Daiwa' s View

Outlooks for UST and JGB Yields in 2024 (as of 25 Dec 2023)

- 10yr UST yield: Core range of 3.7%~4.2% for now, 3.4%~4.0% after rate cuts start
- See 10yr UST yield of 3.2% at end-2024, but significant uncertainties including presidential election
- JGB yields: See 10yr JGB yield of 0.5% at end-2024, declining in tandem with 10yr UST yield

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2024 UST yield outlook (Tani)

For now, our 10-year UST yield core range for 2024 up until just before the Fed starts cutting rates is 3.7%~4.2% and then 3.4%~4.0% after the rate cuts start until the US presidential election. Making a definite decision about the end-2024 landing spot for the 10-year UST yield at this juncture is very difficult considering the US presidential election slated November, as well as the uncertainties about where the US economy will land (soft vs hard landing). However, if interest rates continue to decline in line with the Fed's Summary of Economic Projections (SEP), we think the 10-year UST yield will drop to a 2.9%~3.5% range by around the end of 2024. Given the substantial uncertainties, year-end values should be reconsidered at the time of each quarterly SEP release.

Core range for now set at 3.7%~4.2% until rate cuts start

For now, we expect a core range of 3.7%~4.2% for the 10-year UST yield. Federal Reserve Governor Christopher Waller said in early September (when inflation was much higher than now) that UST yields are probably at their appropriate levels. At that time, the 10-year UST yield was around 4.2% (real yield of 2.2% assuming long-term inflation of 2%). Here, there is a reasonable basis as this real policy rate of 2.2% is consistent with the 2024 real policy rate in the FOMC's December SEP (core PCE inflation base).

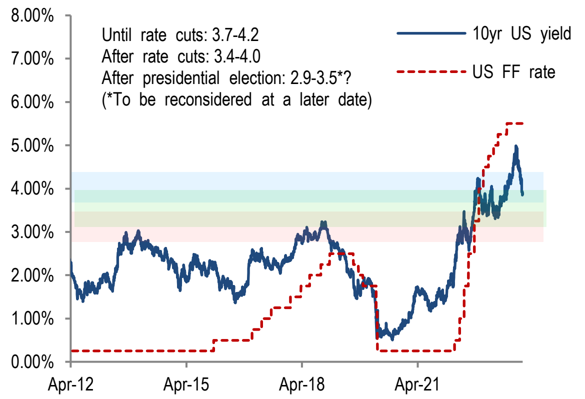
Also, on 28 November Waller said, "Long-term interest rates are still higher than they were before the middle of the year." It is clear that Waller sees around 3.7% as one benchmark needed to quell inflation "before mid-year" (real interest rate of around 1.7%). Therefore, 3.7% is likely to serve as a lower bound until there is confirmation that the Fed will make a rate cut. Since we anticipate the first rate cut to take place over the middle of next year, we expect the rate to land at 3.95%, the midpoint of our core range provided above, at the end of March 2024 (when no rate cut has yet taken place). Of course, depending on the economic and financial situations, there is a reasonable possibility that the Fed will decide to cut interest rates as early as its March FOMC meeting. In that case, we could envision a more rapid transition to the new range after the rate cut. This point is covered in greater detail on the next and following pages.

Chart 1: Outlook for US Long-term Yield

(%)		FY23			FY24								
		Jan-Mar			Apr-Jun			Jul-Sep			Oct-Dec		
		Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
US	10yr	3.40	4.50	3.95	2.50	4.20	3.70	2.50	3.90	3.40	2.50	4.00	3.20

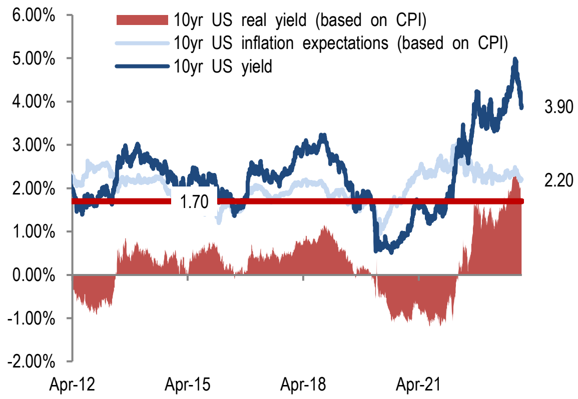
Source: Compiled by Daiwa.

