

Daiwa's View

10-year yield may become less sensitive to core inflation

- Sensitivity to headline inflation is likely to increase

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Daiwa Securities Co. Ltd.

Sensitivity to headline inflation is likely to increase

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In yesterday's report, we pointed out that the Fed's policy may shift to more-balanced stance because of an increase in the number of Fed officials' remarks on headline inflation. This change has implications when we examine the US long-term yield, especially the 10-year real yield.

- ◆ Real yield outlook is becoming more important
When observing the 10-year US yield from the viewpoint of "BEI" + "real yield," the focus of attention is currently shifting to the "real yield." This is because the 10-year US breakeven inflation rate (BEI) has been stable at around 2.3%, consistent with the Fed's policy target, since June 2022 when Fed Chair Jerome Powell announced an "unconditional commitment."
- ◆ Real policy rate indicated by SEP
When forecasting the 10-year real yield, what is helpful to some extent is real policy rates indicated by the Summary of Economic Projections (SEP) that is presented by FOMC members. Of course, the real policy rate does not completely match with the 10-year real yield (it includes term premium etc.). However, the SEP shows FOMC members' projections for the federal funds rate and inflation. Through back calculation, we can learn the real policy rate outlook that the Fed is aiming for.

Confirming the actual levels of real policy rates by using the SEP at the March FOMC meeting, the real policy rate in 2023 based on headline inflation is 1.8% and that based on core inflation is 1.5%. The real policy rate in 2024 based on headline inflation is 1.8% and that based on core inflation is 1.7%. The real policy rate in 2025 is 1.0% for both cases. The longer-run real policy rate is 0.5% (highlighted figures in chart below). One characteristic is that the real policy rate in 2024 is largely maintained, despite the federal funds rate sliding by as much as the drop in inflation, while the real policy rate in 2025 is lowered to reflect a slowdown in inflation.

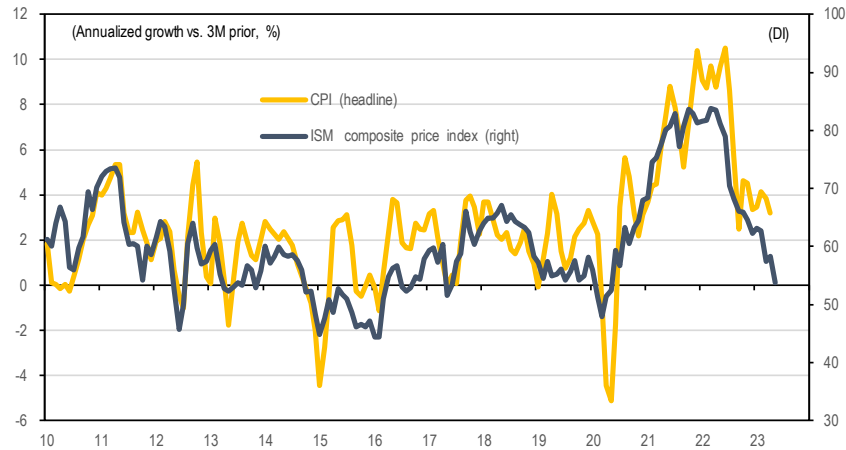
Summary of Economic Projections at Mar FOMC Meeting, Real Policy Rates (based on PCE, %)

	2023	2024	2025	Longer run
PCE inflation (headline)	3.3	2.5	2.1	2
Core PCE inflation	3.6	2.6	2.1	-
Federal funds rate	5.1	4.3	3.1	2.5
Real Policy Rate (Headline)	1.8	1.8	1.0	0.5
Real Policy Rate (Core)	1.5	1.7	1.0	-

Source: Fed; compiled by Daiwa Securities.

In the case of deterioration of the outlook for core inflation, the Fed previously had a strong tendency of trying to maintain the real policy rate level by sliding the federal funds rate by as much as a change in inflation. Going forward, however, if headline inflation shows a favorable path compared to core inflation, the Fed may weaken its existing tendency of adjusting the federal funds rate digitally in response to core inflation. As a result, the tendency for the 10-year yield to be influenced by favorable headline inflation may grow.

US CPI (headline), ISM Composite Price Index

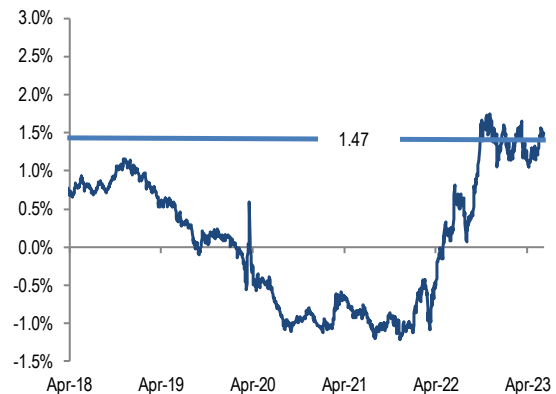


Source: US Department of Labor, ISM; compiled by Daiwa Securities.
Note: ISM data shows weighted average based on industry weighting

[Supplementary information]

Real policy rates, which were directly calculated by figures in SEP on the previous page, are based on PCE inflation. Thus, in order to match the criterion of TIPS yields (based on CPI), we deduct the long-term average for the divergence between PCE and CPI (0.3%). As a result, the real policy rate in 2023 based on headline inflation is 1.5% and that based on core inflation is 1.2%. The real policy rate in 2024 based on headline inflation is 1.5% and that based on core inflation is 1.4%. The real policy rate in 2025 is 0.7% for both cases. The longer-run real policy rate is 0.2%. Since the latter half of 2022, the core range of the real yield has been mostly 1.2-1.5%. This may be partly attributed to this real policy rate level indicated by the SEP.

10Y US Real Yield (TIPS yield)



Source: Bloomberg; compiled by Daiwa Securities.

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