

Daiwa's View

US yield outlook for 2023 (revised on 22 Feb)

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US yield outlook for 2023 (revised on 22 Feb)

We have revised our US yield outlook for 2023, reflecting revisions to our outlook for the Fed's monetary policy as of 20 February. Our new forecast for the US 10-year yield is 3.80% at end-March 2023 and 3.3% at end-2023. In our outlook, we focused on (1) the Fed's plans for real policy interest rate levels, (2) the timing of the Fed pivot, and (3) the limit with inverted yields.

The timing of the Fed pivot changes depending on the outlook for inflation and the economy in the US. This time around, we are assuming the Fed will stop raising rates in the Apr-Jun quarter and start cutting them in the Oct-Dec quarter. However, the term-end projection would rise slightly if the Fed were to delay suspension of rate hikes until June or delay rate cuts until the Jan-Mar 2024 quarter. At this point, the odds of the timing of the pivot being in line with our main scenario and of it being delayed are almost the same, which warrants a certain degree of attention.

Outlook for Monetary Policy and Balance Sheet Reductions (QT) as of 20 Feb 2023

FOMC meeting	Policy rate (median of range)	Balance sheet reductions (QT)
Sep-22	0.75% hike (3.125%)	Maximum roll-off cap of \$95bn/m (US Treasuries: \$60bn/m, MBS \$35bn)
Nov-22	0.75% hike (3.875%)	
Dec-22	0.50% hike (4.375%)	
Feb-23	0.25% hike (4.625%)	
Mar-23	0.25% hike (4.875%)	
May-23	0.25% hike (5.125%)	
	Terminal rate: 5.00%~5.25%	
Jun-23	-	
Jul-23	-	
Sep-23	-	
Nov-23	-	
Dec-23	0.25% cut (4.875%)	Suspension of balance sheet reductions (Continuation of MBS roll-off)
Jan-24	0.25% cut (4.625%)	
Mar-24	0.25% cut (4.375%)	
May-24	0.50% cut (3.875%)	
Jun-24	0.50% cut (3.375%)	
Jul-24	0.50% cut (2.875%)	
Sep-24	0.25% cut (2.625%)	
Nov-24	0.25% cut (2.375%)	
Dec-24	0.25% cut (2.125%)	
	Terminal rate: 2.00%~2.25%	

Source: Compiled by Daiwa Securities.

Note: Official schedule for FOMC meetings from Mar 2024 onwards undisclosed.

US Yield Outlook for 2023 as of 22 Feb 2023 (%)

	2023											
	Jan-Mar			Apr-Jun			Jul-Sep			Oct-Dec		
	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
FF	4.50	5.50	4.88	4.75	5.75	5.13	5.00	5.75	5.13	3.50	5.75	4.88
2y	4.00	5.00	4.75	4.00	5.00	4.75	4.00	5.00	4.70	2.50	5.00	4.25
5y	3.50	4.50	4.10	3.50	4.50	4.05	3.40	4.50	4.00	2.40	4.50	3.70
10y	3.10	4.35	3.80	3.10	4.35	3.75	2.85	4.35	3.70	2.30	4.35	3.30
10y BEI	2.10	2.50	2.30	2.10	2.50	2.30	2.10	2.50	2.30	2.00	2.50	2.30
10y TIPS	1.00	1.85	1.50	1.00	1.85	1.45	0.75	1.85	1.40	0.30	1.85	1.00

Source: Compiled by Daiwa Securities.

