Daiwa's View

US yield outlook (revised on 22 Sep 2023)

- Assume US 10-year yield range centering on 3~5% (need to look at wider than usual range)
- Gradually approaching point where balancing "near-term upward yield bias" and "subsequent yield declining bias (fat downward shift)" necessary

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"The problem is that extraordinary performance comes only from correct non-consensus forecasts, but non-consensus forecasts are hard to make, hard to make correctly and hard to act on." (Howard Marks)

US yield outlook (revised on 22 Sep 2023)

Assume US 10-year yield range centering on 3~5% (need to look at wider than usual range)

We revised our US yield outlook. The FOMC's September Summary of Economic Projections (SEP) provided a figure of about 2.5% as the real policy rate for 2024. If the soft landing (1.5% GDP growth rate for 2024) and FF rate (5.125% at end-2024) projections presented in the September SEP are realized, **"**high-for-long**"** would cause the influence of the 2.5% real policy rate to spread across the entire yield curve, providing the driving force to push the US 10-year yield toward the key 5% level (10-year BEI of 2.2-2.5% + 10-year real yield of 2.5% = 4.7-5.0%). That said, this 2.5% real policy rate corresponds to a significantly upwardly revised GDP growth rate of 1.5% for 2024 and a dot plot forecast of 5.125% at end-2024. Still, at this point, these are optimistic assumptions and we expect that the accumulation of more data is needed before the market can factor in such developments.

Also, current US yields are likely being pushed higher by three factors, which are discussed on the following pages. These factors will continue to smolder as yield-rising factors for the foreseeable future, but if one or more of these factors reverse, the soft-landing outlook would change and the assumed US 10-year yield level would also decline. The combination of a significantly higher base rate and wider credit spreads could create overkill and a **"**cliff,**"** especially if credit spreads reverse in a manner that lags behind the Fed's Senior Loan Officer Opinion Survey (SLOOS). In the latter case, we would expect the US 10-year yield to temporarily fall below 3%.

Upward bias for short span, downward bias for slightly longer span; fat-tailed distribution to downside

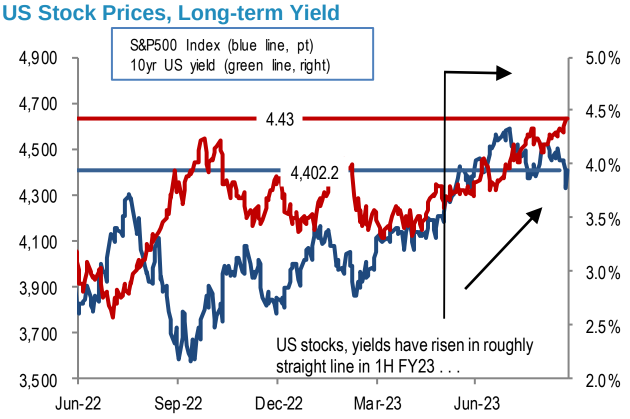
As shown in the Fed's dot plot chart on page 5, the US federal funds rate has a strong upward bias over a short span of time, but a strong downward bias over a slightly longer span, and the tail is fatter to the downside. Taking all of these factors into consideration, we need to look at a wider than usual assumed US 10-year yield range during the current fiscal year, mainly centered on a 3-5% range (can fully expect sudden exit from central range).

