Daiwa's View

Daiwa Securities

US rates outlook for 2022 (revised)

➢ "Unconditional" is about the same as "whatever it takes," we think the rise in US rates is topping out

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Daiwa Securities Co. Ltd.

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US rates outlook for 2022 (revised)

◆ We revise our US rates outlook

We revise our US interest rate outlook, but now think the rise in US rates is topping out. The game changer in the Fed's language is the word "unconditional." The "unconditional" commitment referred to in the 17 June Fed's Monetary Policy Report and Fed chair Powell's testimony to Congress on the 23rd is reminiscent of former ECB President Mario Draghi's commitment to do "whatever it takes" to defend the euro. Just as Mr. Draghi's committed to do whatever it takes to calm the euro crisis, Mr. Powell has unconditionally committed to lowering US inflation expectations (breakeven inflation) to the lower 2% range. The Fed has made it clear that its previous sugarcoating of and tolerance for high inflation expectations is over with and that it is now committed unconditionally to beating back inflation.

This update to our outlook takes account of the large and early rate hike expectations generated by rising inflation, the decline in inflation expectations generated by the Fed's unconditional commitment (explained later), concerns that a recession will arrive around mid-2023 (see page 4), and the neutral interest rate suggested by the 20yr forward 10yr Treasury yield, which has been unusually stable during this cycle of rising rates.

Given also the possibility we see of recession concerns gaining momentum between September and end-December, if risk-off moves deepen we would expect the worst-case scenario to start looking more plausible. At any rate, this increase in our projected range is likely to be the last one and we think Jul-Sep will present a buying opportunity.

10Y US Yield Outlook

Source: Bloomberg; compiled by Daiwa Securities.

US Yield Outlook (%)

		Jul-Sep			Oct-Dec		
		Lower limit	Upper limit	Terminal	Lower limit	Upper limit	Terminal
US	FF	2.25	3.50	2.88	2.00	5.00	3.63
	2Y	2.25	4.25	3.20	1.60	5.00	3.20
	5Y5Y	2.00	3.85	2.90	1.65	4.00	2.85
	10Y	1.90	3.75	2.80	1.70	3.80	2.70
US forward implied	FF			2.85			3.40
	2Y			3.25			3.26
	5Y			3.26			3.26
	10Y			3.20			3.22

Source: Bloomberg; compiled by Daiwa Securities.

◆ <u>The Fed's "unconditional" commitment is lowering inflation expectations</u>

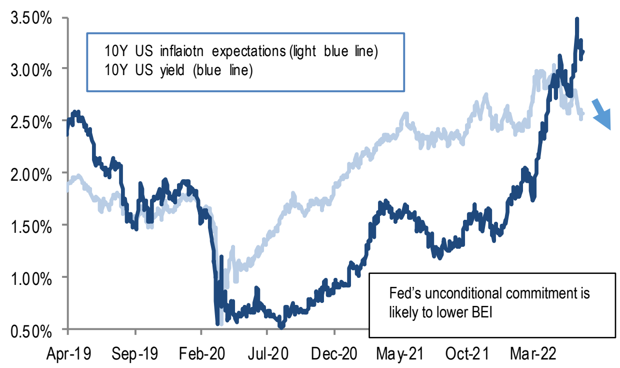
As we already reported, there are signs that the breakeven inflation rate (BEI) is in a declining trend by way of recession concerns weakening commodity prices and thereby pulling inflation expectations lower. The US 10yr BEI has already declined to 2.57%, 47bp below the 3.04% level reached on 21 April this year, and the 5yr forward 5yr BEI, the measure favored by the Fed, is down to 2.29%. This appears to be the result of the market envisioning a future in which inflation is tamed by the Fed's new unconditional commitment.

Looking back, the rise in interest rates since the pandemic was largely driven by rising inflation expectations. Certainly, US interest rates are likely to remain volatile in this illiquid environment and inflation expectations are likely to rebound to an extent during periods of improving sentiment, but the Fed's new unconditional commitment means that any rebound in inflation expectations generated by improving sentiment will by itself trigger a resurgence of recession concerns.

Up until now, the Fed's sugarcoated language had been sowing confusion among market participants, but now that the Fed has indicated a willingness to cause a recession if necessary, we think that, regardless of whether actual inflation remains high or declines on its own, a significant rise in medium- to long-term inflation expectations (BEI) has become unlikely.