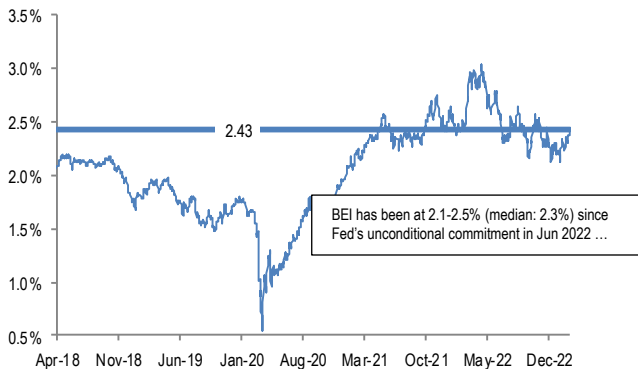
◆ **BEI and real interest rates**

In the previous forecast, our projections had at their core (1) stabilization of inflation expectations (BEI) brought about by the “unconditional” commitment and (2) the Fed’s plans for “sufficiently restrictive” real interest rates. The Fed showed its intention to (1) decide the levels of “sufficiently restrictive” real interest rates in order to contain inflation and (2) guide the entire yield curve to significant positive real interest rates (in the words of Fed Chair Jerome Powell). With the Fed’s monetary tightening (real interest rates) remaining a major theme in 2023, the effectiveness of this methodology, which places BEI and real interest rates at its core, is likely to be maintained.

We now confirm [previous forecasts](#). The real policy rate (short-term) indicated by the Summary of Economic Projections (SEP) disclosed at the December 2022 FOMC meeting was about 1.6% for 2023-2024, 1% for 2025, and 0.5% for the longer run. Since the real policy rate level of 1.6%, the peak during the tightening phase, was not expected to continue over the next ten years, the upper limit of the US 10-year real interest rate was something greater than 1.6% (1.8%?). The upper bound for the US 10-year yield appeared likely to be 3.9-4.3%, taking into account a 10-year BEI of 2.1-2.5%.

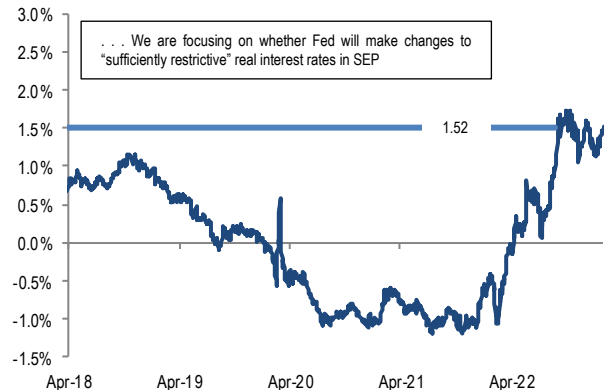
Meanwhile, the terminal rate that is priced in the current OIS market has risen to 5.36%, factoring in one additional rate hike compared to the figure in the SEP as of December 2022. If the real policy interest rate in the SEP at the March 2023 FOMC meeting rises to 1.85% (1.6% [previous figure] + 0.25%), in line with market pricing, the US long-term yield projection is also likely to rise. As the median of the real rate of 1-1.85% is something greater than 1.4%, the yield at end-March is estimated at something greater than 3.7% by applying a BEI of 2.3%. In addition, if we were to add 1.85% to the BEI of 2.3%, the point of reference for the upper limit of the range would be 4.15%. If we were to apply 1.85% to the upper limit (2.5%) of our assumption for the BEI range (2.1%~2.5%), the upper limit would be 4.35%.

10Y US Breakeven Inflation Rate (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Real Yield



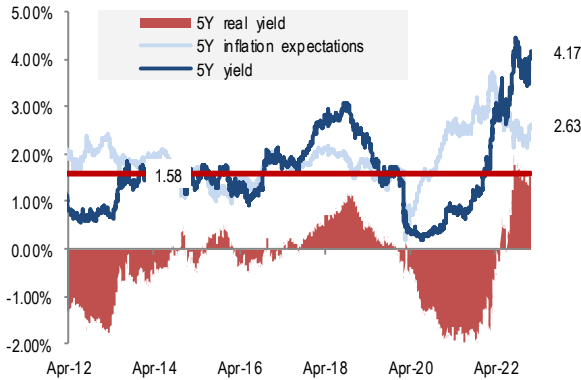
Source: Bloomberg; compiled by Daiwa Securities.