◆ <u>Three yield boosting factors</u>

1. (significant) Upward revision of GDP growth rate

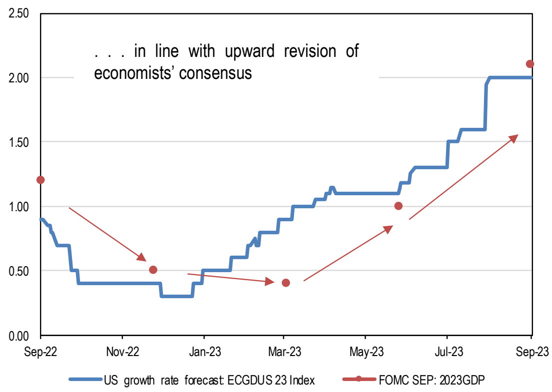
The most unexpected development this year was the significant upward revision of the Fed/private economists' forecast (consensus forecast) for the 2023 US GDP growth rate from 0.3-0.4% at the beginning of the year to 2.0-2.1% as of September (see chart). The estimated US potential growth rate is 1.8% and the impact of the upward growth rate revision from just treading water to such an overheated level is a significant development. Perhaps the biggest factor contributing to the US equities rebound, the narrowing corporate bond spreads, and rising US yields since the beginning of FY23 has been this substantial upward revision of growth rate forecasts.

US Stock Prices, Long-term Yield



Source: Bloomberg; compiled by Daiwa Securities.

Forecasts for 2023 US GDP Growth Rate (%)

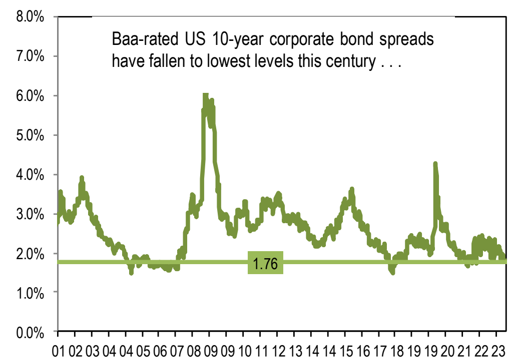


Source: Bloomberg; compiled by Daiwa Securities.

2. Credit spreads

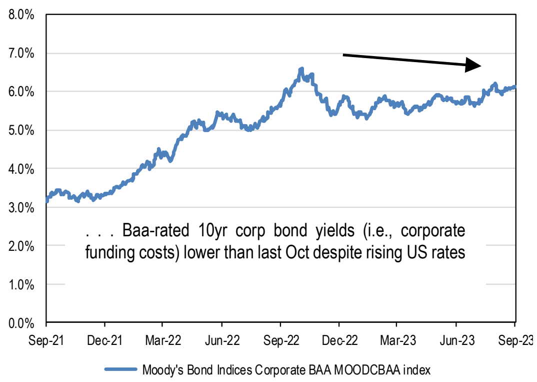
An unexpected narrowing of credit spreads may also have contributed to the higher yields. On 22 March 2023, just after the collapse of Silicon Valley Bank, Fed Chairman Jerome Powell said, **"**Tighter credit conditions could ease rate hike pressure." Meanwhile, looking at the US 10-year Baa-rated corporate bond spread (common benchmark used in FRB/US models) since the collapse of Silicon Valley Bank, the spread has narrowed from around 200-220bp for the September 2022 ~ March 2023 period to the present level of a 170-180bp range. Somewhat similar to Powell's above remark, we think **"**looser credit conditions could ease rate cut pressure.**"** Of course, the easing effects of the Bank Term Funding Program *(*BTFP*)* introduced by the Fed after the Silicon Valley Bank collapse is assumed to have played a reasonable role here. Anyway, current yields on Baa-rated US 10-year corporate bonds are lower compared to last October, despite the significant rise in US yields. It appears that additional increases in government bond yields were necessary to cover the interest rate reduction effect brought about by this narrowing of credit spreads.

10yr Baa-rated US Corporate Bond Spread



Source: Bloomberg; compiled by Daiwa Securities.

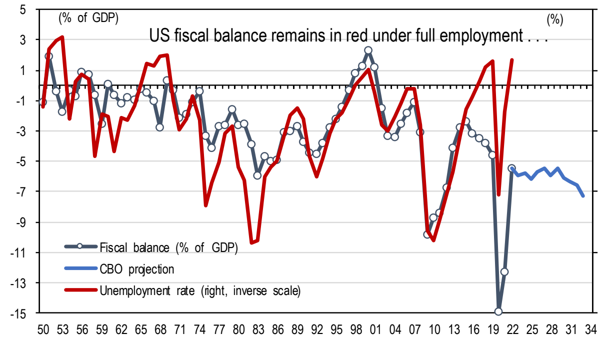
10yr Baa-rated US Corporate Bond Yield



Source: Bloomberg; compiled by Daiwa Securities.

