Daiwa Securities

Daiwa's View

US yield outlook for 2022 (revised)

➢ 10Y US yield of 2.18% under main scenario, 2.75% under upside scenario, 1.25% under downside scenario

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"Did I realize at the time how high interest rates might go before we could claim success? No. From today's vantage point, was there a better path? Not to my knowledge—not then or now." From Paul Volcker's memoir "Keeping At It: The Quest for Sound Money and Good Government."

US yield outlook for 2022 (revised)

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◆ Conclusion

We revised our US Treasury yield outlook for 2022, mainly due to our revised rate hike assumptions. As our new main scenario, we see the 5-year and 10-year US Treasury yields at 2.10% and 2.18%, respectively, at end-2022. Our upside scenario places these yields at 3.00% and 2.75%, while our downside scenario has them at 1% and 1.25%, respectively.

The current FRB may be unable to determine how far it must go with tightening in order to offset the current inflationary pressures, as was the case in the 1980s when Paul Volcker was the Fed chairman. We have meaningfully raised our upside scenario as the probability of rate hikes well above the neutral level will increase if inflation remains stuck at high levels. Meanwhile, the increasingly intense factoring in of more rapid and larger rate hikes beyond the neutral level could entail (1) precautionary rate cuts (or rate hiking pause) under a future soft-landing scenario and (2) emergency rate cuts under a hard-landing scenario (two sides of the same coin). Here, it seems as if the probability of the downside scenario increases as the factoring in of rate hikes becomes more intense.

Assumed Scnearios for End-2022 (%)

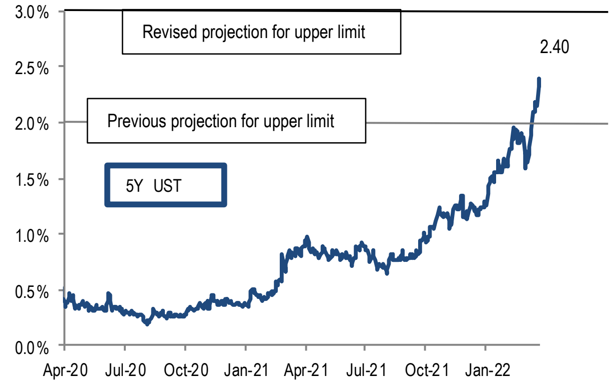
UST	5Y	5Y5Y	10Y
Current level	2.40	2.35	2.37
Main scenario for end-2022	**2.10**	2.25	**2.18**
Upside scenario	**3.00**	2.50	**2.75**
Downside scenario	**1.00**	1.50	**1.25**

Source: Bloomberg; compiled by Daiwa Securities.

◆ What are the main changes?

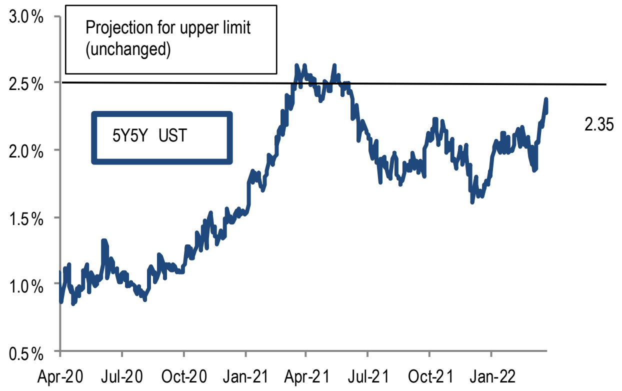
Our outlook as of December 2021 was for a 10-year US Treasury yield of 2.25% (a 5-year of 2% and a 5-year forward 5-year [5Y5Y] yield at 2.5%) under the upside scenario. However, as of 24 March, the 10-year yield stood at 2.37% (5-year at 2.4%, 5Y5Y at 2.35%), topping our upside scenario outlook. In order to examine the background for this upside breakout, we looked at the 10-year yield broken down as the 5-year yield and 5Y5Y yield. Here, we can see that while the 5-year yield rose much more than expected, the 5Y5Y yield remained within our projected range (see following charts). The upside breakout this time means that while rate hike assumptions changed rapidly, the forward rate remained stable. As such, our outlook revision this time also mainly revolves around consideration of the 5-year yield scenario.

