1 December 2020
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Daiwa's View

Where will interest rates be a year from now?

- I. US forward rate implies around 1% for the 10 year
- II. JPY forward rate indicates attractiveness of JGB investment (not future level)

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Daiwa Securities Co. Ltd.

Where will interest rates be a year from now?

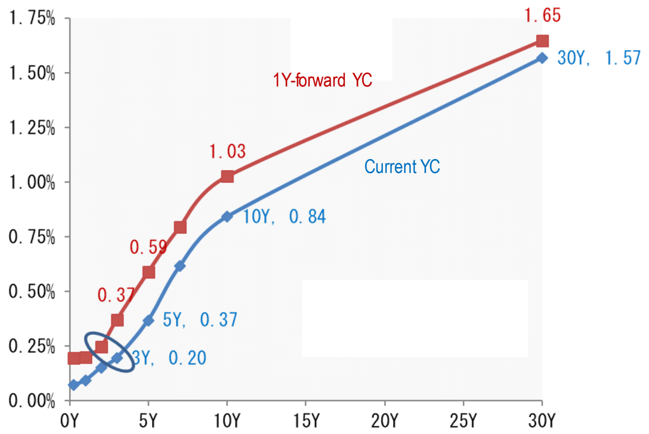
US forward rate implies around 1% for the 10 year

In December 2020, interest rate levels at end-2021 gradually becoming a factor. In this report, we use forward interest rates to consider the one-year forward yield curve now implied by the market.

One year forward Treasury yields are at 0.2% for the 1-year (vs. 0.09% now), 0.37% for the 3-year (vs. 0.19%), 0.59% for the 5-year (vs. 0.36%), 1.02% for the 10-year (vs. 0.84%), and 1.65% for the 30-year (vs. 1.57%). Of particular importance is the 1-year forward 3-year yield, which is 16-18bp higher than currently and 0.25% higher than the current effective fed funds rate.

One interpretation of this is that the clock has basically been moved forward by one year. In other words, the Fed dot chart is forecasting rates to be the same at end-2023, which is 3-year forward from now but 2-year forward from next year. Put differently, the period over which the Fed expects to hold the target range at 0-0.25% will be shortened to two years next year around this time. Because the rise in interest rates equivalent to a shortening of this guidance for interest rates three years and longer increased 15-20bp, the 10-year rate is expected to reach 1%[1].

US Treasury Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

[1] The rise in rates one year forward using a constant maturity basis is not necessarily a loss for investors, because in a year from now the maturity of bonds currently held by investors will be one year shorter. The concept of a forward interest rate is that it adjusts for the effects of maturity shortening over that time frame.

But is it true that the 3-year yield will have risen to 0.37% around this time in 2021? Of course, the key to answering this is knowing how close average inflation will get to 2%. If the US inflation rate is not expected to reach 2% anytime soon, there is a possibility that the Fed will extend the period at which it holds rates unchanged out to end-2024 when it releases its Summary of Economic Projections in September 2021. Conversely, (although unlikely) if inflation overshoots and stays at 2.5%, it is possible that the Fed will move up its projected rate hike earlier than end-2023.

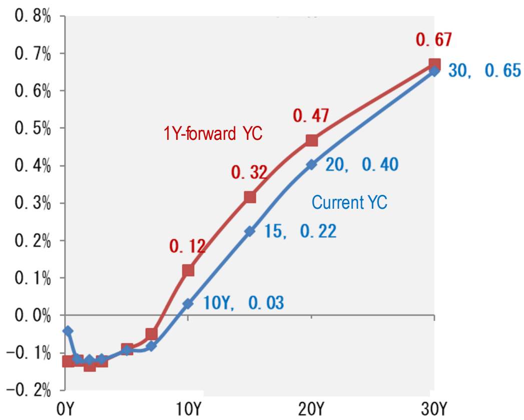
Thus forward yields on Treasurys provide valuable info on the future shape of the yield curve. In comparison, forward JGB yields have almost no information value, because the BOJ is targeting a 10-year yield of zero on a constant maturity basis. Calculated based on current forward JGB yields, the 1-year forward 10-year yield is 0.12% and the 2-year forward 10-year yield is 0.20%, but few expect the BOJ to raise its 10-year yield target to those levels.

JPY forward rate indicates attractiveness of JGB investment (not future level)

Such a constant maturity basis target predicated on yield curve control (YCC) is not bad from an investment perspective. For example, the 11-year JGB yield implies an increase one-year from now to 0.12%, but the 10-year JGB yield is likely to be still near 0% one year later (because of YCC), and thus relatively high rolldown profit is assured. In other words, the gap between the JGB forward yield and the current curve is not a projection of the future level but rather an indication of the high degree of investment attractiveness.

In particular, the (somewhat unrealistic) one-year forward rates in the 10-year to 20-year zone shown in the chart below indicates the extent of excess return in that zone. With the 10-year yield target fixed at zero, the greater the steepening of the superlong yield curve, the greater the benefit. When considering the global steepening pressures and the nature of YCC targeting a constant maturity basis, there is a possibility that investing in JGBs will be preferable to investing in foreign bonds in 2021.

JGB Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

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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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February 2020

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Other Disclosures Concerning Individual Issues:
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.
** The ratio of margin requirements etc. to the amount of the transaction 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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