Daiwa's View

"10-year yield of 0.8%" increasing presence as upper limit of range

➢ Option of "operation twist" putting brakes on rise in term premium

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.

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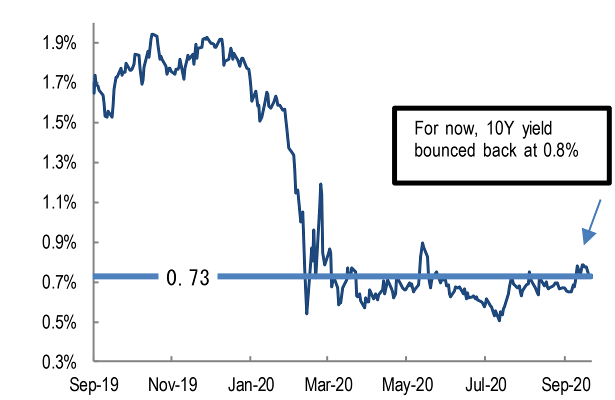
Yesterday, the US long-term yield declined to the lower 0.7% range amid the news that September US core CPI slowed to a four-month low level. We have the impression that yields fell more than stock prices (down 0.6%). The market tone has slightly changed from that until last week.

Probably, the biggest factor of the change in market tone was remarks on asset purchases (QE) by Chicago Fed President Charles Evans, Cleveland Fed President Loretta Mester, and Kansas City Fed President Esther George in the latter half of last week. Specifically, Ms. Mester favored considering whether to concentrate the central bank's bond buying more on longer-dated maturities. In addition, Mr. Evans said that "if we were to target at longer-duration assets, we could probably take duration out of the market without maybe having to increase our balance sheet quite as much."

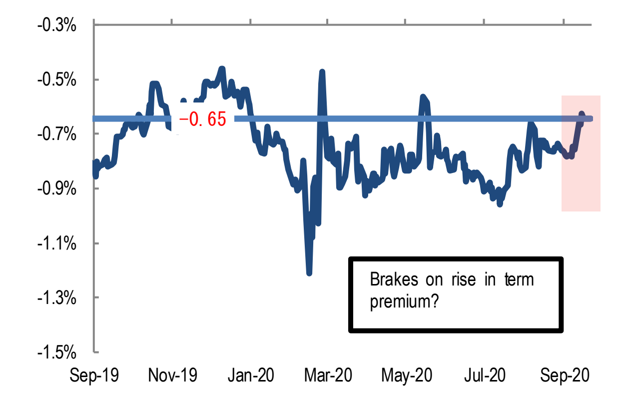
These remarks might have reminded the market of the existence of the option of "operation twist" and put the brakes on the rise in the term premium, the main cause of the latest rise in yields.

10Y US Treasury Yield



Source: Bloomberg; compiled by Daiwa Securities.

Term Premium on 10Y US Treasuries



Source: Bloomberg; compiled by Daiwa Securities.

◆ **Chicago Fed President Charles Evans** (8 Oct 2020)
・There are other things you can do. We're buying across the curve right now. If we were to target at longer-duration assets, we could probably take duration out of the market without maybe having to increase our balance sheet quite as much. That's what we did in 2011 with the Maturity Extension Program. So, that's another option. I'm just sort of throwing tools out that have been used in the past. I'm not saying those are under active discussion. We do have plenty of tools available, we've used them in the past, and we could use them again.

Thus far, the US long-term yield has been bounced back by the 0.8% wall. When the term premium surged in June, the US long-term yield reached 0.9%, but this time it has not exceeded 0.8%. The background factors are as follows:

