Daiwa Securities

Daiwa's View

Minor revision to our US yield forecasts / Two changes in JPY swap market

- ➢ Mechanical change to reflect upward revision to rate-hike outlook
- ➢ Focusing on two changes in JPY swap market

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Minor revision to our US yield forecasts / Two changes in JPY swap market

Mechanical change to reflect upward revision to rate-hike outlook

◆ 10-year US Treasury yield forecast revised to 1.6%

We have revised our 10-year US Treasury yield forecast for end-2021 to 1.6%. This is a mechanical revision to reflect a change in our forecast for the 5-year US Treasury yield (1% → 1.2%) in line with earlier rate-hike expectations. In yesterday's *Daiwa's View*, we moved forward the expected rate-hike timing from June 2023 to December 2022[1].

US Yield Forecasts (%)

UST	5Y	5Y5Y	10Y
Current level	1.16	2.02	1.55
Main scenario for end-2021	**1.0→1.2**	2.00	**1.5→1.6**
Upward scenario	**1.15→1.5**	2.50	**1.75→1.9**
Downward scenario	**0.80**	1.75	**1.25**

Source: Bloomberg; compiled by Daiwa Securities.

At a virtual conference held on 22 October, immediately before the blackout period during the November FOMC meeting, Fed Chair Jerome Powell admitted that higher-than-expected inflation was causing a situation that had not been anticipated when the flexible average inflation target (FAIT) was adopted. At the conference, slightly changing his previous thinking, he lowered (re-assessed) the hurdle for determining maximum employment, a necessary condition for rate hikes. He also pointed out that there was a good chance the labor market situation would match or be close to the maximum employment goal in 2022. These changes in thinking are sufficient grounds for forecasting earlier rate hikes by the Fed.

Currently, US Treasury yields are balanced by a 5-year yield of 1.18% and a 5-year forward 5-year yield of 2.02%. While rate-hike pricing in the short-term/intermediate zone has been increasing sharply, the rate-hike outlook has been calming inflation expectations in the intermediate/long-term zone. As a result, the 5-year forward 5-year yield has been mostly stable. We have been observing somewhat 'excessive' pricing of rate hikes in the short-term/intermediate zone. However, in light of the above-mentioned changes in Chair Powell's thinking, it would be hard to imagine full-scale unwinding of rate-hike expectations between now and end-2021, unless we are hit by very strong risk-off sentiment.

Due to the reasons mentioned above, we have revised our 5-year yield forecast from 1.0% to 1.2% (up 0.2%) and our 10-year yield forecast from 1.5% to 1.6% (up 0.1%), but kept our 5-year forward 5-year yield projection unchanged. The fine-tuning to the 10-year yield estimate is a mechanical one to reflect the revision to our 5-year yield forecast due to the change in the rate-hike outlook.

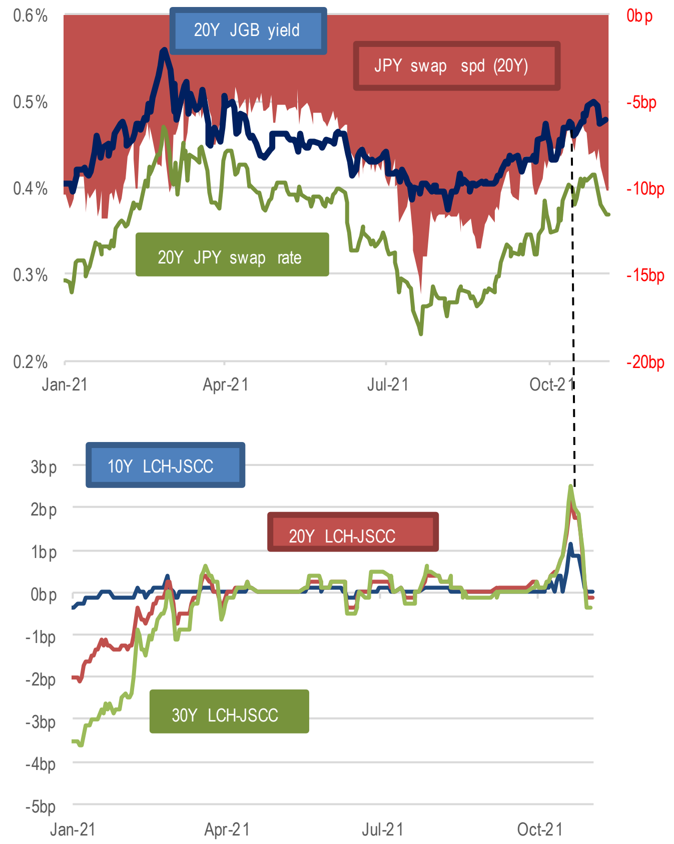
[1] The rate hike being moved forward 6 months creates about 0.2% upward pressure on the 5-year yield.

- JGBs: Focusing on two changes in JPY swap market
  Yesterday's 10-year JGB yield was sold by way of a pre-auction setup, and the auction result itself was weak, which temporarily led to selling to around 0.11%. After that, however, buying became dominant, while we saw futures prices surge. Eventually, the 10-year yield closed at 0.09% (down 0.005% d/d). As JGBs have been mostly bearish since late August, yesterday's strength, in addition to the digestion of an additional supply of Y234.2bn in the non-price competitive Auction II, was striking.

  Yesterday's JGB market showed unexpected strength, and we focus on two changes in the JPY swap market as background factors.

  Since August 2021, when sentiment for JGBs turned bearish, JPY swaps have consistently underperformed JGBs (producing a rise in the swap spread), but the swap spread has been declining since hitting a peak around 20 October. At the same timing, the LCH-JSCC spread in the long/superlong zone also hit a peak, and is now in shallow negative territory. At one point, paying (short) pressure from overseas investors was strong, as witnessed by a rise in the LCH-JSCC spread from 0 to 2bp. However, such movements by overseas players may have played out (Chart below).

JGB Yield, JPY Swap Rate, JPY Swap Spread, JCH-JSCC Spread



Source: Bloomberg; compiled by Daiwa Securities.

  In many cases, the JPY swap spread generally serves as a precursor for the direction of JGBs, and, therefore, the two above-mentioned changes in the JPY swap market deserve attention. Although we are still waiting for events such as the supplementary budget as well as meetings at the RBA and FOMC, the biggest event for JPY yields, the lower house election, has ended without issue. Since the 10-year JGB yield recorded 0.0% on 4 August, sentiment for JGBs has remained bearish for three months, but the time for a reversal may be approaching.

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