Daiwa Securities

Daiwa's View

Fed is behind the curve in more ways than one

➢ It's already in checkmate

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Yesterday, US bank shares temporarily rebounded, with the 2-year US yield rising from 3.98% to 4.24%. Of the SVB shock that occurred last week, the 'acute shock' (systemic concerns) appears to have calmed. If the US authorities had not taken prompt action, we would have seen a broad-ranging chain reaction of bankruptcies. However, it goes without saying that the authorities would deal with this situation. And, from the standpoint of the time lag between inverted yields (which occurred in Nov 2022) and recession, it is too early to forecast the economy falling into a recession at the current time. (There is no precedent for a recession occurring within four months of a yield inversion.)

However, that doesn't mean that the impact of the SVB shock has disappeared from the market. In the current OIS market, projections for a 50bp rate hike at the March FOMC meeting have disappeared, with the market factoring in a 30% probability of rate hikes being suspended and a 70% probability of a 25bp rate hike. Market projections have changed, and now anticipate the start of rate cuts in July, with a peak rate (in May) of below 5%. The difference between the 3-month US yield and 18-month forward 3-month yield, which is a recession signal seen as important by the Fed, is at -0.79%, and implies that preventive rate cuts of 75bp will be required in order to prevent a recession.

In part, risk assets are currently recovering on the assumption that such early rate cuts (a pivot) will be made. If the Fed were to shift to rate cuts in July, the probability of avoiding a recession would definitely increase. However, uncomfortably high February CPI (released last night) is forcing the Fed to keep interest rates "higher for longer" from the standpoint of preventing inflation.

While the Fed eventually needs to deny "higher for longer" interest rates in order to avoid a recession, this is difficult for it to do now, as it is falling behind the curve. However, the situation mentioned above regarding inverted yields suggests that the Fed would be falling behind the curve even if it implemented 'rate cuts.' It appears that the Fed, which is falling behind the curve both in terms of rate hikes and rate cuts, is about to be forced to choose either inflation prevention or a hard landing. As such, the Fed is already in checkmate.

UST Yields (3M, %)

UST yields (3M)	Spot	18M forward	Near-term spread
Current	4.76	3.97	-0.79
In 6 months	4.00	3.73	-0.26

Source: Bloomberg; compiled by Daiwa Securities.

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