Daiwa Securities

Daiwa's View

Forecasts for US yields in 2H FY21

- End-CY21: 10Y yield of around 1.5% (5Y of 1% and 5Y5Y of 2%)
- End-FY21: 10Y yield of around 1.55%

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.

End-CY21: 10Y yield of around 1.5% (5Y of 1% and 5Y5Y of 2%)

End-FY21: 10Y yield of around 1.55%

Forecasts for US yields in 2H FY21

Our US Treasury yield forecasts for end-CY21 are: a 5-year yield of 1%, 5-year forward 5-year yield of 2%, and 10-year yield of 1.5% ranging from 1.25% to 1.75%.

Since the Fed indicated a hawkish dot plot with 6.5 rate hikes in total (0.5 + 3 + 3) at the FOMC meeting on 22 September, US Treasury yields have risen relatively substantially across the curve. That said, this is a recovery process from the overshooting range (details to be explained later in this report), and, therefore, yields are unlikely to continue to rise at the same pace. In the following sections, we examine the developments by breaking down the 10-year yield (10Y UST) into the "5-year yield (5Y UST)" and "5Y-forward 5Y yield (5Y5Y UST)."

Our Forecasts for US Treasury Yields at End-CY21

UST	5Y	(5Y OIS)	5Y5Y	(5Y5Y OIS)	10Y	(10Y OIS)
Current level	0.95	0.85	2.00	1.69	1.45	1.25
Main scenario at end-CY21	1.00	0.90	2.00	1.69	1.48	1.28
Upward scenario	1.15	1.05	2.46	2.15	1.78	1.58
Downward scenario	0.80	0.71	1.75	1.44	1.25	1.06

Source: Compiled by Daiwa Securities.

◆ 5Y UST

In the maturity zone up to the 5Y, the path of the policy interest rate has a dominant influence. Therefore, we mainly examine OIS yields when forecasting the 5Y UST. We forecast that the 5Y UST-OIS spread will remain mostly stable at around 0.10%.

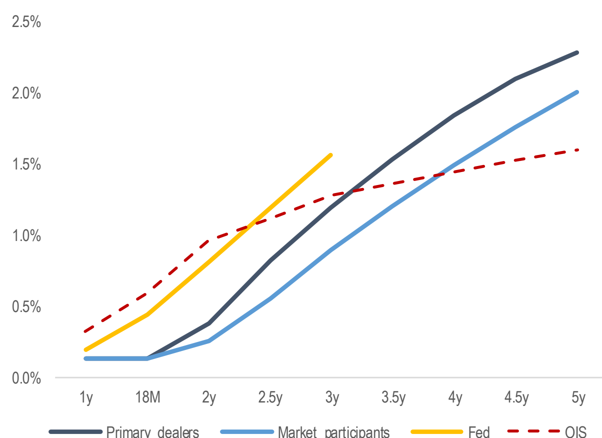
5Y UST = US OIS 5Y yield + UST-OIS spread (5Y)

Since the Fed indicated a hawkish dot plot with 6.5 rate hikes in total (0.5 + 3 + 3) at the FOMC meeting on 22 September, the 5Y OIS yield has risen from 0.82% to 0.95%. In order to confirm the current market pricing, we observe the consensus of the policy rate level in one year, two years, and three years by using the forward 1M OIS yields. Currently, the 1Y-forward 1M OIS yield stands at 0.31%, the 2Y-forward 1M OIS yield at 0.93%, and the 3Y-forward 1M OIS yield at 1.27%. While the 1Y-forward and 2Y-forward yields are roughly close to the dot plot shown at the September FOMC meeting, the 3Y-forward yield diverges substantially from the dot plot (left-hand chart on next page).

Important disclosures, including any required research certifications, are provided on the last page(s) of this report.

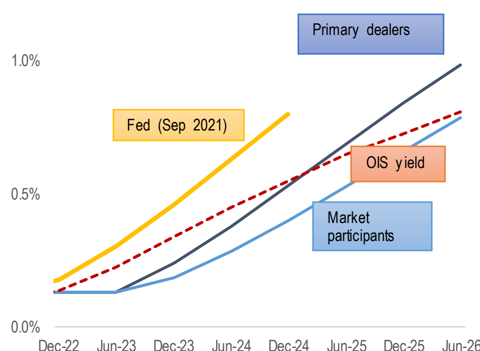
FICC

Projections for Future Policy Rate Level



Source: Bloomberg, Fed, New York Fed; compiled by Daiwa Securities.

OIS Yield Curve



Source: Bloomberg, Fed, New York Fed; compiled by Daiwa Securities.

