

Daiwa's View

Concerns about recession

➤ Oct BOJ MPM is 'live'

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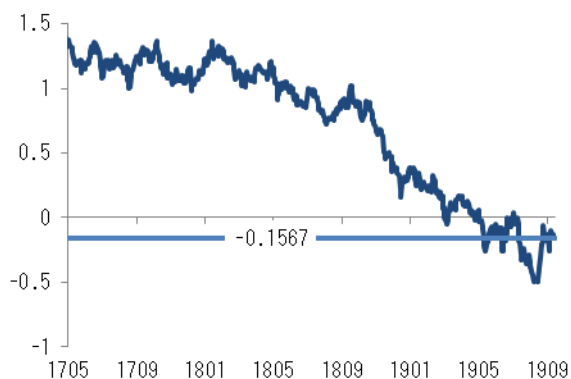
Oct BOJ MPM is 'live'

Yesterday, signs of a recession were also confirmed in the US ISM nonmanufacturing index for September. This strengthened market recognition that deterioration in the manufacturing sector is finally spreading to the nonmanufacturing sector, pushing down the US long-term yield to the lower 1.5% range.

The news is attracting attention alongside the inversion of the US yield curve, in which the 10-year yield is more than 0.15% below the 3-month yield. This is because an empirical rule shows that a recession is avoidable if the inversion spans only around three months. This time around, however, the yield curve has remained inverted for more than four months since May 2019. Therefore, we will not be surprised now if the adverse impact spreads to the entire economy. As we mentioned yesterday, if the Fed postpones a rate cut in October, the US yield curve would remain inverted for a longer time. This is likely to strengthen concerns about a US economic recession. The decline in the September nonmanufacturing index gave a poor impression.

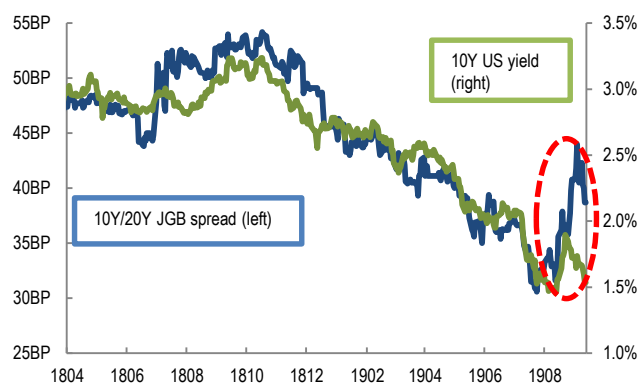
In the JGB market, the 20-year JGB yield has declined below 0.2% in reaction to excessive steepening. Of course, a direct trigger was confirmation of investor demand due to the favorable result of the auction for enhanced liquidity. Looking at the bigger picture, we think that market participants are partially aware of the decoupling from the global yield trends (Chart 2). Although caution about the BOJ's JGB purchase operations and the supply side (such as 30-year JGB auction) is lingering as people look ahead to next week, the possibility of the BOJ boldly reducing the offer amounts amid a risk-off stage is not high. While a slowdown in overseas economies is raising expectations for additional easing at the October BOJ MPM (Monetary Policy Meeting), a rally of superlong yields is expected to continue.

Chart 1: Differential Between US Long-term and Short-term Yields (10Y-3M)



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: 10Y US Yield and 10Y/20Y JGB Spread

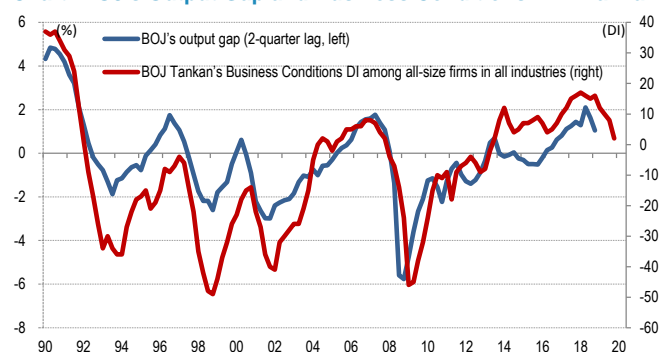


Source: Bloomberg; compiled by Daiwa Securities.