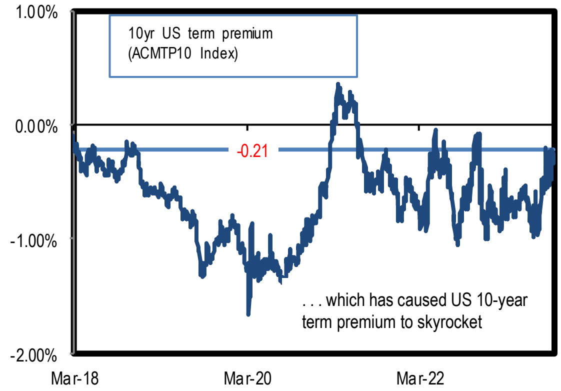
3. Expansionary fiscal policies
The unprecedented budget deficit, which is growing amid full employment and during a period of restrained inflation, is the driver of the unexpected upward swing in the US growth rate this year. This is believed to have contributed to bloating the range of interest rate hikes required in the process this time. The significant deterioration in the fiscal outlook indicated by the August CBO (chart below) will result in an increase in the issuance amount in the regular quarterly auctions. The market is most likely aware of the deteriorating supply/demand conditions for US Treasuries, which could spur on term premium expansion[1].

US Fiscal Balance



Source: CBO, Bloomberg; compiled by Daiwa Securities.

10yr US Term Premium



Source: Bloomberg; compiled by Daiwa Securities.

These three factors will continue to smolder for the foreseeable future and may contribute to further yield upside. On the other hand, once reversed, they will act as factors exerting downward pressure on yields.

As mentioned earlier, the US equities rebound seen in the first half of this year foreshadowed the actual 2023 growth rate ahead of forecasts from economists. Going forward, US equities trends could serve as a good guide for future growth rate prospects. For example, if US equities are unable to withstand the rise in US yields, which reflect a world of 2.5% real yields, and make a significant downturn, we think that the Fed's optimistic GDP growth rate forecast for 2024 could be revised lower. In that case, we should be aware of the possibility of a change in the Fed's 2024 dot plot chart median of 5.125%.

Changes in credit spreads should be noted whenever there is a significant decline for equities. This is because share prices and corporate bond spreads tend to move roughly in line with growth. The current FF rate is premised on a low credit spread. In other words, if the situation defined as **"**tighter credit conditions could ease rate hike pressure**"** is slightly delayed, the cost of private financing, determined by the sum of the base rate and the spread, may increase, creating overkill conditions (which was the trend for US yields and credit spreads before and after the global financial crisis sparked by the collapse of Lehman Brothers).

Finances are a wild card. Ahead of the 2024 US presidential election, it is likely that the baseline will continue to be fiscal profligacy. Meanwhile, some rating agencies downgraded US debt ratings in August to better reflect this deteriorating fiscal trajectory. Also, since the beginning of September, Fed member Chris Waller and former Fed Vice Chairman Richard Clarida also made comments bordering on bitterness about fiscal health and dysfunction. Expectations are not very high at this point, but there is a possibility that some progress restoring finances could be made before or after a potential government shutdown as tensions rise in the months ahead (the smaller the expectation, the greater the impact on the assumed scenario if a change occurs).

[1] When asked about the factors behind the rise in long-term yields at his press conference following the September FOMC meeting, Powell responded, "Either term premium or real yields." This suggests that the recent rise in the term premium is being driven by the real yield term premium rather than the inflation risk premium.