Chart 2: US Long-term Yield, FF Rate (upper limit)



Source: Bloomberg; compiled by Daiwa.

Chart 3: 10yr US Yields (nominal, real, BEI)



Source: Bloomberg; compiled by Daiwa.
Note: On average, "CPI-PCE" is approximately equal to 0.3%. Thus, when CPI-based real yield in chart above is converted to PCE-based real yield, 0.3% needs to be added.

3.4%~4.0% range around time of first rate cut until Sep 2024 (before presidential election)
We expect the core range to drop back to 3.4%~4.0% once the Fed starts cutting rates. The 23 Dec SEP suggests a 2025 real policy rate of 1.4%. We see a lower bound of 3.4%, which is equal to this real policy rate of 1.4% plus the 2% inflation target. (This lower bound is consistent with the 3.41% interest rate level at the beginning of the year.) We expect the psychological resistance level of 4.0% to serve as the upper bound. Since we assume that over time the rate will move lower within the core range, our estimates for end-June and end-September are 3.7% and 3.4%, respectively.

Range of 2.9%~3.5% from after election to year-end?
So, what about the 10-year UST yield's year-end landing spot after the presidential election? Forecasting such a level at this juncture is very challenging as outcomes for the US economy (soft vs hard landing) and the presidential election remain unknown. We will provide tentative reference values while many important issues remain unsettled. That said, in this report we see 3.2% as the end-2024 landing spot, with a core range of 2.9%~3.5%.

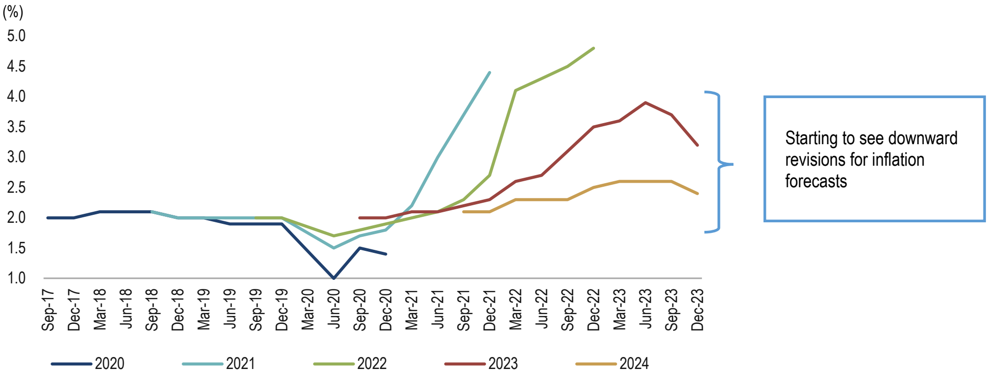
One reference we used was the recent relationship between the SEP and the 10-year UST real yield. The 10-year UST real yield is now approaching 1.8% (nearly equal to 3.8% when adding 2% inflation), which is close to the midpoint between the projected 2024 real policy rate (2.2%) and the 2025 real policy rate (1.4%) indicated in SEP. Using this as one reference point, the 10-year UST real yield could decline to about 1.2% as of end-2024, which is close to the midpoint between the projected real policy rates for 2025 (1.4%) and 2026 (0.9%). If we add 2% inflation, the year-end landing spot becomes 3.2% (1.2% + 2.0%) and we see 2.9% (2026 real policy rate of 0.9% + 2%) as the lower end of the range. Of course, the above estimates are based on the assumption that the December 2023 SEP figures will not change. Since the inflation levels and dot charts provided by SEP are reviewed quarterly, the above estimates will likewise need to be reviewed for each SEP.