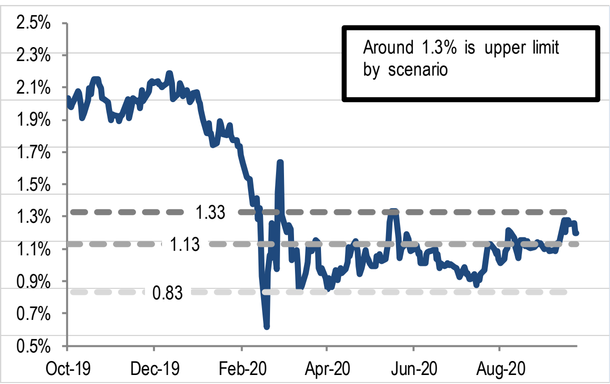
One is that the rise in the 5-year yield, which exceeded 0.45% in June, stopped at 0.35% this time. The reasons behind the limited rise vs. June are (1) the introduction of the average inflation target of 2%, announced at the same time as the Jackson Hole conference in August, and (2) the existence of the new forward guidance introduced at the September FOMC meeting, in our view. If the rise in the 5-year yield is constrained, the degree of the rise in the 10-year yield, whose composition elements include the 5-year yield, would also be somewhat subdued.

Another point is that the rise in the 5-year forward 5-year yield has stopped at 1.28%. As of June, the yield rose as high as 1.33%. We attribute the latest subdued rise in the 5-year forward 5-year yield vs. the case in June to the effects of Fed Chair Jerome Powell's comment at the September FOMC meeting—"if we do lift off, we will keep policy accommodative until we actually have a moderate overshoot of inflation for some time."

Regarding Mr. Powell's aforementioned comment contributing to the subdued rise in the 5-year forward 5-year yield, it is important to estimate concrete figures. According to our simulation that assumes the start of the next rate-hike cycle at the beginning of 2026, the rate-hike pace of twice a year (half pace during period led by former Chair Janet Yellen), and the final level of the federal funds rate of 2%, the theoretical value of the 5-year forward 5-year yield is calculated at 1.33% (chart below). If we change the final level of the federal funds rate to 1.5% and 1%, the theoretical value of the 5-year forward 5-year yield would decline to 1.13% and 0.83%, respectively. Based on Mr. Powell's comment, it is highly likely that the 5-year forward 5-year yield will stay at 1.3% or lower in the near term.

In the case that the aforementioned two points are effective, the 10-year US yield of above 0.8% needs a surge in the "other element" (= term premium). However, if the Fed is putting the option of operation twist on the table, the surge in the term premium is unlikely to continue. In the near term, the 0.8% level of the 10-year yield" is likely to increase its presence as the upper limit of the range.

5Y-forward 5Y US Yield



Source: Bloomberg; compiled by Daiwa Securities.

Estimated 5Y-forward 5Y Yield by Rate-hike Scenario (%)

	2025	2026	2027	2028	2029	2030	Avg
Greenspan/ Upper limit of 2%	0.25	2.00	2.00	2.00	2.00	2.00	1.71
Yellen/ Upper limit of 2%	0.25	1.25	2.00	2.00	2.00	2.00	1.58
Yellen-2/ Upper limit of 2%	0.25	0.75	1.25	1.75	2.00	2.00	1.33
Greenspan/ Upper limit of 1.5%	0.25	1.50	1.50	1.50	1.50	1.50	1.29
Yellen/ Upper limit of 1.5%	0.25	1.25	1.50	1.50	1.50	1.50	1.25
Yellen-2/ Upper limit of 1.5%	0.25	0.75	1.25	1.50	1.50	1.50	1.13
Greenspan/ Upper limit of 1%	0.25	1.00	1.00	1.00	1.00	1.00	0.88
Yellen/ Upper limit of 1%	0.25	1.00	1.00	1.00	1.00	1.00	0.88
Yellen-2/ Upper limit of 1%	0.25	0.75	1.00	1.00	1.00	1.00	0.83

Source: Compiled by Daiwa Securities.
Notes: 1) Figures assume eight rate hikes/year in Greenspan period and four rate hikes/year in Yellen period.
2) For simplification, "simple avg. at end of year" used as avg.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies.
As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter's outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.

2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Daiwa Securities Living Investment Corporation (8986).

3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.

4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of Y10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.

5) Daiwa Securities Group Inc. and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group Inc. is to acquire up to 5.01% of Credit Saison's total common shares outstanding (excl. treasury shares; as of 31 Jul 2019).

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- 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.
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