Daiwa's View

A level-headed perspective is required during a panic

➢ Other people's panic provides opportunities

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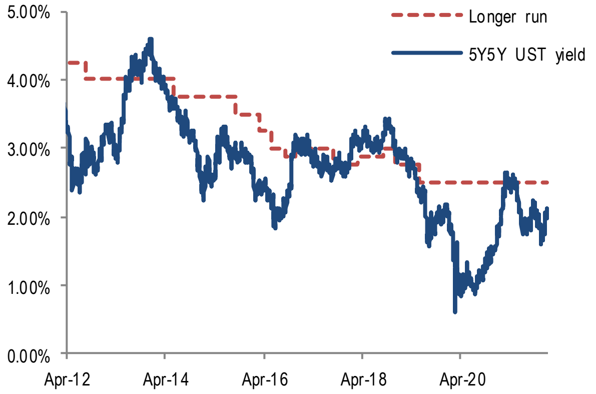
After the 10-year US Treasury yield rose to the 1.9% level during trading hours in Asia and the start of trading hours in Europe, it declined to 1.82% during New York trading hours. Eventually, it closed at around 1.86%. Cheap prices were logged during Asian trading hours, which tend to be less liquid, rather than during mainstream New York trading hours, which is a sign that is often seen during a panic. It is somewhat awkward to talk about fundamentals when taking a sidelong glance at a single day's volatile price movements. However, we would like to reconfirm the thresholds of fundamentals in order to maintain a level-headed perspective during this overshoot (panic), which has now happened during the Jan-Mar quarter for the second consecutive year.

◆ Forward yields

Currently, the 5-year forward 5-year yield stands at 2.08%. As the long-term forward yield contains long-term components, it is strongly consistent with fundamentals. Therefore, past patterns indicate a strong tendency for the longer-run rate to become the ceiling for the forward yield. Recently, we have rarely had the opportunity to hear discussion about a rise in the level of the longer-run rate. However, we come across discussion about a downtrend in the potential growth rate and longer-run rate due to a decline in the labor force participation rate in various minutes and other materials. Given the points mentioned above, as well as the current dot plots and the projections for the longer-run rate in the New York Fed's surveys (Fed: 2.50%; primary dealers: 2.25%; market participants: 2.00%), I basically recommend taking the following stances with forward yields: buying on dips at 2.00-2.25%, strongly buying on dips at 2.25-2.50%, and full-fledged buying at 2.50% and higher.

5Y5Y UST Yield, Longer-run Rate (dot plot)

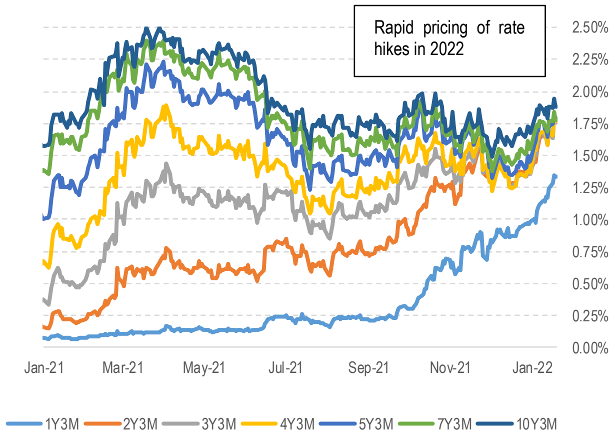


Source: Bloomberg; compiled by Daiwa Securities.

◆ 5-year yield (short-term/intermediate yields)

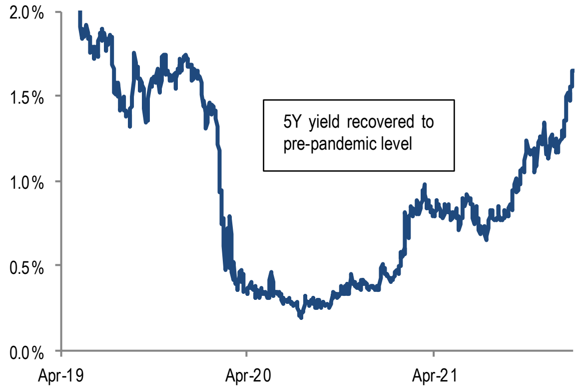
As short-term/intermediate yields tend to easily reflect expectations for rate hikes, the 2-year and 5-year yields have now risen to 1.06% and 1.65%, respectively. The market has already fully factored in four rate hikes (25bp per rate hike) in 2022, and started to price in five or more hikes (or a hike of 50bp or higher).

Forward 3M OIS Yields



Source: Bloomberg; compiled by Daiwa Securities.

5Y UST Yield



Source: Bloomberg; compiled by Daiwa Securities.

In *Daiwa's View* reports, we also expect that a 50bp hike in March and/or five hikes will attract market interest. We have been touching on this in conversations with investors since around last November. However, although the topic is attracting attention, a 50bp hike was denied by Fed Governor Christopher Waller and St. Louis Fed President James Bullard in interviews. Therefore, we think such a hike is unlikely to occur.

With the FOMC minutes also touching on the possibility of five or more rate hikes, we cannot rule out this possibility. However, we must note Fed Governor Waller's comment that "If we start doing some balance sheet runoff by summer, that'll take some pressure off, you don't have to raise rates quite as much," as well as the trade-off between QT and rate hikes.

Regarding the balance sheet, Atlanta Fed President Raphael Bostic stated that at least $1.5tn was considered pure excess liquidity, and that the Fed should allow its holdings to decline by at least $100bn a month to eliminate this excess liquidity. This is just conjecture on our part, but if it is judged that the financial environment needs to be tightened through more than four rate hikes/year, we get the feeling that a decision on an earlier runoff of the portion considered 'excess liquidity' on the balance sheet will be prioritized before more rate hikes are added.

The chance of a 50bp rate hike occurring at once is small. Also, given the trade-off with QT, we now think that it is premature to fully factor in more than four rate hikes. Despite lingering risk scenarios, it is highly likely that a scenario with four 25bp hikes in 2022 will be what ends up happening (with faster QT). If so, 2-year and 5-year yields appear to have temporarily reached reasonable levels.

The pendulum swings back and forth, so overshoots in the market are inevitable. For example, during the Jan-Mar 2022 quarter, we should think carefully regarding how to act if the 10-year yield hits 2.00% with a balance achieved between the 5-year yield at 1.75% and the 5-year-forward 5-year yield at 2.25%. Other people's panic provides opportunities.

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