

# Daiwa's View

## Interpretation of market consensus

- Market is factoring in the start of a rate hike within three years and a pace of rate hikes of once per year

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Daiwa Securities Co. Ltd.

### Market is factoring in the start of a rate hike within three years and a pace of rate hikes of once per year

### Interpretation of market consensus

Expectations of an earlier rate hike have spread in the market amid developments such as the US presidential election and progress in vaccine development. In this report, we examine how the market understands the Fed's forward guidance by observing its consensus on the timing and pace of rate hikes. We first describe the conclusion—currently, the market appears to be factoring in the start of a rate hike sometime within three years and a pace of rate hikes of about once per year.

### Timing of rate hike

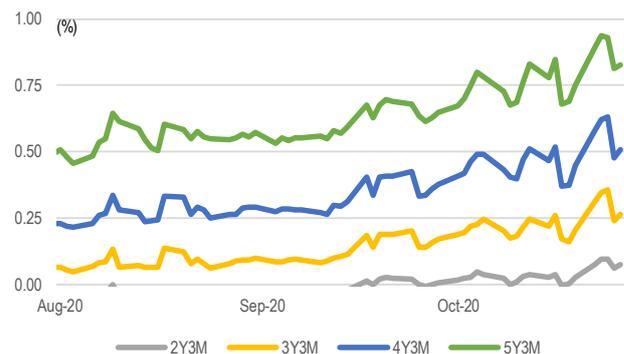
In order to conduct an accurate observation of market expectations regarding the rate hike, we need to use the effective federal funds rate that is derived by the Fed, as well as its estimated value of OIS futures<sup>1</sup>. Currently, the effective federal funds rate is at 0.09%, the 2-year forward 3-month OIS is at 0.17%, the 3-year forward 3-month OIS is at 0.36%, and the 5-year forward 3-month is at 0.92%. The difference between the 3-year forward 3-month OIS (0.36%) and the effective federal funds rate (0.09%) is 0.27%. This figure is larger than the estimated amount of a single rate hike of 0.25%, suggesting that the market is currently factoring in the start of a rate hike within three years.

Effective Federal Funds Rate, OIS Futures (%)

	Effective FF rate	2Y3M	3Y3M	4Y3M	5Y3M	10Y3M
13-Nov-20	0.09	0.17	0.36	0.60	0.92	1.41
06-Nov-20	0.09	0.12	0.30	0.54	0.84	1.38
05-Nov-20	0.09	0.09	0.25	0.47	0.78	1.29
04-Nov-20	0.09	0.09	0.26	0.46	0.77	1.31
03-Nov-20	0.09	0.13	0.35	0.61	0.94	1.42
02-Nov-20	0.09	0.12	0.31	0.56	0.87	1.35
30-Oct-20	0.09	0.13	0.34	0.60	0.92	1.41
30-Sep-20	0.09	0.06	0.19	0.39	0.67	1.21
31-Aug-20	0.09	0.04	0.16	0.36	0.68	1.15
31-Jul-20	0.10	-0.05	0.04	0.20	0.44	0.75

Source: Bloomberg; compiled by Daiwa Securities.

Moves Factoring in Rate Hike (OIS futures – Effective federal funds rate)



Source: Bloomberg; compiled by Daiwa Securities.

<sup>1</sup> Specifically, the degree of expected rise in the effective federal funds rate (approximately equal to the amount of rate hike being factored in by the market) is calculated by deducting the effective federal funds rate level from the OIS futures level. In this report, Bloomberg's FEDL01 Index is used as the effective federal funds rate—S0042FS 1Y3M BLC Curncy, S0042FS 2Y3M BLC Curncy, S0042FS 3Y3M BLC Curncy, S0042FS 4Y3M BLC Curncy, S0042FS 5Y3M BLC Curncy, and S0042FS 10Y3M BLC Curncy are used as 1Y-forward, 2Y-forward, 3Y-forward, 4Y-forward, 5Y-forward, and 10Y-forward 3M OIS, respectively.