◆ **5-year yield and 5-year forward 5-year yield**

We now break down the 10-year yield into the 5-year yield (5Y yield), the first half, and the 5-year forward 5-year yield (5Y5Y yield), the latter half. While the 5-year BEI has risen substantially from 2.33% to 2.63% (up 30bp), the 5Y5Y BEI has been stable (from 2.20% to 2.24%). Since the release of the jobs report, the 10-year BEI has posted a somewhat large increase (from 2.25% to 2.43%, up 18bp). However, as 90% of this derived from the

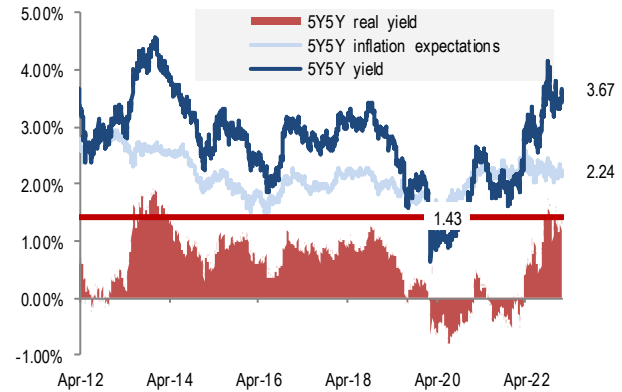
5-year yield, this appears to be relatively short-term price movements caused by revisions to thinking regarding the pace of the slowdown in US inflation since the release of the jobs report. When we consider the sustainability of the yield uptrend and the yield levels after inflation winds down, the fact that the 5Y5Y yield, which reflects the long-term outlook, stays at 3.67% and the 5Y5Y BEI remains stable is highly suggestive.

5Y US Yields (nominal, real, BEI)



Source: Bloomberg; compiled by Daiwa Securities.

5Y5Y US Yields (nominal, real, BEI)

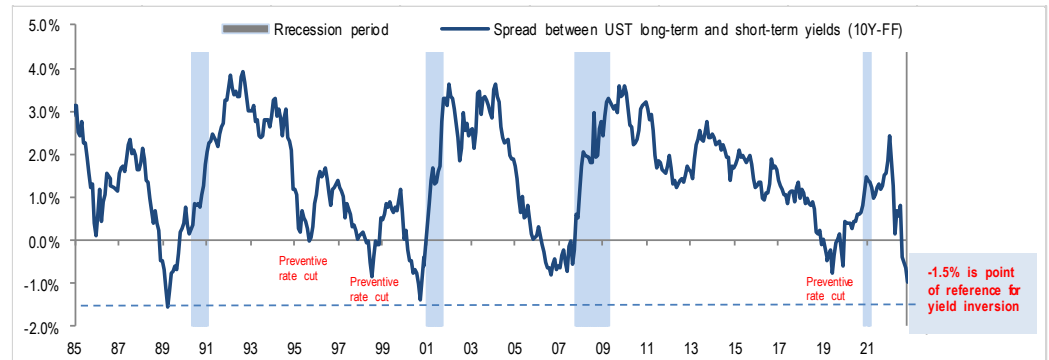


Source: Bloomberg; compiled by Daiwa Securities.

- ◆ The limit with inverted yields: 10-year yield is expected to be 3.3%, even assuming rate cuts

That said, there is a limit of about -150bp between the 10-year yield and the federal funds rate. With inverted yields having deepened to a historical level, a certain degree of upward pressure will very likely be put on the 10-year yield as well if the terminal rate projection rises further. If the effective federal funds rate were raised to around 5.5%, the 10-year yield would turn into a tug-of-war around 4%. Even if rate cuts start at end-December 2023, the 10-year yield at end-2023 is estimated to be around 3.3% (BEI of 2.3% and TIPS of 1%) if the effective federal funds rate at end-2023 is around 4.875%.

Spread Between UST Long-term and Short-term Yields (10Y-FF)



Source: Bloomberg; compiled by Daiwa Securities.

We also need to keep recession in mind, although that is more of a topic for 2024 than for 2023. Deeply inverted yields for a prolonged time are a reliable signal of an approaching recession. If an additional rate hike were decided on at the June FOMC meeting in light of current favorable economic indicators, it would deepen yield inversions further. This would also result in tightening effects around June 2024, after a time lag of around a year. At around the end of 2023, excess savings, which have accumulated since the initial stage of the pandemic, are likely to become scarce, and the short-term equilibrium interest rate, which is now high for the moment, is expected to decline. The tightening effects are likely to reach a peak right at this time. Strong current indicators and additional rate hikes by the Fed in response to those indicators would reinforce the impression of there being a “cliff” from end-2023 onwards.

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