Risk factor (1): Performance of US economy
The biggest risk factor regarding the above forecast is the performance of the US economy. Economist had assumed a low US growth rate of 0.3%~0.4% at the beginning of the year, but the growth rate was as high as 2.6%, 0.8 point above the potential growth rate, mainly due to the Biden administration's increased fiscal spending. This strong growth was the main factor behind the Fed's additional rate hikes and higher UST yields. Naturally, if the US growth forecast is significantly above the December FOMC SEP projection of 1.4% for next year, it is possible that high policy rates will need to be maintained.

However, this “risk of a repeat of this year’s developments” is easy to imagine. On the other hand, we are more interested in a surprise in the “opposite” direction from this year’s developments. This is because recently core PCE inflation has been continuously revised downward in SEP (for example, from September to December SEP: 3.7% → 3.2% in 2023, 2.6% → 2.4% in 2024, 2.3% → 2.2% in 2025). In addition, actual inflation announcements continue to fall short of prior expectations. Specifically, the most recently disclosed inflation-related data include the 3Q GDP report (21 December), which showed core PCE at +2% y/y, 0.3 point below the 2.3% forecast, and the November PCE core deflator (22 December) at +3.2%, 0.1 point below the 3.3% y/y forecast, rising at an annualized rate of 1.9% over the past six month. This suggests that economists’ forecasts, which have underestimated the strength of the US economy and inflation, may now be overestimating the persistence of inflation.

In general, once an upward surprise occurs, upward revisions tend to continue (this year’s growth forecast comes to mind), and once a downward surprise occurs, downward revisions tend to continue. In any case, an early quelling of inflation will hasten the timing of the Fed’s interest rate cuts, so the downward surprises in inflation that have been occurring recently should be viewed cautiously.

Chart 4: Median Forecasts for Core PCE Deflator Among FOMC Participants (4Q/4Q)



Source: Compiled by Daiwa.

