Daiwa Securities

Daiwa's View

Things to watch for in 2020: Part 4

- Whether US Treasury yield curve will steepen sharply (≈ whether Phillips curve will revive)

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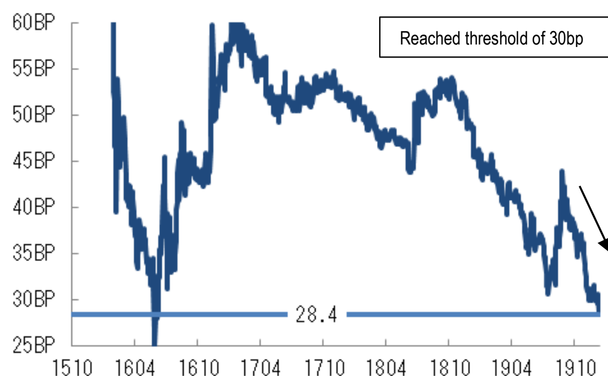
Daiwa Securities Co. Ltd.

Things to watch for in 2020: Part 4

Whether US Treasury yield curve will steepen sharply (≈ whether Phillips curve will revive)

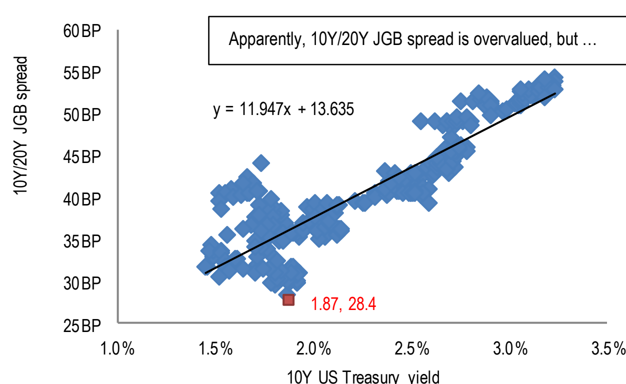
The 10-year/20-year JGB spread has reached its threshold of 30bp. As the yield of the on-the-run 10-year JGB (JB357) is –0.015% and that of the on-the-run 20Y JGB (JL170) is 0.275%, the difference is 0.29%. Due to the 10-year JGB auction on 7 January, the redemption month of the on-the-run 10-year JGB has become December. Given the existence of the three-month difference (about 1bp) with the redemption month (Sep) of the on-the-run 20-year JGB, we can calculate that the 10-year/20-year JGB spread is just 30bp.

Chart 1: 10Y/20Y JGB Spread



Source: Bloomberg; compiled by Daiwa Securities.

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



Source: Bloomberg; compiled by Daiwa Securities.

Until a short time ago, some had pointed out that this flattening was excessive. However, I recently have the impression that the opportunity to hear such an opinion has lessened substantially. This is probably because the background of the flattening has started to become recognized. As a background factor of the currently observed tightening of the 10-year/20-year JGB spread, there is a contrast between "correction of the 10-year JGB yield level" and "superlong JGB yields that are reflecting global yields."

Since the BOJ adopted a flexible stance in its JGB purchase operations, the 10-year JGB yield (strongly influenced by monetary easing) has been apt to follow uptrends of global yields, while it has not followed the downtrend. On the other hand, the components of superlong yields, such as the 10-year forward 10-year yield, have been influenced by the global neutral rate. Therefore, the correlation with global yields has remained high even after the adoption of the flexible stance by the BOJ (Chart 3). As a result, the market moved as if the market segmentation hypothesis has been established. This is the background of the graph, in which the 10-year/20-year JGB spread appears to be overvalued.

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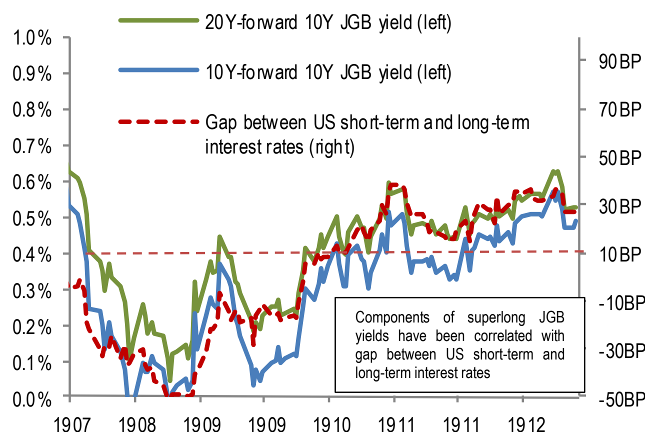
Chart 3: Differential Between US Short-term and Long-term Interest Rates, 10Y-forward 10Y JGB Yield, 20Y-forward 10Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

In the case that the data characteristics are unchanged, graphs based on past data provide effective insight. However, in the case that the characteristics have changed, it is highly possible that such data induces the wrong judgments. If the tightening of the 10-year/20-year JGB spread observed since September 2019 was caused by the BOJ's flexible operations and the resultant correction of the 10-year JGB yield level, we cannot expect a surge in the 20-year JGB yield due to the tightening factor alone. This is because the sector that experienced change in the characteristics was not the 20-year sector but the 10-year one.

On the other hand, if the differential between US short-term and long-term interest rates widens via a change in the global equilibrium interest rate, this would create full-scale upward pressure on the 10-year forward 10-year JGB yield (component of 20-year JGB yield). In that sense, whether the US Treasury yield curve will steepen is an important focal point for investment in superlong JGBs.

In our report dated on 17 December 2019, our yield forecasts for 2020 are based on the judgment that the US Treasury yield curve is unlikely to steepen substantially. Our view is unchanged. Meanwhile, if the curve steepens, a revival of the Phillips curve (recently showing weak relationship between inflation and unemployment) would play an important role in steepening. In that sense, whether 50-year-low unemployment rates and a remarkably accommodative financial condition in the US will finally bring about inflation may be a more essential focal point in 2020.

◆ Fed chair Jerome Powell (11 Dec 2019)

・What's happening there is the fact that the relationship between resource utilization, or unemployment, and inflation has just gotten weaker and weaker over the years. If you go back 50 years, you would have seen that, when there was—when labor markets were tight and unemployment was low, inflation moved right up. And then as the Fed got control of inflation, the connection got weaker and weaker and weaker, to the point where there's still a connection, but it's—it's a very faint one. And what that suggests is that you would need to keep policy somewhat accommodative. And we believe that policy is somewhat accommodative, and we think that that's the appropriate place for policy to be in order to drive up inflation. … The relationship between slack in the economy and inflation has been weak. The coefficient is something like 0.1.

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[Moody's]

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May 2018

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1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies.
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.

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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 Y10bn. 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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