Based on forecasts by primary dealers in the New York Fed's survey (in which responses were submitted before the July FOMC meeting), we estimate the 5Y OIS yield at end-CY21 will be around 1.05%. The forecast among market participants was around 0.85%. Reflecting the hawkish dot plot at the September FOMC meeting, the timing of rate hikes is expected to be moved forward. However, the forecast for the pace of rate hikes is not very different from the Fed's dot plot. Here, too, the pace of rate hikes in three years and beyond differs somewhat from that which is priced in in the OIS market.

If the aforementioned divergence is eliminated by a rise in the OIS yield in three years and beyond, this would also create substantial upward pressure on the 5Y OIS yield. We, therefore, need to recognize such a possibility. However, the 5Y5Y OIS yield and 30Y OIS yield now stand at 1.69% and 1.49%, respectively. Compared to these long-term forward yield levels, the dots at end-CY24 (median estimate of 1.75%) are too high (inconsistent). If a hike in the policy rate proceeded without a rise in long-term forward yields, and if short-term yields exceeded the level of long-term forward yields, this would trigger a recession. We touch on forecasts for long-term forward yields later in this report, but their stability has been increasing since the June FOMC meeting. Therefore, we assume that it is not likely that OIS yields in three years and beyond will approach the Fed's dot plot in 2H.

Currently, the federal funds rate is at about 0.1% and the 5Y1M yield is around 2% (2.04%). With this balance, the 5Y OIS yield is expected to rise by 10bp on average every three months[1]. The 5Y OIS yield stood at 0.85% on 24 September, and simply adding the rise over three months results in a calculation that the yield will rise to 0.95% at end-CY21. However, as the yield underwent an as much as 13bp rise over several days after the September FOMC meeting, there could be a certain degree of backlash. Given the aforementioned factors, we estimate that the 5Y OIS yield at end-CY21 will be 0.9%. The UST-OIS spread is expected to be unchanged at 10bp, and the 5Y UST is likely to be exactly 1%.

The estimated range of the 5Y yield is 0.8-1.15%. The upper limit assumes a rise in the OIS yield to the forecast level among primary dealers (around 1.05%), while the lower limit assumes a decline to the average level during one month before the September FOMC meeting (0.71%). (The UST-OIS spread is assumed to be unchanged at 10bp).

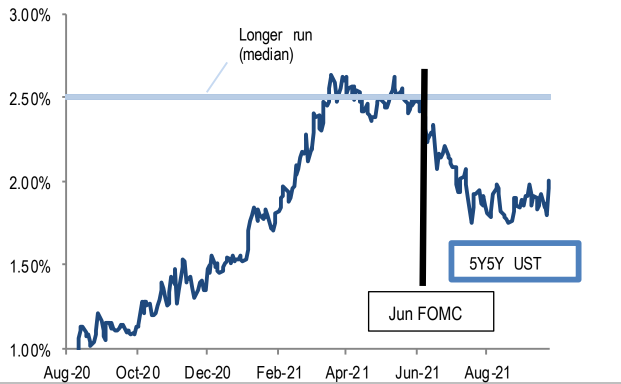
◆5Y5Y UST

We estimate that the 5Y5Y UST at end-CY21 will be exactly 2%. After the September FOMC meeting, the 5Y5Y UST rose from 1.85% to 2.00%. That said, the level before the FOMC meeting was excessively low compared to its benchmark for the projection for the neutral interest rate among FOMC participants (longer-run)—specifically, the Fed's median of 2.5%, primary dealers' projection of 2.25%, and market participants' projection of 2%. Therefore, the surge after the FOMC meeting can be interpreted as a recovery process from the overshooting range.

[1] [(2.04%-0.1%)/60 months] × 3 months.

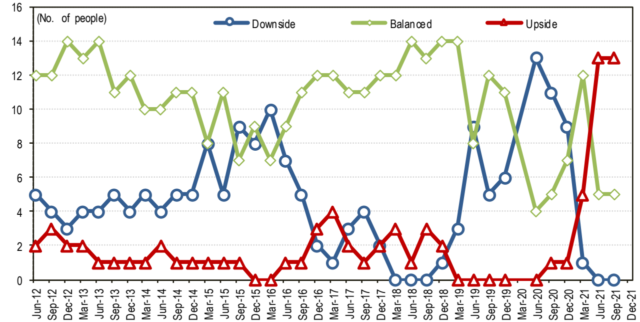
However, looking at the span since the June FOMC meeting, the 5Y5Y yield has just recovered to the 2% level after having fallen by 75bp from 2.5% to 1.75%. As the drop in long-term forward yields since the June FOMC meeting has become a concern at the Fed, primary dealers were questioned about this in the New York Fed's survey before the July FOMC meeting.

