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Daiwa Securities

# Daiwa's View

## CPI shock once again

➢ If inflation rate continues to decline, adjustment rate cuts will become more likely

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◆ CPI shock once again

Yesterday, US yields declined by about 20bp across the curve, reflecting US CPI readings, which were slightly lower than the market estimate. The 10-year yield fell to 4.45%, lower than its threshold of 4.5% (BEI of 2.29% and real yield of 2.16%). On 5 September, when Fed Governor Christopher Waller commented that Treasury yields were probably about where they should be, the 10-year BEI and real yield were at 2.3% and 1.96%, respectively (10-year yield of around 4.2%). Therefore, yields can be said to have approached these levels. Of course, if yields continue to decline sharply, more caution would be necessary regarding strong growth that could lead to a risk of a resurgence in inflation and market optimism (loosening of financial conditions). Meanwhile, if inflation cools more than expected, we would need to pay attention to different risks.

◆ Adjustment rate cuts necessitated by decline in inflation rate

Previously, New York Fed President John Williams pointed out that nominal interest rates would need to come down at some point in order to appropriately set the real federal funds rate (i.e., nominal federal funds rate – actual inflation rate). This is because, if it didn't, the Fed's policy would automatically increase the extent of tightening due to the decline in inflation.

**New York Fed President John Williams** (28 Nov 2022)
At some point, nominal interest rates will need to come down. Otherwise, real interest rates will be going up and that would just be tightening policy further and further in terms of its effects on the economy. … I do see a point, probably in 2024, that we'll start bringing down nominal interest rates because inflation is coming down and we would want to have real interest rates appropriately positioned.

**Four scenarios going forward**

Given this, we see four scenarios in the near future—(1) the Fed implements adjustment rate cuts in a timely manner to handle calming inflation → soft landing (mild decline in yields); (2) the Fed's adjustment rate cuts for calming inflation are delayed → hard landing (yields drop sharply after staying at a high level); (3) the Fed does not implement adjustment rate cuts to handle a "false" calming of inflation → improvement in the Fed's credibility (yields are high for long); and (4) the Fed implements adjustment rate cuts to handle a "false" calming of inflation → resurgence of inflation and a decline in the Fed's credibility (yields rise again). Due to the slowdown in inflation in October, the probability of scenarios (3) and (4) has declined slightly, but the probability of scenario (1) has increased. Accordingly, US yields are naturally expected to decline. That said, having before fallen behind the curve in the rate hike stage and suffered from the nightmare of resurging inflation in the 1970s, I wonder if the Fed will actually be able to implement rate cuts in a timely manner. Given the trauma in the past, we think there is still a possibility of scenario (2). In any case, with expectations for rate hikes having virtually disappeared following the latest CPI data, the market's focus has definitely shifted from rate hikes to adjustment rate cuts.

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