

Daiwa's View

Declining inflation risk premium

- Unless inflation risk premium recovers, yields unlikely to repeat surge seen in 2016

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Daiwa Securities Co. Ltd.

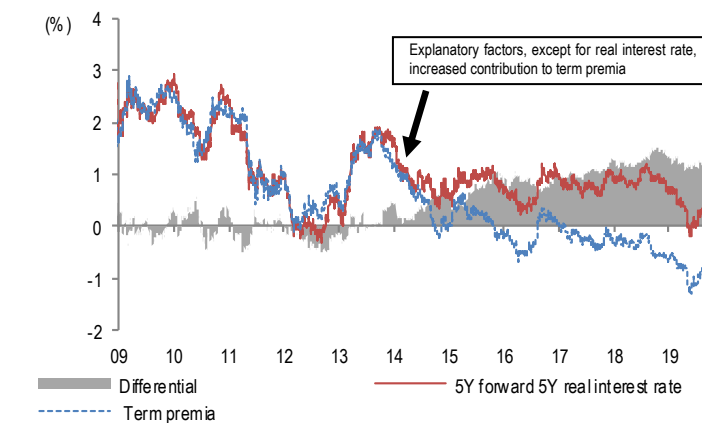
Unless inflation risk premium recovers, yields unlikely to repeat surge seen in 2016

Declining inflation risk premium

Yesterday, US yields declined, leading to bull flattening. The long-term US interest rate fell to 1.78% (down 3bp d/d), the lower side of our estimated range from 1.65% to 1.95%, which is explained in [our 6 November report](#). Amid the cooling down of euphoria on excessive optimism, we are not uncomfortable with a pause in the rise in term premia that had driven yield rises thus far.

Previously, the level and trends of the term premia and 5-year forward 5-year real interest rate were roughly the same, enabling us to regard the real interest rate as a proxy variable of the term premia. However, these two figures started to diverge around 2014, resulting in a clear anomaly of the term premia (gray part in chart below). The divergence implies an increase in the contribution to the term premia from explanatory factors, except for the real interest rate. Specifically, this appears to be reflecting the decline in the inflation risk premium, which is to be explained later in this report.

Chart: 5-year Forward 5-year Real Interest Rate and Term Premia



Source: Bloomberg; compiled by Daiwa Securities.

Under the concept of the term premia, the differential between the nominal interest rate and estimated average short-term interest rate (calculated by model under risk-neutral assumption based on rational expectations hypothesis) is regarded as a risk premium. Inevitably, the key is the degree of precision for the model to estimate the average short-term interest rate. Generally, [the ACM model developed by New York Fed economists Tobias Adrian, Richard Crump, and Emanuel Moench](#) is used. In the market, the term premia based on this ACM model is serving as one benchmark.

On the other hand, when observing the nominal interest rate, the method to differentiate the “real interest rate” from “inflation” is also useful. Therefore, the risk premia is also analyzed by using the similar method for the “real interest rate” and “inflation” respectively, although the model becomes complicated.

Nominal interest rate = “Risk-neutral real interest rate” + “Real term premia” + “Risk-neutral inflation expectations” + “Inflation risk premium”

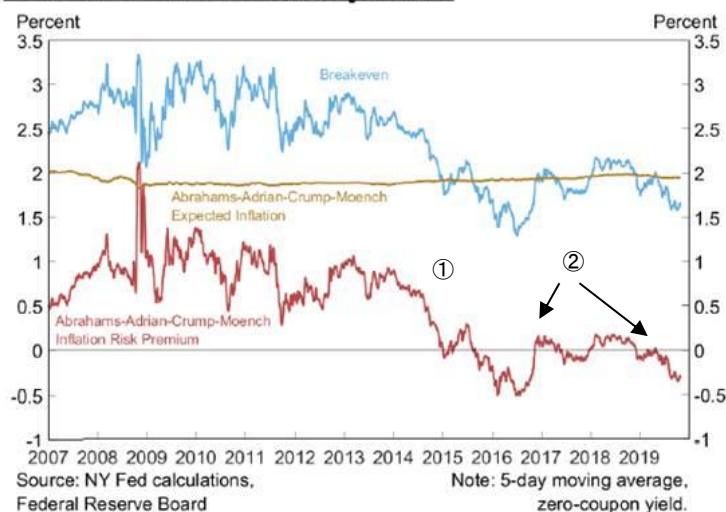
Based on this formula, we observed the background of the divergence between the 5-year forward 5-year real interest rate and term premia, which had emerged since 2014. We then attribute the divergence to a decline in the “inflation risk premium,” which economically means that the market has started to factor in the logic that “in the case of a change in inflation, concerns about the downside are stronger than those about the upside.”

In fact, the New York Fed is releasing the data of inflation risk premium. According to the data, US inflation risk premium has substantially declined and fallen to negative territory since 2014, while expected inflation itself has maintained 2%.

In 2016, inflation risk premium temporarily recovered, driving the yield surge. On the other hand, the inflation risk premium in the yield uptrend since September 2019 has been completely opposite to the 2016 case, making a downward contribution. Unless the inflation risk premium recovers, US yields are unlikely to repeat the surge seen in 2016. This is one reason behind my opinion that [“yields are unlikely to continue to rise without inflation.”](#)

Chart: Term Premia and Inflation Risk Premium

5-10 Year Forward Decomposition



Source: Extracted from NY Fed materials.
 Note: Comments added by Daiwa Securities.

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[Standard & Poor's]

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[Moody's]

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As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter's outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.
- 2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Nippon Healthcare Investment Corporation (3308), Japan Rental Housing Investments (8986).
- 3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.
- 4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of ¥10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.
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- 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.
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- 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.

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Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

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