Daiwa Securities

# Daiwa's View

## What is the true value of the US real yield?

- Current true value is estimated at around 0%
- If Fed hurries to raise real yields too quickly without an early slowdown in inflation, this would cause inversion of yield curve

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### What is the true value of the US real yield?

**Current true value is estimated at around 0%**

One week has passed since New York Fed President John Williams mentioned on 14 January that real yields should rise, which triggered a surge in US real yields and a plunge in asset prices. Although the long-term yield reached the 1.9% level at one point, it has now declined to 1.75% due to flight to quality reflecting the sharp drop in asset prices. If this week's FOMC meeting does not provide a hawkish surprise, there may be a break in the confusion. Of course, if the Fed signals risk scenarios, such as a 50bp rate hike in March and/or earlier and faster balance sheet runoff, this may confuse the market further.

◆ What is the true value of the US real yield?

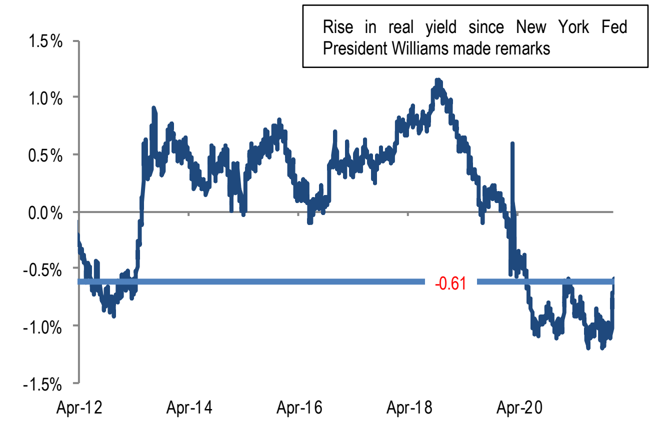
As mentioned, New York Fed President John Williams expected a rise in the US real yield. What is the true value of the US real yield? It is important to have an estimate as a point of reference in this regard. The longer-run rate and (long-term) inflation expectations are important reference information in estimating this. To state our conclusion at the outset, the current true value of the US real yield is estimated at around 0%.

(Long-term) real yield = Longer-run rate – (Long-term) inflation expectations

Up to 2018, the longer-run rate and (long-term) inflation expectations had stood at around 3% and 2%, respectively. Calculating backwards using the above formula, the (long-term) real yield at that time was 1%. In the dot plot at the December 2021 FOMC meeting, the longer-run rate had declined to 2.5%. In the latest New York Fed surveys, the median projection for the longer-run rate among primary dealers is 2.25% and that among market participants is 2%. In addition, the 5-year forward 5-year (5Y5Y) yield currently stands at 1.98%, and it has stayed at around 2% for a long time. If we assume that the current longer-run rate is 2%, the true value of the (long-term) real yield—longer-run rate minus (long-term) inflation expectations—would be 0% (if longer-run rate were regarded as 2.5%, the true value would be 0.5%).

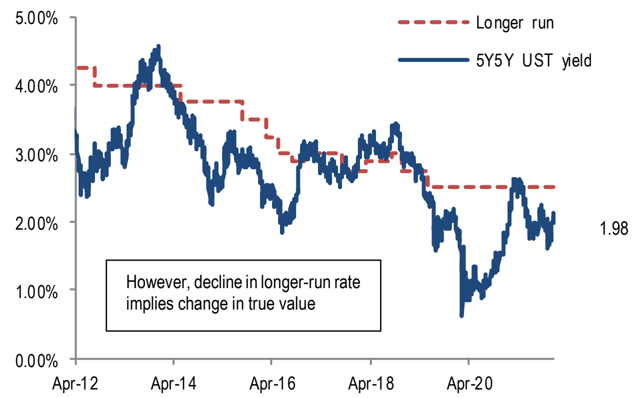
If we apply the conclusion mentioned above to our buy-on-dip recommendation levels, we can recommend taking the following stance with the (long-term) real yield: buying on dips at 0-0.25%, strongly buying on dips at 0.25-0.5%, and full-fledged buying at 0.5% and higher. One thing to be noted is that we should not expect a rise in the real yield to around 1% in the current stage of yield rises, although the real yield rose to around that level in the final stage of past tightening cycles.

