Daiwa's View

90% milestone

- Current position in this 10yr UST yield cycle largely coming into view

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"What is wrong is obvious. The masses are optimistic at the peaks and pessimistic at the valleys. As such, in order to be profitable, one must be suspicious of the optimism that prevails at the peaks and the pessimism that prevails at the valleys." (Howard Marks)

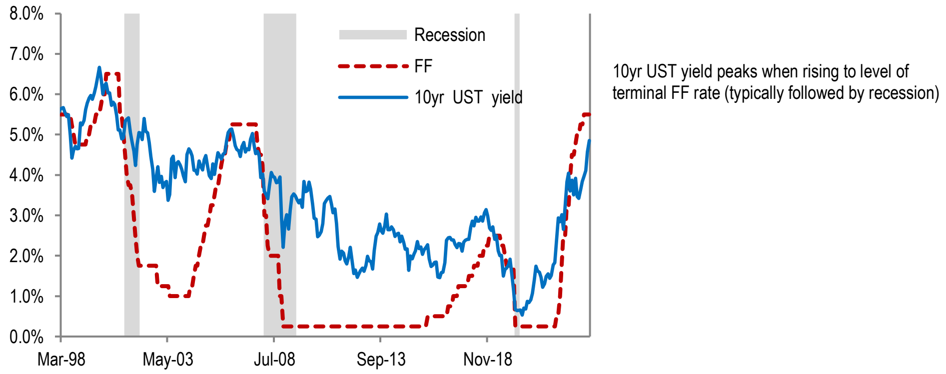
Current position in this 10yr UST yield cycle largely coming into view

90% milestone

On 4 October, the 10-year UST yield briefly rose to 4.88%. We believe that the current near-term fair value indicating the Fed's "high for long" de facto forward guidance and the 2.5% real interest rate "world" is around 2.3% BEI + 2.5% real interest rate, or roughly 4.8%. We also think that a rise to 5% or higher could be regarded as entering overshoot territory at this point. However, the 10-year UST yield has risen at an accelerated pace since the September FOMC meeting. If this pace is maintained, the yield is on track to surpass 5% this week and 5.5% this month. That said, several criteria that we focus on signal the possibility that this cycle has already passed the 80% milestone toward its peak and is nearing the 90% level. In this report, we will elaborate on that point.

1. FF rate and 10-year UST yield: One rule of thumb in the past has been that the 10-year UST yield peaks (and a recession ensues) at the same time that it reaches the level of the (high) terminal rate set by the Fed. Based on this rule of thumb and assuming a given terminal rate of 5.4%, which is the current OIS market assumption, the 10-year UST yield will peak at around 5.4% and the current remaining upside will come to around 50bp. We could even argue that there is still plenty of room to the upside. However, if we assume a 10-year UST yield rise from 0.5% as of August 2020 to a 5.4% peak (roughly equivalent to a 500bp gain) in the current cycle, then the yield has already crossed the cycle's 80% milestone toward its peak and is now approaching the 90% milestone (of course, if the terminal rate continues to rise, the 10-year UST yield peak would also rise).

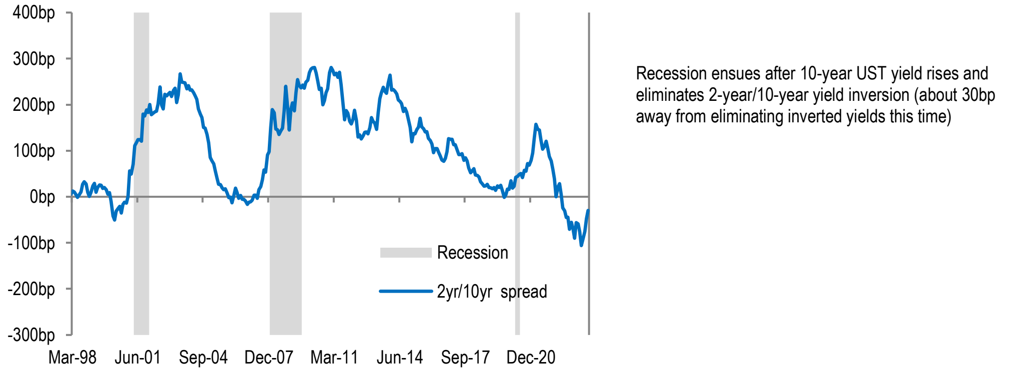
FF Rate, 10yr US Treasury Yield (%)



Source: Bloomberg; compiled by Daiwa Securities.

2. Flattening (resolving inverted yields): Historically, the 10-year UST yield has tended to peak out at the same time that the yield curve starts to steepen after eliminating inverted yields (typically followed by a recession). In this case, the Fed's "high for long" forward guidance is stabilizing the 2-year UST yield at around 5.125%, the end-2024 FF rate forecast. Therefore, if the 10-year UST yield rises to that same level and the curve flattens, we could calculate that this yield has around 30bp of additional upside before peaking, lifting it to a 5.1-5.2% range. Whether 30bp seems small depends on the perception of each investor. Still, in terms of upside for the current cycle (0.5% to 5.2%, +470bp), our calculations suggest that the cycle's 90% milestone has already been crossed (of course, if the 2-year UST yield rises significantly in the future due to factors such as an elevated FF rate forecast for end-2024, the assumed level at which US Treasury yield curve flattening occurs would also increase).