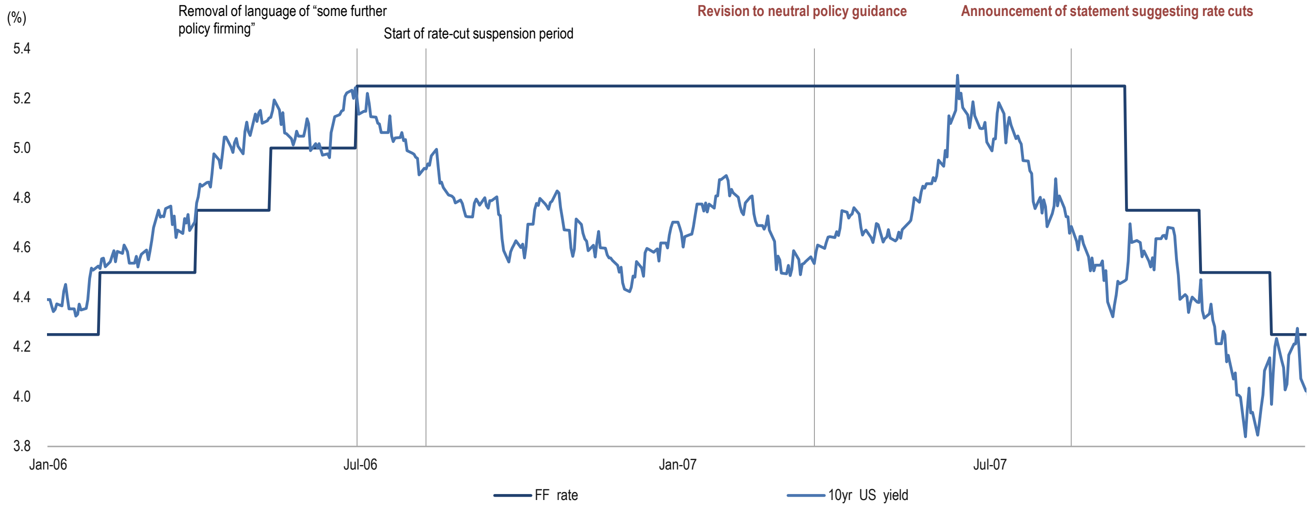
Risk factor (2): QT

Another point to keep in mind is the market disturbances that quantitative tightening (QT) could cause. This risk is discussed in detail in our 22 December report (Japanese only). The Fed has indicated that once it stops raising the FF rate (its most active tool) and actually cuts rates, it intends to continue QT for the time being in the case of an adjustment rate cut (if there is a US economy soft landing). However, an important point to note is Fed Chairman Jerome Powell’s comment that, “At a certain point, there will be a level where the reverse repo (RRP) facility levels out, and at that point, reserves will start to come down.” At that time, if the effect of balance sheet reductions corresponds to a rate hike of 0.35~0.50 point, as previously pointed out by former Federal Reserve Bank of Chicago President Charles Evans, the financial environment could tighten non-continuously through the middle of next year. Of course, in that case, executing an adjustment rate cut to cover just that amount would be good. However, if the Fed is hesitant to make an adjustment rate cut due to fears that the ultra-loose financial environment that produced record-high stock prices and the narrowest corporate bond spreads this century could reignite inflation, market disturbances brought about by QT could become a risk factor for financial markets.

Risk factor (3): Similarities with period before global financial crisis

Finally, we also want to point out the similarities between the present and the period just before the global financial crisis triggered by the collapse of Lehman Brothers. Prior to the Lehman Brothers collapse, the FF rate was raised to 5.25% on 29 June 2006 and the 10-year UST yield rose to 5.24% on 28 June of that year. After that, long-term interest rates briefly fell by about 0.7%~0.8% in anticipation of a neutralization of the Fed’s stance. Still, around the time that the rate hike bias was lifted in March 2007, expectations of a soft landing increased further, with the DJIA30 reaching an all-time high in July 2007 and the 10-year UST yield rising again to 5.29% in June of that year (formed double-top chart pattern at 5.2%~5.3% level).

Chart 5: FF Rate and US Long-term Yield Before Global Financial Crisis



Source: Bloomberg, Fed; compiled by Daiwa.

We are not going to suggest that the current situation is exactly the same as just before the collapse of Lehman crisis, but there are many similarities. Examples include interest rates moving above 5% and equities reaching new highs due to expectations for a soft landing that increased following the suspension of interest rate hikes. If stock prices continue to rise and the Fed is more willing to again switch to a "high for long" rate stance in order to deter monetary conditions from easing in the future, we should perhaps keep in mind the possibility that the 10-year UST yield could again form a double top above 5%, as was the case just before the collapse of Lehman Brothers. In the case of such a development, the final outcome will probably differ from a soft landing. We do not think that such an outcome is likely at this juncture. However, if the market develops in such a similar manner as that just before the collapse of Lehman Brothers and if the 10-year UST yield again reaches 5%, we think we would anticipate some good opportunities to buy that maturity. (Tani)

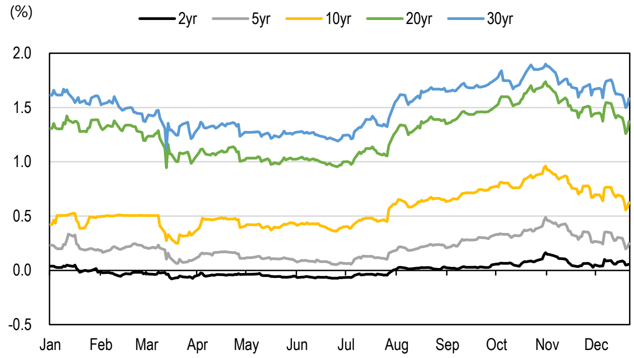
JGB yield outlook (Kawahara, Sato)

The JGB market in 2023 was heavily influenced by developments at the BOJ, including the appointment of Governor Kazuo Ueda and repeated yield curve control (YCC) revisions. The 10-year JGB yield continued to rise from around 0.5% at the start of the year, reaching around 1.0% in November. However, since then the effect of year-end position squaring (short covering), along with the lower 10-year UST yield, has brought the 10-year JGB yield closer to the level seen the beginning of the year (around 0.6%) (Chart 6).

