Daiwa Securities

Daiwa's View

10-year US yield temporarily topped 2.7%

➢ Forward yield rose to exceed longer-run rate

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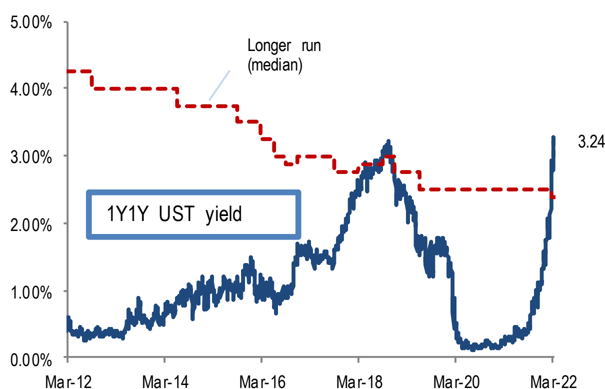
At the end of last week, the 10-year US Treasury yield temporarily topped 2.7% (the 5-year yield rose to 2.75%). Due to a further increase in expectations for rate hikes by the Fed, short-term/intermediate yields are continuing to rise, which is an important trend. However, a noteworthy point is a rise in the 5-year forward 5-year yield, which had been stable thus far, to 2.67%, far above the longer-run rate (2.375%). This implies that the US yield uptrend has entered a new phase.

What was the cause of the rise in the forward yield? A common hypothesis is that the term premium has risen due to concerns about deterioration in bond supply/demand because the outlook for balance sheet reduction by the Fed (QT: quantitative tightening) became clear following the speech by Fed Governor Lael Brainard on 5 April and the FOMC minutes released on 6 April.

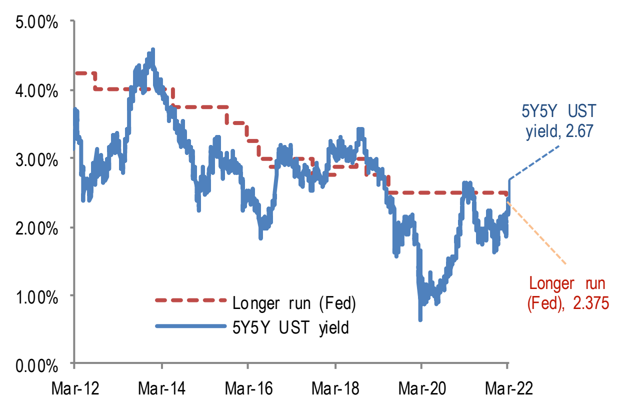
That said, the contents of the FOMC minutes were actually completely within expectations, offering no hawkish surprises. Confirming the data, we found that the term premium of the 10-year US yield was mostly in the recent range (chart on next page), and it did not substantially rise unlike the case in the Jan-Mar 2022 period and the taper tantrum triggered by former Fed Chair Ben Bernanke. Consequently, it is too much of a stretch to say that the current modulation of the forward yield is due to a rise in the term premium.

1Y1Y UST Yield, Longer-run Rate



Source: Bloomberg; compiled by Daiwa Securities.

5Y5Y UST Yield, Longer-run Rate



Source: Bloomberg; compiled by Daiwa Securities.

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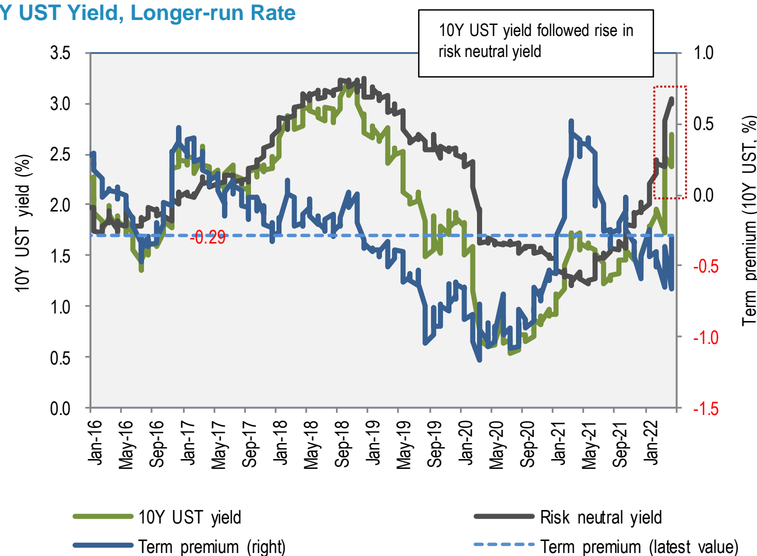

Source: Bloomberg; compiled by Daiwa Securities.

As QT-related information has just been released, people tend to think that the modulation was led by QT. In fact, however, a much more likely story is that the current movements are further reflecting the policy rate path, with QT only serving as a trigger.

The 5-year forward 5-year yield rose beyond the longer-run rate about three weeks after the 1-year forward 1-year yield similarly rose beyond the longer-run rate. Interestingly, the 'risk neutral yield' of the 10-year US yield (ACM model) also rose from 2.5% to around 3% with the same timing. Therefore, the current rise in the 10-year yield and the forward yield seems to have followed the rise in the risk neutral yield.

We note that at the time of the previous QT implementation in 2018, there were similar price movements led by the risk neutral yield. On that occasion, too, a breakdown of the upward factors showed the effect of the risk neutral yield, not the term premium (which was at 0% to negative territory).

We cannot overly trust the ACM model, from which the risk neutral yield and the term premium are derived, because it is just a model. Also in the current case, we are unable to deny the possibility that the ACM model is reflecting only the near-term rate hike outlook in the process of deriving the risk neutral yield, without factoring in future preventive rate cuts that are priced into the OIS yields.

That said, at this time, to what extent can we be strongly confident in the time frame of a story of preventive rate cuts being implemented in the future? All we can state with certainty at this moment is the outlook that the policy rate is likely to exceed the neutral rate. When we rephrase this in the context of bond investment, the probability of aggravated hedging cost for foreign bond investment (US Treasuries' negative spreads) is high, and the outlook means that it is still hard to forecast how long negative spreads will continue before preventive rate cuts are conducted.

Given such current uncertainty, it is too early to build positions in anticipation of ordinary times in the future. Therefore, it is no wonder to see that investors are temporarily building defensive positions (hedging, reduction in risk exposure). We think that QT-related news has triggered the acceleration of defensive activities like these.

In any case, it is possible that, instead of the longer-run rate (which serves as a benchmark in ordinary times), the ceiling of the current rate-hike process (terminal rate) or the highest dot plot will become a benchmark for the forward yield in the near term. Stability of the forward yield and anchoring to the longer-run rate are important preconditions for our yield outlook. If these preconditions change, we need to change our yield outlook. For example, when we temporarily change our assumption for the 5-year forward 5-year yield from 2.5% to 3% (+50bp), the 10-year yield is estimated to reach 3%. The 10-year yield of 3% can be

approximately broken down into 'a 5-year yield of slightly above 3% & a 5-year forward 5-year yield of slightly below 3%,' 'risk neutral yield of 3% & term premium of around 0%,' and 'inflation expectations of 2.9% & real yield of around 0.1%.'

If we could look at the current conditions from a vantage point in the future, we would probably think that the yield level exceeding the longer-run rate is a good buying opportunity. However, the current conditions at the Fed and escalating inflation in the US provide an excessively chaotic situation, making it difficult to build positions based on the perspectives of less fraught times. In the current phase, it would probably be wiser to try not to be wise (overly adhere to logic.)

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