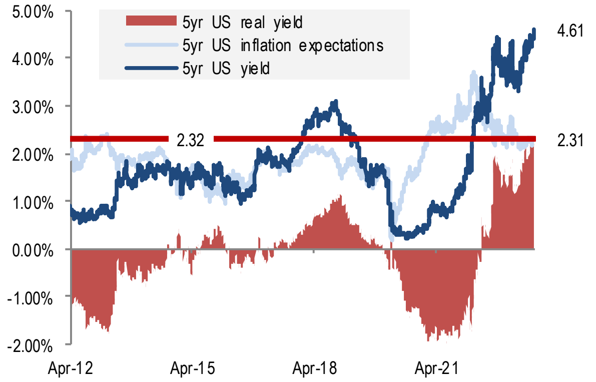
◆ **Comments from Former Fed Vice Chair Richard Clarida** (14 Sep 2023)

If US bond yields rise, I do not think it will be the fault of US monetary authorities. Washington's fiscal dysfunction will be the cause. US monetary authorities are very powerful, but they are not the only factor moving bond yields. Fiscal policy is another factor.

◆ Review of current conditions

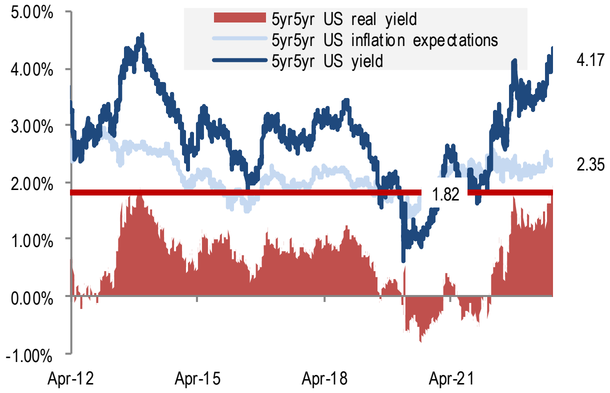
Currently the US 10-year yield is at 4.43%, which breaks down as break-even inflation (BEI) of 2.35% and a real yield of 2.08%. Breakeven inflation is generally stable across the entire yield curve. As such, if we look at the remaining "real yield" factor broken down as the 5-year yield and 5-year–5-year forward yield, the 5-year yield is 2.32% and the 5-year–5-year forward yield is 1.82%, which is roughly in line with the potential growth rate. This is a level that is seen as having some validity as fair value at this time when the Fed has clearly expressed its intention to guide real yields to a restrictive level.

5yr US Yields



Source: Bloomberg; compiled by Daiwa Securities.

5yr-forward 5yr US Yields

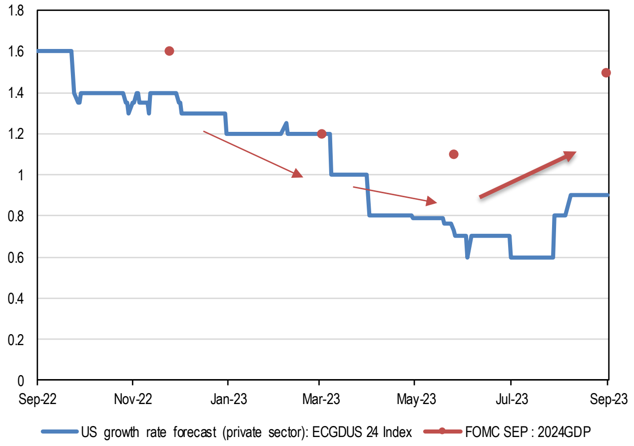


Source: Bloomberg; compiled by Daiwa Securities.

However, if the yield curve becomes inverted, building up short positions in a deeply inverted sector (maturity) could provide positive carry and roll-down returns (exact opposite for JGBs). For that reason, provided that "high-for-long" Fed rates are assured for the time being, short positions can easily become a source of excess returns with good risk reward and supply/demand conditions could easily deteriorate due to short selling. Accordingly, unless the "high-for-long" Fed rates are shaken, the real yields in the short- to medium-term zone targeted by the Fed are likely to spill over into the long and super-long zones. Assuming that the 10-year real yield will eventually rise through this process to 2.5%, the same as the real policy rate, and that the 10-year breakeven inflation rate range is 2.2% to 2.5%, the target range for the 10-year yield would be 4.7% to 5.0%. It is important to recognize that a 5% US long-term yield is now within a realistic range for this calculation.