We view US interest rate trends as the most important factor when forecasting JGB yield trends in 2024. Japan and US government bond yields remain closely interlocked. Last year, for sure, YCC limited the upside for the 10-year JGB yield, so there were times when this yield lost its connection with the rising 10-year UST yield. However, there has been a resumption of that close linkage since July when the BOJ made its YCC policy more flexible (Chart 7).

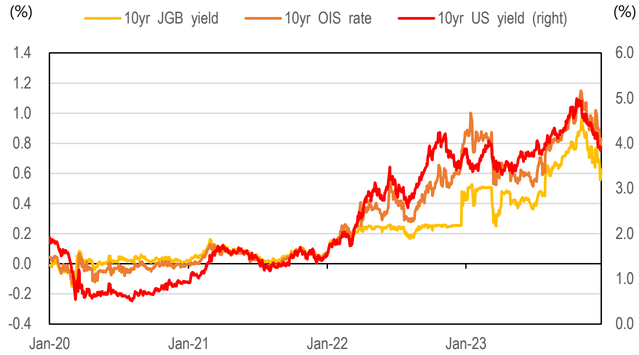
As mentioned earlier, if US Treasury yields trend downward, we could reasonably assume that JGB yields would also basically trend lower. That said, when looking at JGB yield levels during a downward trend, one area of concern is the impact of the BOJ scaling back its JGB purchasing operations.

Chart 6: JGB Yield Trend in 2023



Source: Bloomberg; compiled by Daiwa.

Chart 7: 10yr Yields in Japan and US



Source: Bloomberg; compiled by Daiwa.

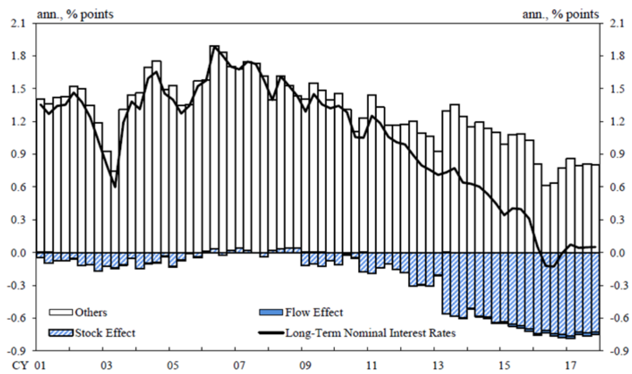
The BOJ released an analysis showing that its JGB purchases had “statistically significant effects” on 10-year JGB yields in terms of lowering them. This would suggest that a reduction in such JGB purchases would exert upward pressure on JGB yields.

However, most of that downward pressure on JGB yields via these BOJ purchasing operations is due to the Bank’s large holdings of outstanding JGBs (stock effect), while the contribution from the scale of purchasing operations (flow effect) during each period is considered to be limited. As such, the direct impact on JGB yields from the BOJ reducing its JGB purchasing operations would not be significant (Chart 8).

Meanwhile, our simulations calculated based on the government bond issuance plan and redemption amount for the next fiscal year show that the stock effect too will have only a small impact on JGB yields. Keeping in mind the BOJ’s inflation-overshooting commitment, if the BOJ tries to reduce its purchasing operations until the amount of JGBs held in FY24 is about the same as FY23, we would expect purchasing operation to be reduced by about Y500bn each quarter in FY24 (Chart 9).

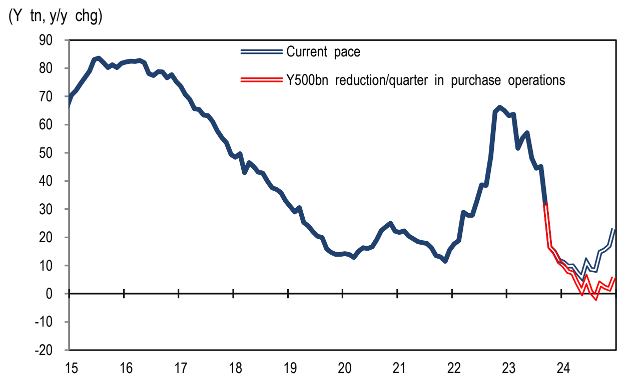
Taking into account the JGB issuance and redemption amounts in FY24 within this calculation, the BOJ’s share of all outstanding JGBs at the end of FY24 will probably come to about 56% (down 2 points from FY23). According to a BOJ report, if we calculate the upward pressure on JGB yields due to reduced purchasing operations in FY24, based on the downward pressure on JGB yields (when increasing purchase operations), the impact would be only around 4bp (-0.02 x 2 = 0.04).