5Y Yield, Previous and Revised Projections for Upper Limit



Source: Bloomberg; compiled by Daiwa Securities.

5Y5Y Yield, Projection for Upper Limit (unchaned)



Source: Bloomberg; compiled by Daiwa Securities.

◆Main scenario

The results of the March FOMC meeting and the content of FRB Chairman Powell's speech before the National Association for Business Economics (NABE) stressed the need to "move expeditiously" (including 50bp rate hike at next meeting) to return the stance of monetary policy to a more neutral level, and then to move to more restrictive levels (tightening) if that is what is required to restore price stability.

This means that the FOMC has suggested it is actively working to slow inflation as a "top priority," using policy to intentionally "slow demand" and even allow for a recession if necessary. Considering these recent information releases, and based on our assumption that the Fed will tighten policy aggressively for now, we revised our US monetary policy outlook on 24 March.

Specifically, consecutive rate hikes through the July meeting, including two consecutive 50bp hikes at the next FOMC meeting in May and the meeting in June, will quickly return the policy rate to its pre-coronavirus level by this summer. Then, if inflation slows as expected, we would expect the pace of rate hikes to slow down, with additional 25bp hikes in December 2022, March 2023, and June 2023, raising the policy rate to 2.25-2.50%, near the FOMC's neutral rate assumption and halting the rate hike cycle. We also assume execution of a precautionary rate cut (mid-cycle adjustment) toward the end of 2023 and two precautionary rate cuts of 25bp each.

Under our main scenario, the FF rate at the end of 2022 is assumed to be 1.875% and the 5-year yield is around 2.1%. Also, if for the 5Y5Y yield we assume 2.25%, the benchmark neutral interest rate in the Fed's dot plot, the 10-year yield would be 2.18%. Under this main scenario, the yield curve shape returns to a positive (upward slopping) yield curve, albeit at a nearly flat level.

Outlook for Monetary Policy

FOMC meeting	Policy rate (median of range)	Balance sheet reducitons (QT)
Jan-22	-	Releases " Principles for Reducing the Size of the Federal Reserve's Balance Sheet"
Mar-22	0.25% hike (0.375%)	Parameters disclosed in minutes of meeting
May-22	0.50% hike (0.875%)	Supplementary statement / QT decision
Jun-22	0.50% hike (1.375%)	Start of QT Initial roll-off cap of $25bn/m (US Treasuries: $15bn/m, MBS $10bn)
Jul-22	0.25% hike (1.625%)	
Sep-22	-	Final roll-off cap of $100bn/m (US Treasuries: $60bn/m, MBS $40bn)
Nov-22	-	
Dec-22	0.25% hike (1.875%)	
Jan-23	-	Potential start of MBS sales
Mar-23	0.25% hike (2.125%)	
May-23	-	
Jun-23	0.25% hike (2.375%) Terminal rate: 2.25%～2.50%	
Jul-23	-	
Sep-23	-	
Nov-23	-	
Dec-23	0.25% cut (2.125%) Mid-cycle adjustment	Continuation of balance sheet reducitons
Jan-24	0.25% cut (1.875%)	
	Terminal rate: 1.75%～2.00%	
Mar-24	-	

Source: Compiled by Daiwa Securities.
Note: Official schedule for FOMC meetings from 2023 onwards undisclosed.

