Daiwa Securities

Daiwa's View

When will US yields shift towards full-scale decline?

- Under normal circumstances it would be 15-20 months from now, but it could happen as early as six months from now if the current cycle progresses twice as fast

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At the end of last week, the 10-year US yield closed at 2.83%. (The 5-year yield closed at 2.79%.) A noteworthy point is that the 5-year forward 5-year (5Y5Y) yield rose to 2.89% and exceeded the longer-run rate by around 50bp. An obvious characteristic of the recent uptrend in US yields is that it is led by forward yields.

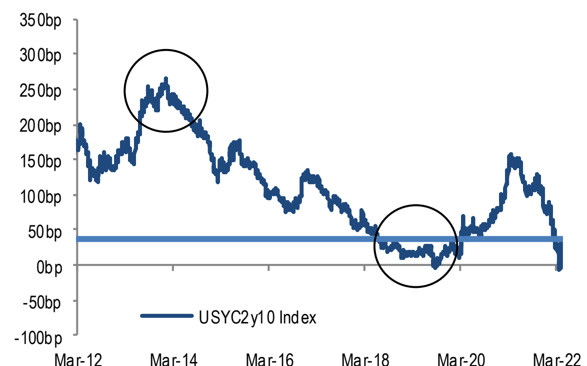
Since 2012, the 5Y5Y yield has exceeded the longer-run rate by more than 50bp twice (in late 2013 and in 2018, chart below). In the former case, the 5Y5Y yield significantly exceeded the longer-run rate for 233 days from 31 July 2013 to 21 March 2014. In the latter case, it did so for 320 days from 1 February 2018 to 18 December 2018.

That said, in the former case (2013-14), this happened during steepening of the 2-year/10-year spread. In terms of economic cycles, it can be thought of as a phenomenon occurring sometime between the beginning and the middle of the cycle. In the latter case (2018), on the other hand, it happened when the 2-year/10-year spread approached negative territory, which is a typical characteristic at the final stage of the cycle. As the current case has also happened when the 2-year/10-year spread was approaching negative territory amid expectations of an early end to the rate-hike process and balance sheet reduction, it is characteristic of the final stage of the cycle, similar to the case in 2018. Another similarity is the fact that Fed officials (incl. Governor Lael Brainard, in this case) anticipate rate hikes in excess of the neutral rate, reflecting the tailwind of demand due to fiscal stimulus. So the latter case (in 2018) more closely resembles the current situation.

5Y5Y UST Yield, Longer-run Rate

Source: Bloomberg; compiled by Daiwa Securities.

2Y/10Y UST Yield Spread



Source: Bloomberg; compiled by Daiwa Securities.

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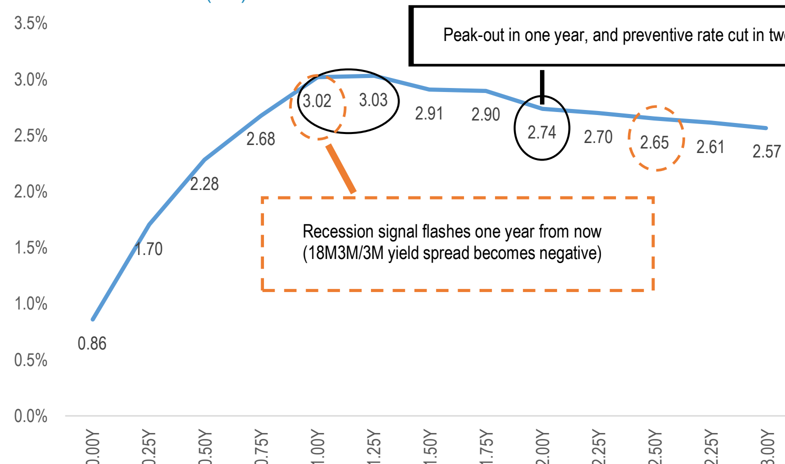
If the case in 2018 has cyclical similarities, it may also serve as a useful reference for when the forward yield will start the process of 'mean reversion' towards the longer-run rate. In 2018, the forward yield fell below the longer-run rate on the day when the FOMC decided to suspend rate hikes at the meeting in December 2018. The Fed actually implemented preventive rate cuts at the FOMC meeting in July 2019. However, it is worth noting that the day on which the forward yield recovered to the longer-run rate level was not the day when the preventive rate cut was implemented but the day when rate hikes were suspended—seven months before the preventive rate cuts.

Keeping this in mind, we confirm current pricing in the OIS forward yield market. The market is factoring in the outlook that the OIS 3-month yield will hit a peak in about one year and then decline from the peak by 25bp (i.e., 25bp rate cut) in about two years. Given that we are referring to the OIS 3-month yield, we calculate that rate hikes will be suspended 15 months from now and a preventive rate cut will be implemented 27 months from now.

The recession signal prioritized by the Fed will flash in one year, which is largely consistent with the aforementioned timing for rate hike suspension. Applying the time frame for mean reversion in the previous case based on pricing of OIS forward yields, we calculate that the 5Y5Y yield will recover to the longer-run rate level 15-20 months from now.

OIS Forward Yields (3M)



Source: Bloomberg; compiled by Daiwa Securities

Of course, there have never been any cases in the market in the past that were exactly the same as the current situation, so there will definitely be differences. For example, inflation was not overheated in 2018, but it is noticeably overheated now, and rate hikes are expected to take place more than twice as fast of before. If, like the speed of rate hikes, the cycle also progresses twice as fast, the forward yield in the current cycle could recover to the longer-run rate level in seven months.

In both of the previous two cases, the 5Y5Y yield achieved mean reversion about slightly more than one month after it peaked out. Given this point as well, we think that US yields may start to decline rapidly as early as six months from now, around the end of 1H FY22 or the beginning of 2H FY22. Based on this time schedule, we can probably observe the yield uptrend with a sense of leeway in the first half of 1H. However, in our view, in the last half of 1H, we will need to gradually build positions in preparation for mean reversion.

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