

Daiwa's View

Quite excessive

- Current yield declines approaching an end

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Daiwa Securities Co. Ltd.

Current yield declines approaching an end

Quite excessive

Yields have declined tremendously. With the 10-year US Treasury yield closing at below 1.3%, the 30-year yield slid to a level far below 2%. The 5-year yield also declined to 0.74%, lower than the level before the June FOMC meeting, which showed hawkish dots. Of note is that the 5-year forward 5-year breakeven inflation rate (BEI) fell to 2.07%, which is a level that is not consistent with achieving the Fed's mandate (core PCE of 2%). I suppose you could interpret this as the market starting to factor in the possibility of a 'policy mistake' by the Fed.

Many regarded the minutes of the FOMC meeting (released yesterday) as uneventful. However, I was personally surprised by the fact that staff projected that inflation would slow to slightly below 2% in 2022 (in reaction to moves in 2021). In the Summary of Economic Projections at the June FOMC meeting, members raised their inflation projection in 2022 from 2.0% to 2.1% alongside an upward revision to dots. If the staff projection were correct, Fed members would be more hawkish than the level where it should be.

If so, there would be a risk of inflation being killed, rather than overheating, which was the concern thus far. It may be necessary to avoid overinterpretation amid wild fluctuations. However, the scenario makes sense if we assume that concerns about a 'policy mistake' by the Fed are the reason behind the decline in the 5-year forward 5-year BEI to a level that is inconsistent with the Fed's mandate and diminishing responses to rate hikes.

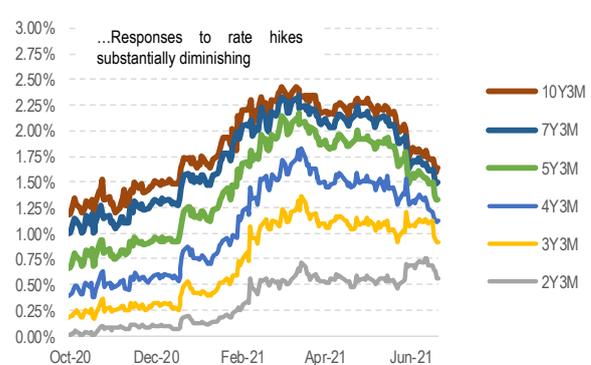
Regarding the question of whether it is correct that the Fed will go back to a dovish stance, such a move would raise concerns about an imbalance (bubble). In short, [the Fed appears to already be in checkmate](#).

US Treasury Breakeven Inflation Rate



Source: Bloomberg; compiled by Daiwa Securities.

3M OIS Yields



Source: Bloomberg; compiled by Daiwa Securities.

That said, the current long-term/superlong yields are judged to have declined to around the lower limit of the longer run target federal funds rate, as described later. While temporary declines caused by short-covering are undeniable, unless a serious risk-off scenario occurs, it is probably okay to view current yield declines as approaching an end.

In the latest survey by the New York Fed (released yesterday), the median estimate of the longer run target federal funds rate remained at 2.31% among [primary dealers](#) and 2.0% among [market participants](#). Meanwhile, the 5-year forward 5-year yield and the 20-year forward 10-year yield currently stand at 1.92% and 2.14%, respectively, falling to a level largely consistent with the estimate among market participants (2.0%), vs. the Fed's 2.5% and primary dealers' 2.31%. One can see some basis for the current levels. However, there is significantly less validity for declines going forward¹.

The survey also disclosed expectations for the average federal funds rate over the next ten years (corresponding to 10-year OIS). The median estimate was 1.63% among primary dealers and 1.3% among market participants. Meanwhile, the 10-year OIS currently observed in the market is at 1.07%. This is below the 25th percentile of the primary dealers' estimate, but closing in on the 25th percentile of the market participants' estimate.

The feeling we get from these comparisons also gives us the impression that current yield declines are quite excessive, and that further declines are unlikely.

US Treasury Yields (%)

UST	5Y	(5Y OIS)	5Y5Y	(5Y5Y OIS)	10Y	(10Y OIS)	UST	10Y	10Y10Y	20Y	20Y10Y	30Y
Current level	0.74	0.65	<u>1.92</u>	1.54	1.29	1.07	Current level	1.29	2.52	1.84	<u>2.14</u>	1.93

Source: Bloomberg; compiled by Daiwa Securities.

Survey of Primary Dealers by New York Fed

	Longer Run	10-yr Average FF Rate
25th Pctl	2.06%	1.25%
Median	2.31%	1.63%
75th Pctl	2.50%	1.85%

Source: Extracted from New York Fed survey.

Survey of Market Participants by New York Fed

	Longer Run	10-yr Average FF Rate
25th Pctl	1.75%	1.00%
Median	2.00%	1.30%
75th Pctl	2.50%	1.63%

Source: Extracted from New York Fed survey.

The result of the ECB's strategic review was also announced yesterday. We note that the central bank set a new, symmetric 2% inflation target, and denied that it is doing average inflation targeting like the Fed.

¹ A decline in the longer run target federal funds rate reflecting a lower potential growth rate would be an important topic in the future. However, it is not a topic that is going to change in a day or so. At this point, it would be premature to factor in a longer run of below 2%.

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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 ¥10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.
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- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- 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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Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

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