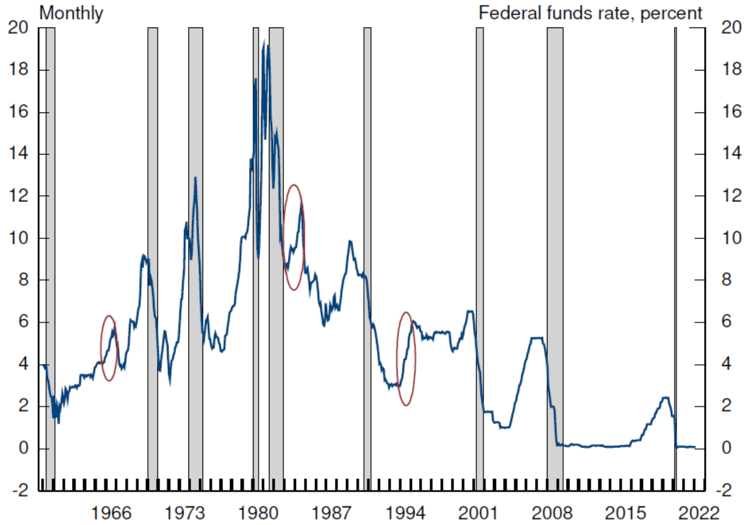
◆Upside scenario, downside scenario

However, as we have reported from time to time, the persistence of high inflation remains difficult to predict. If the PCE deflator remains above 4%, even at the start of 2023, there is a risk of "ongoing increases" in interest rates to "restrictive" levels above the neutral level. In particular, this risk will probably increase if time is needed to resolve "imbalances" in the economy and labor market and if rent and other service inflation continues to rise.

In the case of persistently high inflation, the hard part is determining to what extent should rates be raised to actually quell inflation. That is a difficult question. Paul Volcker, who was the FRB chairman from 1979 to 1987, once said, "Did I realize at the time how high interest rates might go before we could claim success? No." Likewise, it is possible that the current FRB can no longer make a clear determination of how much tightening to implement to offset current inflationary pressures. In that case, theoretically speaking, the best option is probably to take the dynamic approach of tightening beyond the neutral level with a new precautionary rate cut after inflation has actually been lowered.

The fact that Powell and James Bullard (president of Federal Reserve Bank of St. Louis) have both recently cited 1994-95 as a historical example of an economic soft landing makes us aware of their inclination toward such a process.

FF Rate and Recessions (three soft landings)



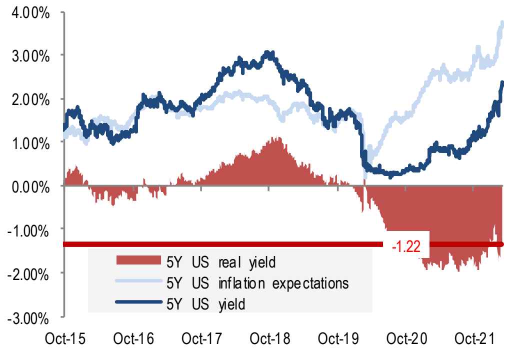
Source: Excerpted from "Restoring Price Stability" by Jerome H. Powell (21 Mar 2022).

How much would the 5-year US Treasury yield rise in the event of a return to such a dynamic approach? It is difficult to come up with a precise answer to this question assuming that the FRB itself is no longer sure how far it will go in raising interest rates to actually quell inflation. At best, the FRB will probably provide a ballpark figure based on some bold assumptions.

In order to obtain some clues to consider, we examined market levels for the 5-year US Treasury breakeven inflation rate (expected inflation rate), the 5-year yield (nominal yield), and the 5-year real yield. Currently, the expected inflation rate is 3.66%, the 5-year nominal yield is 2.4%, and the 5-year real yield is -1.22%. If we take these levels as a given and assume that the expected inflation rate remains stuck at a high level (unchanged), which is the assumption for our upward scenario, we can calculate that the 5-year yield would need to climb over 3.5% in order for the real yield to rise to 0%.

Of course, a 0% real yield is viewed as close to the neutral level and not strong enough to rein in robust inflation within our upside scenario. In the past, a sharp economic slowdown occurred in 2018 at a time when the 5-year real yield rose to around 1%. This time as well, we can calculate that a 5-year yield level of 4.5-5.0% is needed when assuming a case in which the expected inflation rate remains unchanged at 3.66%, while raising the 5-year real yield climbs over 1%. From here, we can expect inflation to subside even in our upside scenario provided the policy rate is raised to 5% and held there for the required period of time.

