Daiwa's View

US long-term rates momentarily rose to 3.6%

➢ Real rates are now above 1% across the curve

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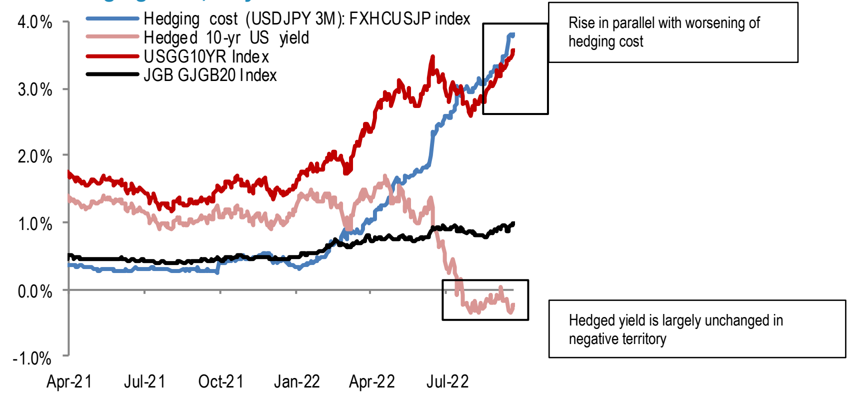
Real rates are now above 1% across the curve

US long-term rates momentarily rose to 3.6% yesterday, then closed at 3.56%. We attribute the broad-based rise in interest rates yesterday primarily to the surprise 1ppt rate hike announced by Riksbank, Sweden's central bank. Sweden is close to being a satellite member of the EU and we think yesterday's move by the Riksbank was a response to the hawkish surprise from the ECB (and is unlikely to affect the Fed's decision-making), although coming as it did prior to a nervous Fed's FOMC meeting we think it had more than enough reason to stand pat.

◆ The rise in long-term rates is connected to the worsening of basis costs

The single day move yesterday aside, over the several weeks since Jackson Hole, the rise in US long-term rates seems to be roughly in parallel with the rise in dollar basis cost, which is the same as saying that hedged 10yr US Treasury yields have been flat. This suggests the possibility that the high level expected of the Fed funds rate since Jackson Hole followed by the increase in the expected terminal rate after the CPI surprise may lengthen the period that basis costs are expected to worsen and accelerate the exit of foreign investors from the US Treasury market.

Dollar Hedging Cost, 10-year Yield



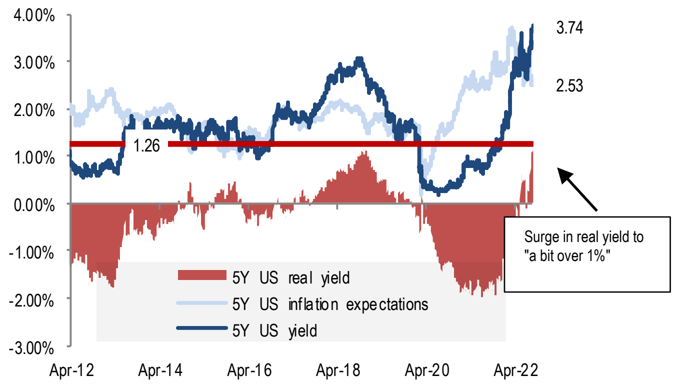
Source: Bloomberg; compiled by Daiwa Securities.

◆ Real interest rates are above 1% across the curve

Meanwhile, because inflation expectations have remained low and stable (a 10yr BEI of 2.4%), a reflection of Fed resolve, this rise in nominal rates has led directly to an increase in real rates, and the real 10yr Treasury yield rose to 1.12% yesterday. Separating the 10yr out into its components, the 5yr yield and the 5yr forward 5yr yield, the 5yr real yield is over 1.2% and the 5yr forward 5yr real yield is over 1.1%, and the entire yield curve now has real yields a bit over 1% across (see Chart below).

