Daiwa Securities

Daiwa's View

Supplementary examination regarding upper-end scenario

- Scenario estimating 10-year yield of 4.6%, 5%, and 5.4%

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Yesterday, the new Chancellor of the Exchequer in the Truss administration in the UK took the decisive step of reversing almost all of the tax cut plans, which led to a sharp drop in the UK long-term yield from 4.34% to 3.98% (down 36bp). Meanwhile, the US long-term yield temporarily fell to 3.92% in line with the decline in UK yields, but it rose once again and closed at 4.01%. With the 10-year US yield closing at above 4% for two consecutive days, it appears to be becoming gradually fixed at the 4% level.

- Supplementary examination regarding upper-end scenario

In Daiwa's View dated 29 September, we set the upper-end of the 10-year US yield at 4.55%, commenting that the figure came from a breakeven inflation rate (BEI) of 2.55% plus real yield of 2%. Since then, the 10-year yield appears to have become entrenched at the 4% level due to a rise in the market's projections for the terminal rate. Under the circumstances, we judge that it is becoming increasing important to conduct an additional examination regarding the upper-end scenario. We explain this examination in the following sections.

- If projections for both BEI and real yield were to rise

In the previous report, our estimate for BEI was limited to 2.55% even under the upper-end scenario because we assumed that the Fed's unconditional commitment would be reliable. However, if the Fed's credibility on taming inflation declines due to a further uncontrollable surge in energy prices and greater pressure to avoid economic deterioration from the political side after the mid-term election, BEI may rise towards the 3% level. If so, of course, the 10-year yield, the total of BEI and the projected real yield of 2%, would be expected to rise towards 5%.

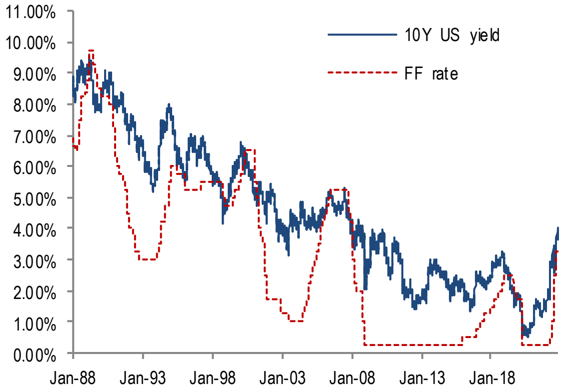
Meanwhile, if the view that an extremely high real yield of far above 2% is needed in order to calm inflation becomes widespread, the US long-term yield would be calculated at above 5% (even under the assumption of stable BEI). Based on the dot plot and the remarks by Chicago Fed President Charles Evans and Chair Jerome Powell, a real yield of higher than 2% is not what the Fed intends. The Fed's projection appears to be 1.5%. However, if a 75bp rate hike continues in December in addition to November due to realization of the view that the Fed is unlikely to stop its tightening stance, a terminal rate of 5.375% and real policy rate of 2.275% may loom into view.

Chicago Fed President Charles Evans (10 Oct 2022)
When we get to this, I would say, 4.5 to 4.75 nominal rate, I think inflation coming down will make this ultimately consistent with about a 1.5% real rate. That is historically on sort of the upper range of when the Fed has had restrictive monetary policies in order to bring in inflation.

◆ <u>The rule of thumb is for the ceiling of 10-year yield to be greater than or equal to terminal rate</u>

Since 1988, the rule of thumb is that there is a general tendency for the ceiling of the 10-year yield to be greater than or equal to the terminal rate. The terminal rate in the dot plot at the September FOMC meeting is 4.625%, in the OIS it is around 5%, and under the Fed's ongoing tightening stance it is 5.375%. If we assume that the 10-year yield exceeds these levels, we estimate a 10-year yield of at least 4.6%, 5%, and 5.4%, respectively. Calculating backwards assuming BEI at 2.5%, the real yield would be 2.1%, 2.5%, and 2.9%, respectively. These figures would not suggest an optimistic view envisioning the emergence of recession concerns.

Long-term Trends of 10Y US Yield and FF Rate



Source: Bloomberg; compiled by Daiwa Securities.

Of course, as the Fed itself has been emphasizing, future rate hikes will depend on data and economic, price, and financial conditions. As a supplementary examination regarding the upper-end scenario, this report has focused exclusively on the terminal rate moving in an upward direction. However, it is also possible that the terminal rate could shift downwards. For example, in December 2018 (when rate hikes were suspended at the terminal rate of 2.25-2.5%), the Fed was forced to suspend rate hikes (suspension → preventive rate cuts) due to the crash of asset markets. A suspension in rate hikes during 2018 had not been expected at all before this happened. In fact, the dot plot at the September 2018 FOMC meeting, immediately before the suspension, showed 3.1% at end-2019, 3.4% at end-2020, and 3.4% at end-2021. As such, it was regarded as almost certain that there would be continued rate hikes and the federal funds rate would remain high. (In Nov 2018, the 10-year yield rose to 3.24% and hit a peak, reflecting the dot plot of Sep 2018 that was not realized.)

Dot Plot at Sep 2018 FOMC Meeting (median projections)

(CY, %)	2018	2019	2020	2021	Longer-run
Sep 2018 projection	2.4	3.1	3.4	3.4	3.0
Jun 2018 projection	2.4	3.1	3.4	-	2.9

Source: Fed; compiled by Daiwa Securities.

There is increased potential for asset markets to crash at the end of the year, when US banks tend to reduce the supply of liquidity ahead of the determination of G-SIB scores. This year, liquidity and dollar funding have already become major topics in the market. Of course, with the inflation situation being very different from that in 2018, it would be hard for the Fed to suspend rate hikes even if we were to see a crash similar to that in 2018. However, such speculation could cause an even more severe crash. For example, applying the aforementioned rule of thumb in reverse, if the 10-year yield were to stay at around 4% from now on, we could interpret this as suggesting the possibility of the terminal rate stopping at 4-4.25% (suspension of rate hikes in 2022). At this point, it is hard to imagine this. However, if a hard landing or crisis scenario were to become visible, this would not be far-fetched. With the situation being highly uncertain, it is impossible to say for sure whether the upside or downside scenario is the way things will go.

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