Amid increasing speculations about additional easing, BOJ board member Yukitoshi Funo made a speech in yesterday's meeting with business leaders in Shimane. This was the first speech by a board member since the announcement of the BOJ Tankan and US ISM manufacturing index. In addition, as he is positioned as one of the consensus indicators, it is possible the speech could provide hints about the latest economic recognition at the BOJ reflecting updated economic data. To make a long story short, we gained the impression that the upcoming MPM will be 'live.'

In his speech on 24 September, BOJ governor Haruhiko Kuroda stated that "it is becoming necessary to pay closer attention to the possibility that the momentum toward achieving the price stability target will be lost." Then, he emphasized that "developments in the output gap warrant particular attention." Yesterday, the BOJ announced that the output gap in Apr-Jun 2019 shrank to +1.04% from +1.64% in the previous quarter. The positive gap was the narrowest since Jul-Sep 2017 (+0.81%). That said, the output gap, which shows price momentum, remained positive, as Mr. Funo stated.

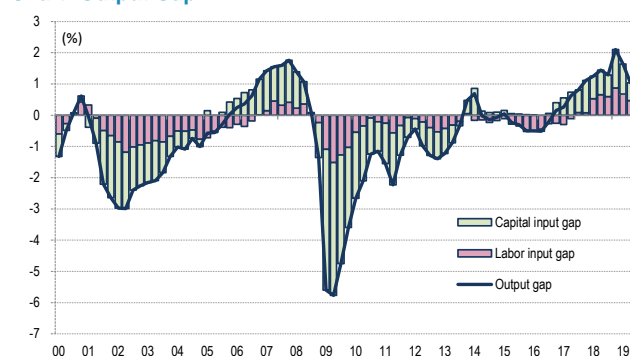
Chart: BOJ's Output Gap and Business Conditions DI in Tankan



Source: BOJ; compiled by Daiwa Securities.

Note: Latest Business Conditions DI indicates forecast DI.

Chart: Output Gap



Source: BOJ; compiled by Daiwa Securities.

However, the statement says that "the Bank will not hesitate to take additional easing measures if there is a greater possibility that the momentum toward achieving the price stability target will be lost." Therefore, the fact that the output gap remains positive alone is not a sufficient reason to avoid additional easing. The key point is whether the BOJ will judge that there is "a greater possibility that the momentum toward achieving the price stability target will be lost." However, this judgment would depend on the BOJ's assessment of the situation. At the very least, the fact that the positive output gap has narrowed must strengthen the recognition that momentum's momentum (?) is being lost. (The key is whether the BOJ will see this as constituting a greater possibility that the momentum will be lost.)

We forecast that the output gap in Jul-Sep will remain roughly flat partly on the effect of last-minute demand. However, the positive gap is expected to narrow again in Oct-Dec due to a reactionary decline after the tax hike. If the positive gap in Oct-Dec becomes nearly zero ('the results are in'), the BOJ would judge that "the momentum toward achieving the price stability target will be lost." Of course, "it would be too late (to act) when the outcome appears," as Mr. Funo stated. Therefore, the BOJ is likely to make a conclusion, considering preventive policy steps. Due to the slowdown in US economic indicators, the October FOMC meeting was pulled back to 'live.' Similarly, the October BOJ MPM is definitely 'live.'

◆ Speech by BOJ board member Yukitoshi Funo (3 Oct 2019)

• The main purpose is to examine how various activities will have an impact on the output gap in the real economy. It is important to forecast the general developments, rather than waiting for the visible stage. It would be too late when the outcome appears. We need to make a conclusion, considering preventive policy steps.

• As we still have three weeks before the MPM, we will not stop thinking just because of the Tankan results. We will continue to prepare for the meeting by carefully examining information gathered from various sources.

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[Standard & Poor's]

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[Moody's]

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* 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.

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