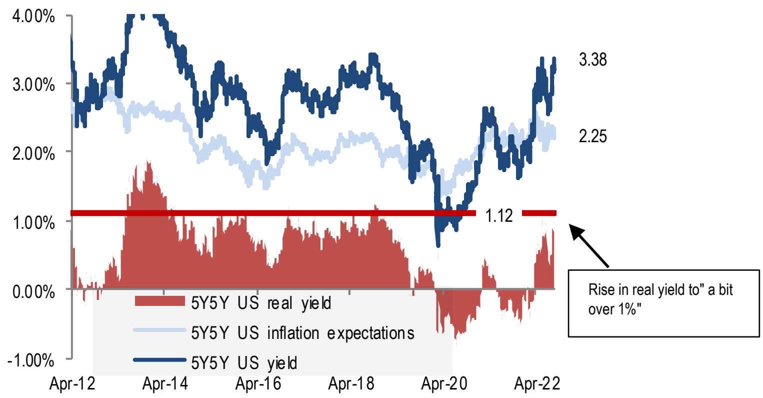
This "a bit over 1%" is the real yield that equates to the short-term neutral rate (3.1% according to San Francisco Fed President Mary Daly) when the Fed funds rate is raise to a bit over 4%, and during the current tightening process it is worth considering the level of real rates the Fed wants to maintain. Fed officials have stated in the past that they want to see positive real rates across the yield curve and we expect them to express a degree of satisfaction at the level of real rates currently forming in the market, but we will have to wait until the post-FOMC press conference to confirm whether the Fed desires even higher real rates.

5Y US Treasury Nominal Yield, BEI, Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

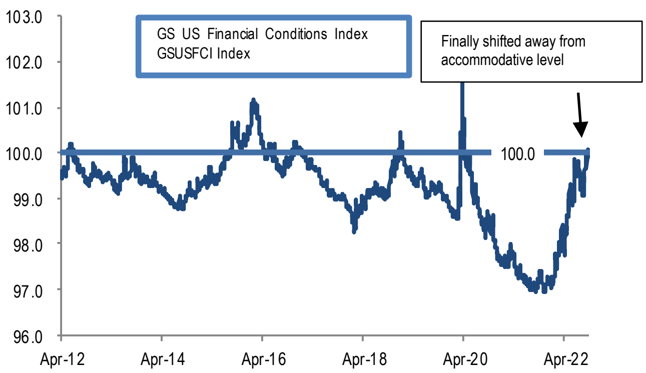
5Y5Y US Treasury Nominal Yield, BEI, Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

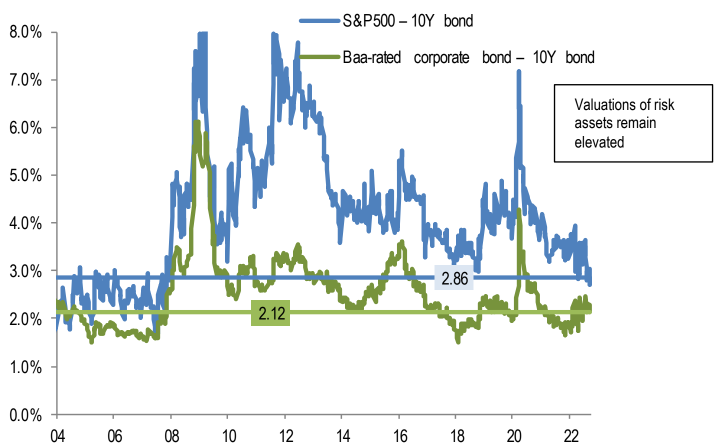
Critical to determining whether real rates are high enough will be the US economic outlook and whether it causes risk asset markets to cool. In this regard, the US financial conditions index (GSUSFCI) has just reached 100 and thus is no longer in loose territory. Another good sign is that risk assets have started correcting again, with the S&P 500 index now down to 3,855. However, although there has been a small correction, the US equity yield gap and Baa corporate bond spreads are still at their lowest since the 2008 financial prices and close to where they were during the subprime bubble. This suggests that the Fed may view a further correction in valuations as necessary.

US Financial Conditions Index



Source: Bloomberg; compiled by Daiwa Securities.

Yield Gap, Baa-rated Corporate Bond Spread



Source: Bloomberg; compiled by Daiwa Securities.

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