This market response regarding the rate hike timing is inconsistent with economic/price projections and the dot chart shown at the September FOMC meeting. If such inconsistency is confirmed with projections and the dot chart to be disclosed at the next FOMC meeting, the recent rise in yields would not be justified. In this report, we think that the market has somewhat optimistic expectations regarding (1) the probability that three requirements for a rate hike will be met and (2) the timing of achieving average inflation of 2%. It is therefore possible that consensus on the timing of the start of a rate hike will be pushed back after the December FOMC meeting.

### Pace of rate hikes

Another important point to be observed is how the market is factoring in the pace of rate hikes. In this regard, a key is the market's interpretation of Fed chair Jerome Powell's remark at the post-meeting press conference in September—"if we do lift off, we will keep policy accommodative until we actually have a moderate overshoot of inflation for some time."

Confirming the OIS level, the 3-year forward/4-year forward spread is 0.24% and the 4-year forward/5-year forward spread is 0.32%. These figures show that the market is factoring in a pace of rate hikes of roughly once per year. We can say that this is a very slow pace in comparison with the pace of past rate hikes<sup>2</sup>. In [our previous report](#), we assumed that a rate hike would start in five years and the pace of rate hikes would be the Yellen pace/2 (twice a year).<sup>2</sup> However, the timing of the rate hike appears to have been much later than the market consensus, while the pace of rate hikes appears to have been much faster.

In closing, we have calculated the estimated value of the 5-year forward 5-year yield by scenario (i.e., the timing of the start of a rate hike) based on the new consensus regarding a pace of rate hikes of about once per year. We have examined several patterns, in which the upper limit of the effective federal funds rate is 1.5% or 2%, focusing on the fact that the current value of the 10-year forward 3-month OIS is at around 1.5%.

The results are shown in the chart below. The average value of the 5-year forward 5-year OIS during the last week stood at 1.17%, which factors in an upper limit of 1.5% and the start of a rate hike in three to four years. Given this, we can calculate that the 5-year forward 5-year yield will decline by around 10bp if consensus on the timing of the start of a rate hike is postponed by one year after the December FOMC meeting.

#### 5Y-forward 5Y OIS Rate by Scenario (%)

<b>Upper limit of 1.5%</b>	1Y OIS	2Y OIS	3Y OIS	4Y OIS	5Y OIS	6Y OIS	7Y OIS	8Y OIS	9Y OIS	10Y OIS	5Y-forward 5Y OIS
Rate hike starts next year	0.34	0.59	0.84	1.09	1.34	1.50	1.50	1.50	1.50	1.50	1.47
Rate hike starts in 2 years		0.34	0.59	0.84	1.09	1.34	1.50	1.50	1.50	1.50	1.41
Rate hike starts in 3 years			0.34	0.59	0.84	1.09	1.34	1.50	1.50	1.50	1.30
Rate hike starts in 4 years				0.34	0.59	0.84	1.09	1.34	1.50	1.50	1.14
Rate hike starts in 5 years					0.34	0.59	0.84	1.09	1.34	1.50	0.95

<b>Upper limit of 2%</b>	1Y OIS	2Y OIS	3Y OIS	4Y OIS	5Y OIS	6Y OIS	7Y OIS	8Y OIS	9Y OIS	10Y OIS	5Y-forward 5Y OIS
Rate hike starts next year	0.34	0.59	0.84	1.09	1.34	1.59	1.84	2.00	2.00	2.00	1.80
Rate hike starts in 2 years		0.34	0.59	0.84	1.09	1.34	1.59	1.84	2.00	2.00	1.64
Rate hike starts in 3 years			0.34	0.59	0.84	1.09	1.34	1.59	1.84	2.00	1.45
Rate hike starts in 4 years				0.34	0.59	0.84	1.09	1.34	1.59	1.84	1.22
Rate hike starts in 5 years					0.34	0.59	0.84	1.09	1.34	1.59	0.97

Source: Bloomberg; compiled by Daiwa Securities.

<sup>2</sup> In past rate hikes, former Chair Alan Greenspan implemented rate hikes at every FOMC meeting (eight/year, hereinafter referred to as the Greenspan pace), and former Chair Janet Yellen conducted quarterly rate hikes (four/year, the Yellen pace).

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- 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).
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