Daiwa Securities

Daiwa's View

Will concerns about recession prove unfounded?

➢ Rate cuts necessary to maintain degree of monetary easing

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

Will concerns about recession prove unfounded?

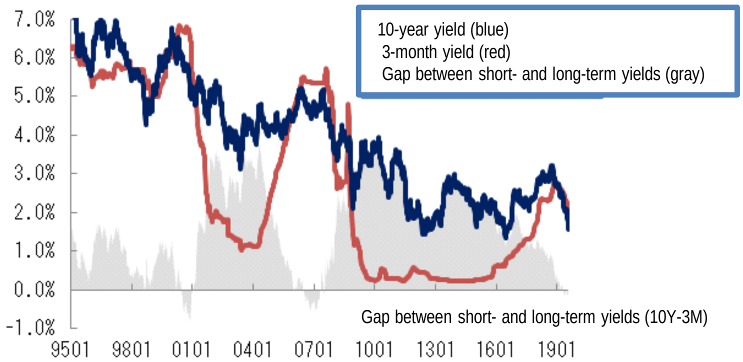
Currently, the US 10-year and 3-month yields are in a full-scale inversion. This yield curve condition implies a recession if the Fed shows a cautious stance on rate cuts.

Rate cuts necessary to maintain degree of monetary easing

In the past recession cases in around 2001 and 2009, a clear inversion was observed between short- and long-term interest rates (red line > blue line in chart below). On the other hand, looking at "mini-recession" cases in both 2012 and 2016 after the Lehman crisis, we found that the differential between US short- and long-term interest rates was around the lower 1.0% range as the short-term rate was quite low. At that time, people pointed out the risk of a recession. However, at least the differential between short- and long-term interest rates did not signal a recession.

This time around, the differential between short- and long-term interest rates has inverted after substantial rate hikes, similar to the recession cases in the past. Meanwhile, the decline in the 3-month yield has followed that in long-term yields, unlike the past cases. This means that the Fed has not fallen behind the curve (with respect to rate cuts). It is highly possible that a full-scale recession will be avoided if the Fed maintains a stance on expeditious rate cuts, putting aside technical judgment.

Chart: US Treasury Yields and Differential Between Short- and Long-term Interest Yields



Source: Bloomberg; compiled by Daiwa Securities.

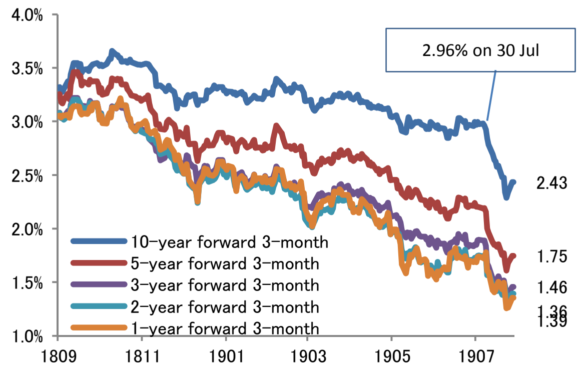
In forecasting the continuity of the Fed's stance, key is Chair Jerome Powell's speech at the economic symposium in Jackson Hole, slated for 23 August. If he sends out a message that he will not hesitate to implement rate cuts if needed, concerns about a recession would be eliminated, which is our main scenario. However, if he shows a cautious stance on rate cuts, this may again raise the market's demand for rate cuts. This may lead to concerns about the possibility that the Fed will be forced to cut interest rates further.

As there is a risk that the Fed may shows a cautious stance on rate cuts (although this is not our main scenario), we should closely watch how the economic cycle and appropriate interest rate level will be recognized. This is because some market participants (particularly economists) say that rate cuts are unnecessary on the grounds of the economic cycle, stating that "rate cuts are not needed in light of economic indicators," and "there are no precedents in which the central bank embarked on a rate cut at this level of ISM and employment data."

Of course, if the appropriate interest rate level (= natural rate of interest + inflation expectations) is unchanged, a rate cut/hike can be decided on based on the economic cycle. However, recent structural low inflation and monetary easing to address this have been causing a decline in the natural interest rate. It is thus estimated that the neutral interest rate has been trending down. If the interest rate remains unchanged, the level would tighten. In other words, rate cuts are necessary in order to maintain the degree of monetary easing. This is one reason that the Fed tends to be behind the curve when it waits for data. As President Donald Trump has a certain business sense, he appears to have also perceived this point (he tweeted yesterday that Fed should cut rates by 1 percentage point).

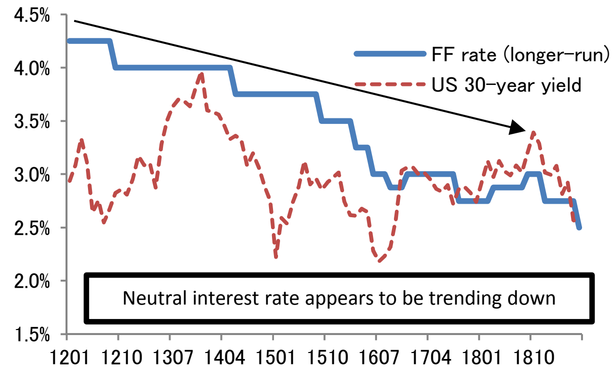
Usually, concerns about a recession disappear if the authorities take appropriate monetary/fiscal policies. In that sense, the past recession cases following the inversion of short- and long-term interest rates can be called central bank policy mistakes—the Fed failed to change course quickly despite the need for rate cuts[1]. If by any chance the Fed hesitates to cut the rate and US-China conflict heats up when the US imposes a fourth round of tariffs on Chinese imports on 1 September, the market may demand rate cuts again alongside a resurgence of concerns about a recession.

Chart: US Treasury 3-month Forward Yields



Source: Bloomberg; compiled by Daiwa Securities.

Chart: FF Rate (longer-run projection) **and US 30-year Yield**



Source: Bloomberg; compiled by Daiwa Securities.

1 Background is that emergence of asset bubble prevented Fed from taking expeditious rate-cut action.

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2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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[Fitch]

The Name of the Credit Rating Agencies group, etc

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The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association