5Y5Y UST, Longer Run



Source: Bloomberg; compiled by Daiwa Securities.

FOMC Participants' Risk Balance on Core Inflation



Source: Fed; compiled by Daiwa Securities.

As the Fed has moved forward with its exit strategy, forward yields have dropped. One possible factor behind this could be that the hawkish shift by the Fed since the June FOMC meeting has reminded the market of "the pattern of secular stagnation" that prevailed before the pandemic, which Treasury Secretary Janet Yellen made reference to.

In the first place, the flexible average inflation target (FAIT), which was introduced at last year's Jackson Hole conference, implies policy operations for a "high-pressure economy." Therefore, when the Fed strengthens its rate-hike stance for the purpose of "risk management" to cope with a near-term rise in inflation, it reduces the leeway for addressing secular stagnation issues (the reason for adopting FAIT), such as a decline in the potential growth rate and a substantial drop in the equilibrium real interest rate (r*). In other words, if the Fed's policy operations are more constrained by near-term inflation, downward pressure on the longer-run, which had been observed before the pandemic, will easily resurge.

In fact, the dot plot at the September FOMC meeting showed a hawkish rate-hike outlook, while the neutral interest rate projection among FOMC participants (average) declined from 2.48% to 2.46%.

Moreover, due to stock effects from enormous QE since the outset of the pandemic, it is highly likely that the financial environment and bond supply/demand conditions will remain very favorable. If interest rates are raised in line with the pace indicated by the median of the dots, the reduction of balance sheets will come within sight in around 2024. Until then, however, we do not forecast a major change in the basic structure regarding these bond supply/demand conditions.

Due to these factors, we forecast that the 5Y5Y will remain stable at the current level of around 2%. We assume the range's upper limit will be 2.46%, which is the average of the dots, and the lower limit will be 1.75%, which is close to the lowest value since the June FOMC meeting.

◆ 10Y UST

By adding up the aforementioned 5Y and 5Y5Y forecasts, we estimate that the 10Y UST at end-CY21 will be around 1.5%. The range is from 1.25% to 1.78%, which is calculated by simply totaling the upper limit and lower limit of the 5Y and 5Y5Y, respectively. We would like to emphasize here that 1.78%, which applies to the upper limit of the 5Y and 5Y5Y, is very conservative, because downward pressure on the 5Y5Y is expected to increase when the Fed becomes overly aggressive regarding rate hikes.

End-March 2022
Our forecasts for end-FY21 (Mar 2022) are as follows: a 5Y of 1.1%, 5Y5Y of 2%, and 10Y of 1.55% (1.45% as of 22 Sep 2021). Our forecast for a 5Y of 1.1% reflects a rise at a pace of 10bp every three months. (The 5Y5Y is assumed to remain unchanged.) In this case, it is calculated that the 5Y/10Y spread will narrow by about 5bp (flattening) during the three months from end-December 2021 to end-March 2022.

◆ Risk factors
As risk factors, we point out a taper tantrum after the decision on tapering, a rise in long-term forward yields, the development of fiscal discussions, and deterioration of the debt ceiling issue.

Regarding the taper tantrum, we basically view it as having already occurred in 2H FY20. The 10Y term premium on US Treasuries surged by 150bp from –1% to 0.5% in 2H FY20. This matches the taper tantrum when the Fed was led by Chair Ben Bernanke (0.5%→2%: +150bp).

Following the September FOMC meeting, the start of tapering in November and its completion in mid-2022 are already a done deal. Also, at this year's Jackson Hole conference, Chair Jerome Powell was mostly concerned about separating rate hikes from tapering. The possibility of a resurgence of a full-scale taper tantrum, a more than 100bp surge in the term premium, is not high, although a mini tantrum may happen. For reference, at the time of the previous taper tantrum, the term premium declined substantially after the actual start of tapering.

Term Premium on 10Y US Treasuries (ACM model)

Source: Bloomberg; compiled by Daiwa Securities.

We need to pay attention to long-term forward yields and fiscal discussions/the debt ceiling issue. That said, the DI of FOMC participants' risk weightings on core inflation remained unchanged at a high level. Therefore, if inflation pressure increases further, the Fed may become more hawkish. This is a major difference between now and 2H 2020 when yields surged in line with fiscal expansion by President Joe Biden, and it serves as a factor in constraining upward risk with long-term forward yields as pertains to changing developments with fiscal discussions/the debt ceiling issue. Their correlation is unlikely to be as strong as it was in 2H 2020.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:
https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- 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.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association