That said, the 2024 growth rate forecast, dot plot chart, and real policy rate presented in the SEP still leave the impression that there are too many confirmations to make before concluding a high probability for such outcomes at this juncture. In particular, realization of the 2024 GDP growth rate forecast, which was set much higher than the expectations among private-sector economists, must be confirmed going forward. Whether credit spreads will continue to remain at their pre-global financial crisis lows over the next year is also inconclusive at this juncture.

Forecasts for 2024 US GDP Growth Rate (%, Economist consensus, FOMC SEP)



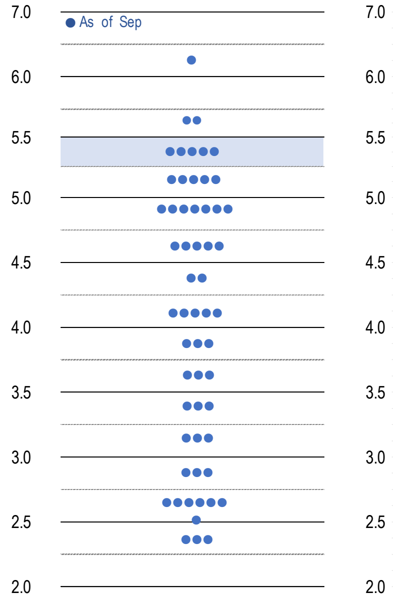
Source: Fed, Bloomberg; compiled by Daiwa Securities.

◆ Upward bias over near term, but fat-tailed downward shift over slightly longer span

The future is uncertain. Did the Fed's interest rate hikes actually end in July of this year? Or, is an additional rate hike toward 5.625% possible by the end of the year? Or will there be additional rate hikes to 6% or even higher next year? Future data will determine the answers to these questions. It is premature to draw any conclusions at this juncture.

If we humbly recognize the fact that neither a rate hike nor a rate cut can be reliably timed, and if we consider a slightly longer view, the time when we should be on the lookout for an "early rate cut" may be approaching. While just a thought-experiment, the following distribution is obtained when discarding the "point in time" for the September FOMC's three-year (2024~2026) dot plot chart. As is clear from a glance, the expected policy rate distribution has a fat shape to the downside when viewed over the next three years (of course, we all know that there is a strong upward bias over the very short term).

Dot Plot (%, simple sum in 2024-2026)



Source: Fed; compiled by Daiwa Securities.

As we reported previously, the Beveridge curve has declined vertically due to a decrease in the job offer rate, suggesting that the US labor market may have returned to a state of equilibrium. Excess savings accumulated through the government's past pork-barrel spending are expected to be used up by the end of this year to the first half of next year. The Fed's QT, which continues to develop in the background even after the suspension of rate hikes, is expected to result in a decrease in US bank reserve deposits at some point, putting additional pressure on banks. At this point, about ten months have passed since inverted yields occurred last November. Looking at past patterns, recessions have almost always come within 18 months of such occurrences.

During his press conference after the September FOMC meeting, Powell seemed surprisingly unsure when asked whether a "soft landing" has become the baseline outlook and he appeared reluctant to answer that question. This is in stark contrast to the further pricing in by the market under the assumption of "not this time." Perhaps the rate hike process is coming to an end and the probability of a soft-landing scenario is not as high as the September SEP suggests.

The point at which we need to balance the "near-term upward bias for yields" with a subsequent "fat downward yield bias" going forward is approaching. We probably need to keep in mind the words of Howard Marks, who said, "Refuse to fall into line with the herd behavior that renders so many investors dead wrong at tops and bottoms."

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