Daiwa's View

Focal points after US-China partial agreement

➢ Whether (1) optimism about US-China trade talks will continue and (2) Fed will continue preventive rate cuts

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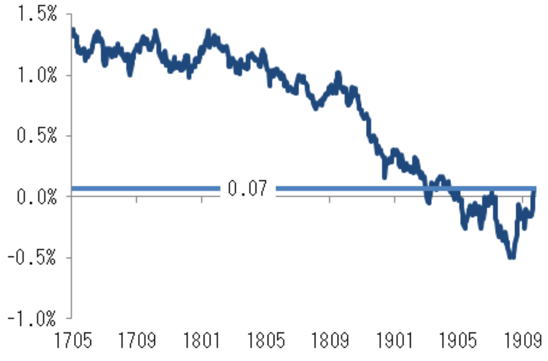
Due to the partial agreement between the US and China, the hike in US tariffs on Chinese products, which was supposed to be implemented on 15 October, was postponed. US Treasury Secretary Steven Mnuchin explained that, due to the agreement, China would spend $40-50bn/year, more than double the current figure, for US agricultural products over the next two years. This is good news for both nations.

As Fed chair Jerome Powell noted in his 8 October speech, the FOMC formally announced that it would expand its balance sheet. The Fed plans to buy Treasury bills for approximately $60bn/month at least into 2Q 2020 in order to maintain reserves. As this is a step among a series of measures to cope with the surge in short-term interest rates, it is positioned as a technical adjustment, which is different from QE.

From the market viewpoint, we first focus on the fact that the yield curve is no longer inverted. The differential between the long-term and short-term Treasury yields has recovered to +7bp for the first time since 3 May 2019, when US-China trade talks took a turn for the worse. While the US long-term yield rose to 1.73% reflecting the US-China partial agreement, the 3-month yield hovered at the 1.60% level due to expectations for the Fed's rate cut and its balance sheet expansion policy. The rise in the long-term yield is directly leading to improvement in the differential between the long-term and short-term yields.

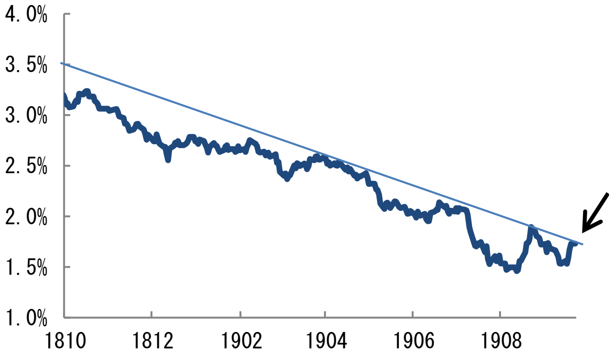
On the other hand, another focal point is that the 10-year Treasury yield topped out toward last Friday's closing. The yield met upside resistance by a trend line over the past six months (Chart 2). This implies that some investors are not necessarily optimistic about the story that the latest agreement is the first step toward an entire agreement, as President Donald Trump stated.

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



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: 10Y US Treasury Yield



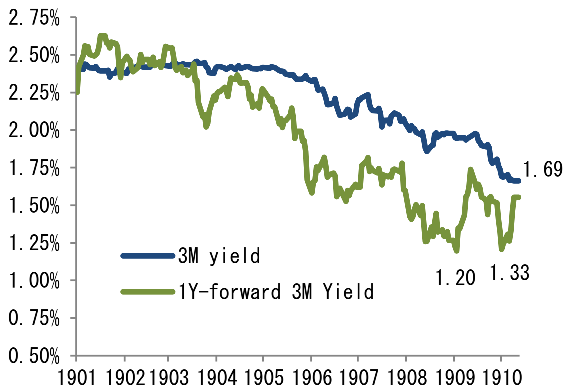
Source: Bloomberg; compiled by Daiwa Securities.

Looking at intraday data on last Friday (11 Oct), the 10-year Treasury yield declined and closed at 1.729% after rising to 1.765%. A long upper tail was thus illustrated in the chart. Similarly, US equities also narrowed their gains via a sharp reversal from the intraday high. They continued to decline on Monday, the following business day. After substantial price movements, profit taking may be natural, but the market lacks a sense of elation.

In forecasting the market, I have two focal points. The first is whether optimism about US-China trade talks will continue. Last week, US Treasury Secretary Steven Mnuchin stated that both nations reached a fundamental agreement about several trade issues but that there were many items that are subject to documentation. From the Chinese side, the Commerce Ministry just said that both made practical progress. Chinese media reports also noted in a cautious tone that "both agreed to make an effort to reach a final agreement." Everyone knows that the hurdle is high toward easing of tensions for important issues caused by structural factors, including the Huawei bashing. I wonder whether (1) the US and China will steadily move toward the second and third agreements toward an entire agreement, (2) the status quo (postponement of imposing additional tariffs), will remain, or (3) the debate will get complicated again in the process of documentation of the current verbal agreement. As the rise in the current market is partially caused by the optimism about US-China trade talks, there are substantial downside risks, not limited to upside potential.

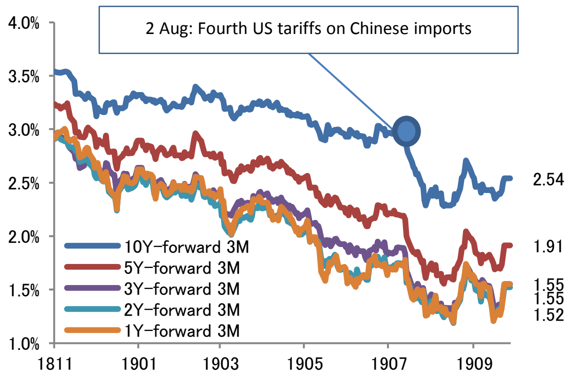
The second is whether the Fed will implement a "preventive rate cut" in line with the market consensus in the case of continued optimism about US-China trade talks. President Trump again announced his opinion that the Fed should continue rate cuts irrespective of the current agreement. At the Fed, Mr. Powell signaled another rate cut by the end of this year. However, it appears that some FOMC members are not necessarily in agreement, meaning the situation is unpredictable. If by chance the Fed skips another rate cut in 2019 reflecting the US-China partial agreement, the 3-month US yield would rise from the current 1.60% level to around 1.80%, entailing risks of the flattening and inversion of the yield curve. As the market is currently factoring in optimism about US-China trade talks and the Fed's rate cut in 2019, we may need to consider the possible disappearance of expectations for either factor.

Chart 3: US 3M Treasury Yield and 1Y-forward 3M Yield



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: US Treasury Forward Yields (3M)



Source: Bloomberg; compiled by Daiwa Securities.

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[Standard & Poor's]

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[Moody's]

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May 2018

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