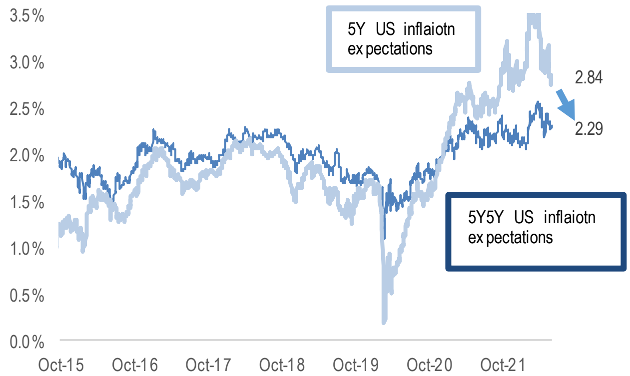
If the market believes in the Fed's new "unconditional" commitment, which is akin to Mario Draghi's commitment to do whatever it takes, the likely result is a peaking of the rising rate cycle that began early in the pandemic and has been driven by rising inflation expectations.

US Long-term Yield, Inflation Expectations (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

US Breakeven Inflation Rates (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

◆ <u>A sudden change in stance following the midterm elections is unlikely</u>

With political pressures easing after the midterm elections, some market participants expect the Fed to become more dovish, but we do not expect it to change its stance. What the sharp (farcical) change in stance that occurred during the latest blackout period has made clear is that the Fed's response function to upside inflation risks (data) is very asymmetrical.

It is significant that in April this year, the common inflation expectation (CIE) derived by Fed staff and referred to by the FOMC as an indicator of overall inflation expectations was revised to give households' inflation expectations, especially near-term ones, a higher weight. This updating of the CIE is an indication that inflation is not just problematic for the Biden administration's approval rating but has become a problem for the nation (and for the Fed's credibility). Although the midterm elections are certainly a major political event, when the elections are over there is unlikely to be a sudden change in the Fed's efforts to contain inflation, efforts based on the accumulated wisdom of its staff. This is especially true given the Fed's current need to restore its lost credibility.

◆ <u>What does the end-2025 dot chart look like?</u>

In *Daiwa's View* reports, we argue that as inflation expectations (BEI) become less likely to rise and concerns over a US (or global) recession deepen, market participants will gradually become more open to recognizing the factors with a downward impact on interest rates.

Although it may be a bit premature to talk about, it will be interesting to see, when it releases its Summary of Economic Projections (SEP) following the September FOMC meeting, what the Fed will forecast for the fed funds rate at end-2025. If the Fed is truly committed to taming inflation, it should expect actual inflation to subside prior to end-2025. This means there should be little need to leave the fed funds rate at restrictive levels until end-2025 and that the end-2025 dot chart may wind up being close to the long-run rate of 2.5%.

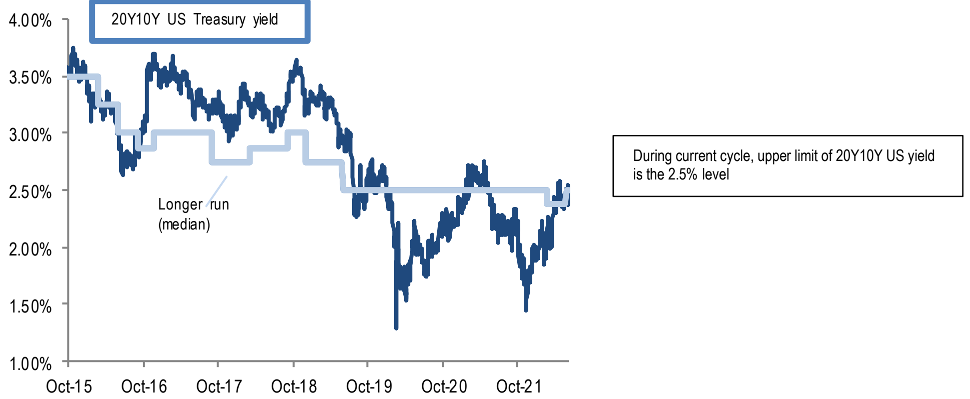
If market participants start to price in an end-2025 fed funds rate projection in the September FOMC SEP of 2.5% and a long-run rate of 2.5%, unless they assume a very high term premium, the 10yr Treasury yield would be unlikely to remain above 3% (based on the rational expectations hypothesis). In that sense, the new dot chart coming out in September is an important one to watch.