5Y Yield, Breakeven Inflation Rate, Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

However, if the Fed succeeds in sharply lowering inflation toward 2% after raising the policy rate to 5%, the real yield would take a sudden turn and spike to a "super" restrictive level of 3%. Therefore, once inflation shows signs of abating, a quick and substantial interest rate cut would be required to avoid a recession. In the above case, a rate cut of at least nearly 3% would be required, and in the case of a failed policy approach (= recession), a return to zero interest rates would probably result.

If we assume a return to the neutral level at end-2023/start-2024, we can envision a 5-year yield of around 3% as of end-2022. If we combine a 5Y5Y yield of 2.5% to this 5-year yield level, we obtain a 10-year yield of 2.75% under our upside scenario. Under this upside scenario, the yield curve shape is a deeply inverted yield curve that reflects the large immediate rate hikes and large future rate cuts.

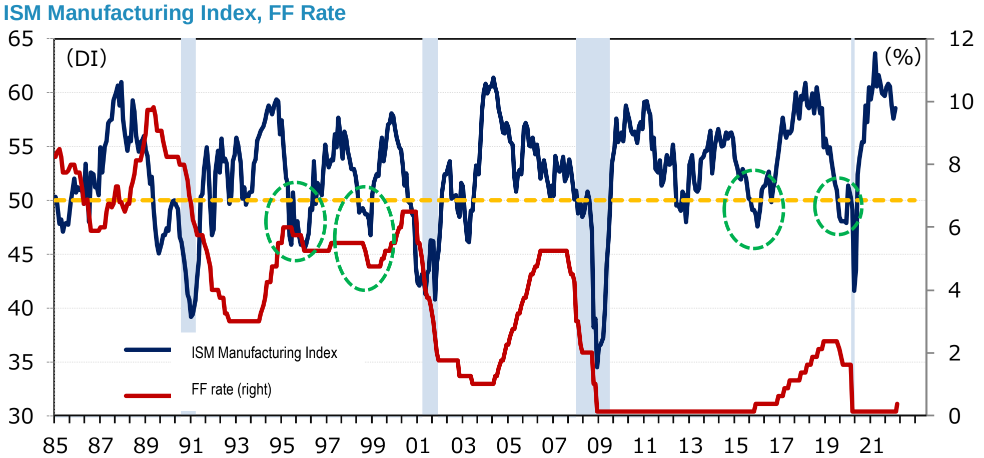
Meanwhile, under the hard-landing scenario (downside scenario) the policy rate is expected to reverse course and return to around 0%. Under this scenario, which anticipates a full-fledged recession, we envision the 5-year yield dropping to around 1%. The 5Y5Y yield is also expected to drop to the lower end of the 2019-2021 range (excluding certain periods after the pandemic) to land near 1.5%. By combining the 5-year yield of 1% with the 5Y5Y yield of 1.5%, we envision a 10-year yield of around 1.25% under this (hard-landing) scenario. Under the downside scenario, the yield curve shape is positive on the factoring in of a future return to zero interest rates.

◆ After formulating scenarios

Formulating these scenarios was the most difficult endeavor we have tried so far. The biggest reason why this task was so challenging is perhaps because the FRB itself, which sets policy rates, has lost sight of how much it needs to raise rates to quell inflation.

"Once lost, credibility is hard to restore" (from Paul Volcker's memoirs). The Fed, which understands the weight of these words, will probably now head for rapid rate hikes that will be accompanied by a stalling economy. Even in the case of the 1994-95, when precautionary interest rate cuts succeeded in extending the life of the business cycle, the ISM fell well below 50, but this time conditions are expected to be even bumpier. We should be very aware of the point that the more yields rise above the neutral levels, the more feasible the underlying recession scenario becomes.

ISM Manufacturing Index, FF Rate



Source: Fed, ISM; compiled by Daiwa Securities.

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