Chart 8: Stock Effect and Flow Effect



Source: Excerpted from BOJ materials.

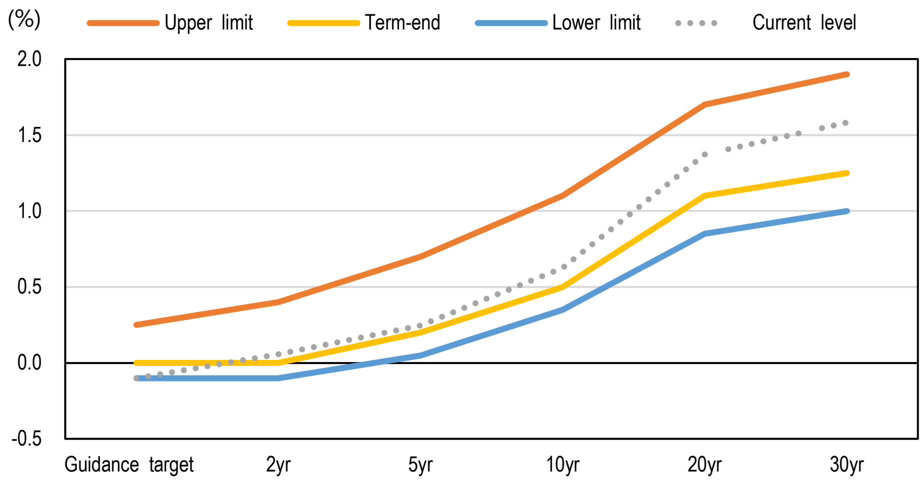
Chart 9: Amount of JGBs Held by BOJ



Source: BOJ; compiled by Daiwa.

As mentioned above, if the impact of reduced JGB purchasing operations is negligible, we would expect JGB yields to decline next year in tandem with declining US Treasury yields. Another risk scenario that we dare to present is a case in which the BOJ turns more hawkish than expected. In the event that the US economy remains strong and the yen does not appreciate to the same extent as the narrowing of the US/Japan interest rate differential, the possibility of the BOJ continuing to raise interest rates after ending negative interest rates would become visible. Such a development does not seem likely at this juncture. Still, in light of the fact that no one could have predicted the current strength of the US economy at the beginning of 2023, the same scenario should be considered as a tail risk. However, the Japanese economy is not in good shape in terms of its fundamentals. The government is also implementing economic policies to completely end deflation, but the actual effects will not be seen until next year. With likely US rate cuts, the time given to the BOJ appears to be limited. (Kawahara, Sato)

Chart 10: Estimated Yield Curves at end-2024 by Scenario



Source: Bloomberg; compiled by Daiwa.

Chart 11: Outlook for JGB Yields

(%)	FY23			FY24								
	Jan-Mar			Apr-Jun			Jul-Sep			Oct-Dec		
	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
Guidance target (lower limit)	-0.10	0.00	0.00	-0.10	0.00	0.00	-0.10	0.25	0.00	-0.10	0.25	0.00
2yr	0.00	0.25	0.05	-0.10	0.30	0.05	-0.10	0.40	0.00	-0.10	0.40	0.00
5yr	0.15	0.50	0.30	0.05	0.60	0.25	0.05	0.65	0.20	0.05	0.70	0.20
10yr	0.50	1.00	0.70	0.35	1.05	0.65	0.35	1.10	0.55	0.35	1.10	0.50
20yr	1.10	1.60	1.40	0.85	1.65	1.30	0.85	1.70	1.20	0.85	1.70	1.10
30yr	1.30	1.80	1.55	1.00	1.85	1.45	1.00	1.90	1.35	1.00	1.90	1.25

Source: Compiled by Daiwa.

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