Treasury yield approaches upper end of range
- However, 10yr real rate rise stalled just before 2%, as it did last month
- As long as rate cutting orientation unchanged, see BEI 2.3 + real rate 2 ≈ 4.3% as key resistance line; may need to discuss r* increase to go beyond 2.4 + 2.1 ≈ 4.5%

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On 14 March, the US 10-year Treasury yield rose a meaningful 10bp, from 4.19% to 4.29%, and the 2-year yield jumped 6bp, from 4.63% to 4.69%. Even though US retail statistics fell far short of prior expectations and the outlook for US consumer spending deteriorated (also sharp downward *GDPNow* revision from 3.18 to 2.34), the better-than-expected US PPI for both the headline and core readings caused the market to further scale back its expected timing and number of rate cuts by the Fed this year. On 14 March, the market reduced its anticipated probability of a June rate cut to 67%. Its expected number of rate cuts for the year is also slightly below the three cuts indicated by the dot chart. Of course, this may have reflected the possibility of a decrease in the number of expected rate cuts from three to two this year in the new dot chart to be disclosed at this month's FOMC meeting. It was also revealed that at the December 2023 FOMC meeting, the last time the Fed's SEP (Summary of Economic Projections) was disclosed, members changed the SEP after seeing the weak PPI immediately prior to the meeting. As such, the importance of PPI is indisputable.

Meanwhile, even amid such data, it is noteworthy that the rise for the US 10-year real rate stalled just before 2% (1.98%). In September of last year, Fed Governor Christopher Waller expressed some satisfaction with the "10-year real rate of 2%" level. This is also the level at which the uptrend actually recoiled during the middle and end of last month. Ultimately, even if the start of rate cuts is delayed, as long as the rate-cutting orientation itself is not shaken, "BEI 2.3% + real rate 2% ≈ 4.3%" is likely to be a well-founded resistance line against a rise for the US 10-year Treasury yield. In particular, a change in the Fed's stance (return of "high for long" on nominal interest rate basis) or another term premium outburst would be required to exceed the upper limit defined as "BEI 2.4 + real rate 2.1 = 4.5%," which is derived by adding the standard amplitude margin of 10bp to both BEI and the real rate.

That said, Fed officials acknowledged last Oct-Nov that a rise for the US 10-year Treasury yield shouldered rate hikes. In cases where the term premium spikes, it is likely that the expected number and timing of Fed rate cuts would start to recover after slight delays. Therefore, a yield rise beyond 4.5% due to a term premium outburst (if such an outburst occurs at all) is likely to be short-lived. Ultimately, a discussion about the natural rate of interest (r*) that affirms "high for long" on a nominal interest rate basis is necessary for the US 10-year Treasury yield to be continuously anchored at above 4.5%. In that sense, in addition to the end-2024 FF rate level in this month's FOMC SEP, we also need to pay attention to levels at the end of 2025 and 2026, along with the level of the longer-run FF rate.

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