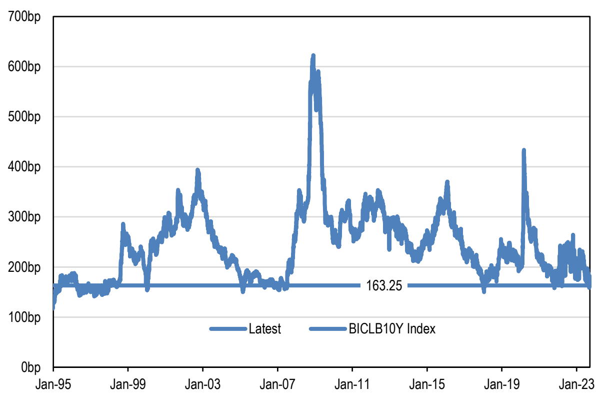
2yr/10yr US Yield Spread (%)



Source: Bloomberg; compiled by Daiwa Securities.

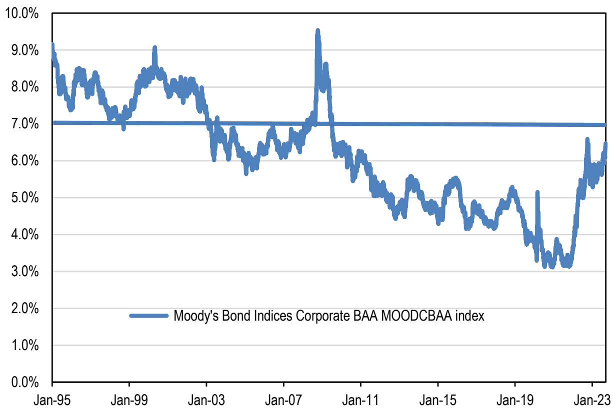
3. Corporate bond yields: As widely reported, private credit provided by non-banks, especially high-yield leveraged private credit, is currently flourishing in the market (see 2 Oct 2023 Bloomberg report about US asset management firm Marathon adding personnel as it eyes $2tn (Y300tn) opportunity in private credit market). In the past, a tightening of the credit environment often occurred when the Senior Loan Officer Opinion Survey on *Bank* Lending Practices (*SLOOS*) confirmed a tightening of lending attitudes among US banks. Rather, this time the US corporate bond spread has narrowed from 230bp to 163bp since the collapse of Silicon Valley Bank in March of this year. Based on the current corporate bond spread, which is near the historical low, we can assume a 10-year UST yield level of 5.37% by calculating backwards from a corporate bond yield of 7% (standard for stress). (We note that a corporate bond yield of 8.5% was borderline for 1995-2001, but the potential growth rate was much higher compared to now).

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.

Of course, no one knows in advance the actual peak. However, based on the current terminal rate assumptions and the current corporate bond spreads, we recognize the possibility of the 10-year UST yield rising (if there is a further rise) to a peak of around 5.1-5.4%. If so, more than 80% of the yield increasing process envisioned for this cycle (0.5 to 5.4%, or about 500bp) has already been realized and the 90% milestone could be approaching (possible that peak has already been reached). We think the current position within the cycle is becoming clearer.

Howard Marks said, "*When one of the last to resist finally raises the white flag and buys at a price that has gone up considerably, or sells at a price that has gone down considerably, there is no one new to join the circle. If more people stop buying, the bull market will end. The reverse is also true. The last person to surrender will lead the market to a ceiling or bottom, setting the stage for a cycle reversal*." Unpopularity is the buyer's friend. The current situation, in which investors surrendered at a time when prices were generally declining due to cooling sentiment and panicking, along with the rapid expansion of term premiums, has led to a rapid advance for the 10-year UST yield from the 80% to the 90% milestone. This seems to suggest that the climax for this cycle is not far away.

We could see signals that the peak (100% milestone) has been reached even before the 10-year UST yield rises to 5.1-5.4%. Examples include (1) the 10-year UST yield rises to a level that flattens the yield curve, where hedging costs, a headache for foreign investors investing in US Treasuries, can be offset by yield on the underlying assets and (2) corporate bond yields approach a milestone level, while corporate bond spreads widen and risk assets spiral sharply downward. By closely watching the shape of the yield curve, term premiums, and trends for stock and corporate bond spreads when yields rise, we want to determine the current position within this cycle and the best timing for going on the offensive.

Note that forward guidance from central banks, whether "low for long" or "high for long," has the effect of distorting the market in an intended direction. This also means that if the forward guidance is withdrawn, the distortions will dissipate and the situation will change drastically at around that time. We also want to pay close attention to whether the Fed and government officials increase their statements that add optionality while watering down the "high for long" forward guidance. In that sense, on 3 October, US Treasury Secretary Janet Yellen said, "The economic resilience that they see maybe suggests higher for longer, but we'll see. I think it's by no means a given." As far as we know, this is the first time that a high-ranking official has said that 'high for long' is "by no means a given."

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