**10Y US Real Yield**




*Source: Bloomberg; compiled by Daiwa Securities.*

**5Y5Y UST Yield, Longer Run**

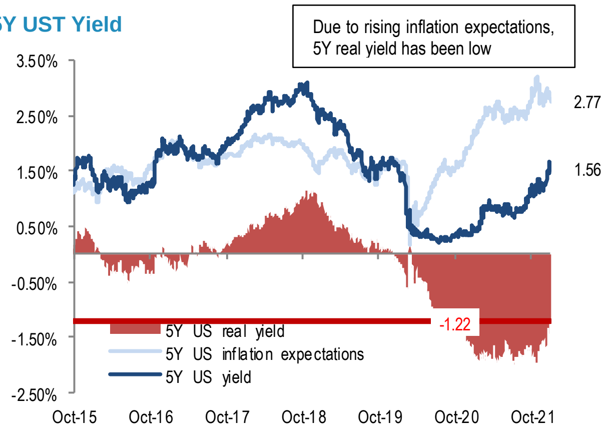



*Source: Bloomberg; compiled by Daiwa Securities.*

**5Y5Y real yield stands at the true value, but 5-year yield is too low**

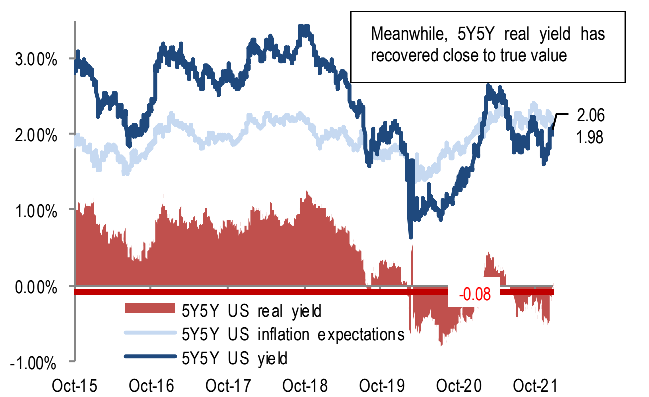
Currently, the 10-year real yield stands at –0.61%, far below our estimate for its true value of slightly above 0%. Accordingly, real yields are expected to rise as the tightening cycle progresses, as New York Fed President Williams pointed out it. When observing the 10-year real yield by breaking it down into the 5-year yield (first half) and the 5Y5Y yield (latter half), the latter half, the 5Y5Y real yield, is at around its true value of –0.08%. Therefore, if we really see an uptrend of the real yield, it is expected to be led by a rise in the first half, the 5-year real yield.

**5Y UST Yield**




*Source: Bloomberg; compiled by Daiwa Securities.*

**5Y5Y UST Yield**




*Source: Bloomberg; compiled by Daiwa Securities.*

**Premature hike in real yields before slowdown in inflation would cause inversion of yield curve**

We should note here the following point. Given the current high breakeven inflation rate (market-based inflation expectations), we need to see a rise in the nominal 5-year yield to a high level of around 2.77% in order for the 5-year real yield to surface to 0%, which is estimated to be its true value. If the 5-year yield were to rise to 2.77% with the forward yield staying at around 2%, we would see an inversion of the US Treasury yield curve.

This fact implies that the US will fall into a recession unless escalating inflation is reversed. On 23 December 2021, former Treasury Secretary Lawrence Summers stated, "That's why my fear is that we are already reaching a point where it will be challenging to reduce inflation without giving rise to recession." This assertion is supported by the aforementioned situation with real yields. If the Fed hurries to raise real yields too quickly without an early slowdown in inflation, the chances do not appear to be low that the US economy could eventually fall into a recession.

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