Daiwa's View

Relationship between US-China trade talks and yields

➢ Substantial impact on superlong yields

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Daiwa Securities Co. Ltd.

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Substantial impact on superlong yields

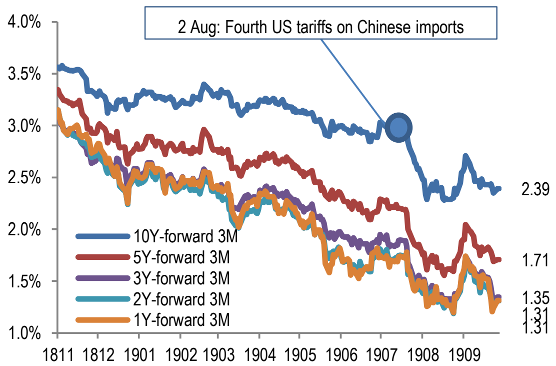
During late August and early September, the 10-year and 30-year US Treasury yields slid to the 1.3% level and record-low 1.9% level at one point, reflecting greater pessimism about US-China trade talks. Here, one focal point was that only the superlong (30-year) yield, which is less susceptible to near-term monetary policy trends, hit its record low.

Why were superlong yields influenced the most? To gauge the reasons, we think of superlong yields by breaking down "inflation expectations" and the "natural rate of interest" in this report. In conclusion, uncertainty about US-China trade talks has a substantial impact on superlong yields via a decline in the natural rate of interest. In thinking of flattening pressure on the global yield curve, US-China ministerial-level talks scheduled for 10 October should be closely watched.

The natural rate of interest is the equilibrium real interest rate that balances savings and investment under full employment. The natural rate of interest has recently been on a downtrend in developed nations. In his late-August speech in Jackson Hole, Fed chair Jerome Powell also stated that standard estimates of the US natural rate of interest have declined between 2 and 3 percentage points over the past two decades.

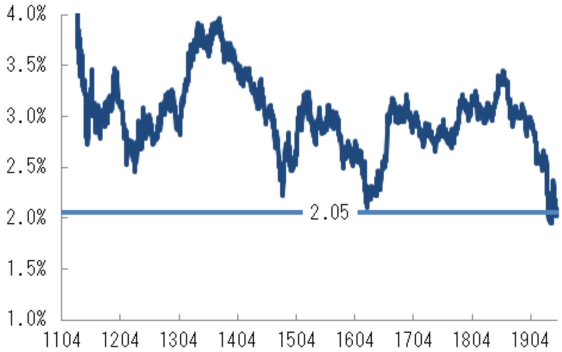
Regarding the natural rate of interest, a recent concern is the possibility of a further decline triggered by uncertainty over US-China trade policies. This is because retaliatory impositions of high tariffs between the two nations since 2018 appear to have an impact on the potential growth rate via greater uncertainty, not limited to short-term negative impacts on the GDP growth rate amid confusion in the supply chain

Chart: US Treasury Forward Yields (3M)



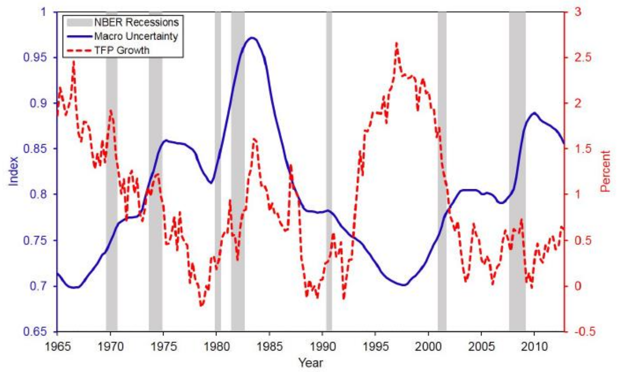
Source: Bloomberg; compiled by Daiwa Securities.

Chart: 30Y Treasury Yield



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Macro Uncertainty and TFP Growth, US



Source: Extract from Dario Bonciani, Joonseok Jason Oh (2019), "The long-run effects of uncertainty shocks."

For example, in their working paper released on 7 June 2019[1], BOE staff pointed out the possibility that "shocks increasing macroeconomic uncertainty negatively affect economic activity not only in the short but also in the long run."

A concrete path is that, due to increased uncertainty shocks, long-term risk-averse preference and precautionary savings moves strengthen at companies (long-run risk channel), which causes a decline in output, consumption, investment in physical capital, and investment in R&D. As a result, uncertainty shocks have negative long-run effects on economic activity via a decline in total factor productivity (TFP), which is the conclusion of the paper.

Moreover, the paper says that uncertainty shocks can cause a decline in consumption, output, investment in physical capital and investment in R&D for over 40 quarters and lead to a persistent decline in TFP. If so, we should expect downward pressure from US-China trade friction on the US natural rate of interest to continue for several decades.

From the viewpoint of yields, the decline in TFP caused by stronger uncertainty weakens demand for investment funds at companies. This serves as a factor to lower the natural rate of interest. It is no accident that the US 30-year yield fell to its record low in line with growing uncertainty. If so, US-China ministerial-level talks to be held in Washington on 10 October will likely influence the flattening pressure on the global yield curve (incl. JGB yields).

[1] Dario Bonciani, Joonseok Jason Oh (2019), "The Long-run Effects of Uncertainty Shocks."

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[Standard & Poor's]

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[Moody's]

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[Fitch]

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May 2018

Daiwa Securities

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