◆ <u>The implications of the 20yr forward 10yr rate being stable at 2.5%</u>

If interest rates do decline, how far down will they go? One interesting aspect of the current period of rising interest rates is how stable the 20yr forward 10yr rate has remained. Although the 10yr yield is trading around 3.1-3.2% and the 30yr yield around 3.2 to 3.3%, the 20yr forward 10yr yield is just above 2.4% and its peak during the current cycle, 2.59% on 18 May, never reached as high as 2.6%.

The 20yr forward 10yr yield shows the marginal return sought by investors when lengthening the term from 20 years to 30 years, and it is well worth noting that this has been equal to the long run rate of 2.5% during the current cycle of rising rates (this suggests the possibility that even after the pandemic, long-term investors will seek an expected return on 30yr bonds of around 2.5%). This is another indication of the likelihood that 2.5% (a 2% inflation expectation + real rate of 0.5%) is an effective level to target, and a benchmark equilibrium rate for US rates to return to after inflation is subdued.

20Y10Y US Yield, Longer-run Rate



Source: Bloomberg; compiled by Daiwa Securities.

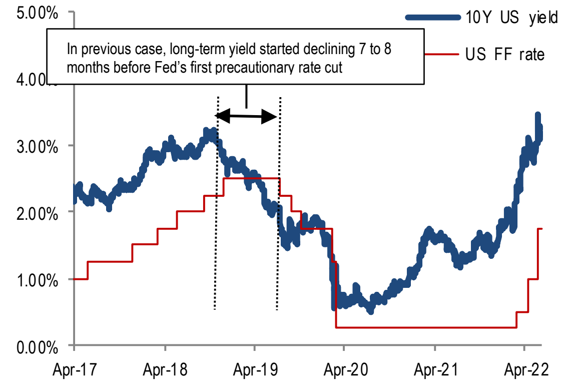
◆ Recession concerns and preventative rate cuts (an inverted OIS yield curve)

Now that the Fed has become committed unconditionally, the debate has shifted from whether inflation can be subdued to whether a hard landing can be avoided. In *Daiwa's View* reports, we argue that recession concerns are no longer a question of if but now a matter of when and that the most likely scenario is a mild recession. Based on this, we forecast the Fed will make precautionary rate cuts around the fall of 2023 (see the following page).

During the last cycle that included precautionary rate cuts by the Fed, which occurred back in 2018-2019, the 10yr yield started declining around December 2018, 7-8 months before the Fed's first precautionary rate cut in July 2019. Applying the same "7-8 months prior" pattern and assuming the Fed starts its precautionary rate cuts in the fall of 2023 in line with our base scenario, the 10yr yield would begin a significant declining trend around Jan-Feb 2023. Of course, the 10yr yield could start declining earlier if the recession and precautionary rate cuts are shifted forward in time.

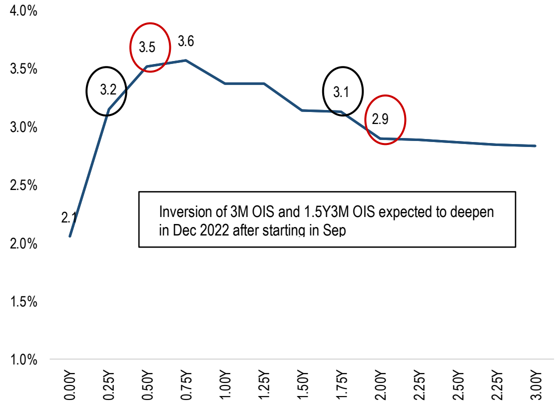
The current OIS 3-month forward rate and 1.5yr forward 3-month forward rate are pricing in a yield inversion in three months (around September 2022) and a deepening of that inversion in six months (around December). This suggests the possibility of the market sensing a strong recession signal in Sep-Dec this year.

10Y US Yield, FF Rate



Source: Bloomberg; compiled by Daiwa Securities.

US OIS 3M Forward Rate



Source: Bloomberg; compiled by Daiwa Securities.

This update to our rates outlook is based on a holistic look at the factors outlined above. The Fed's new unconditional commitment is rich in meaning, and we think this will wind up being the last upward revision to our rates outlook. Additionally, given the tendency in the current cycle for things to happen faster than anticipated, recession concerns could gain momentum even earlier than we are forecasting, and we think Jul-Sep will provide a solid buying opportunity for hedging purposes.

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