

Daiwa's View

Yield curve reverts to normal

- Inversion was caused by “flight to quality,” rather than concerns about recession

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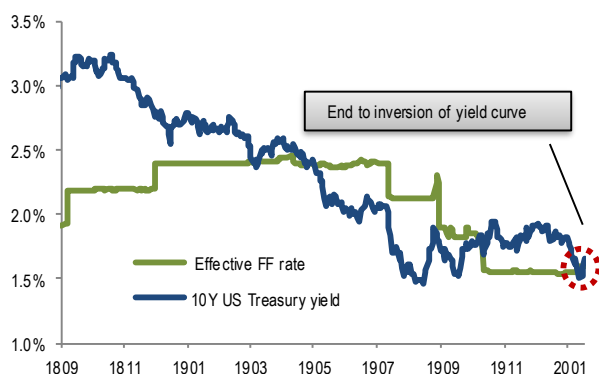
Daiwa Securities Co. Ltd.

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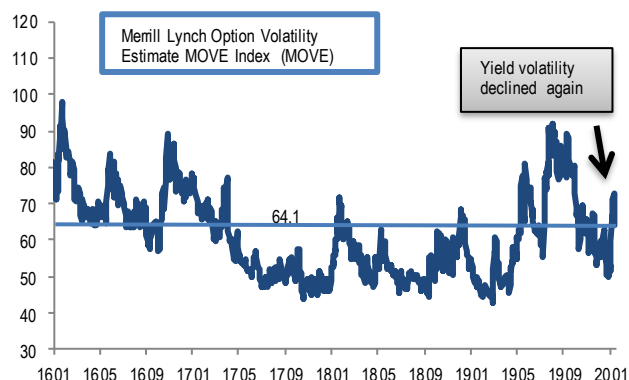
Yesterday, the long-term interest rate rose to 1.65% on the US Treasury market, resulting in the yield curve reverting to normal. US stocks also gained substantially, alongside a recovery of crude oil prices to the \$50 level. Since the end of the Chinese New Year, risk-off sentiment has been gradually easing, reflecting bold policy actions by the Chinese government. Last night, some media sources reported that a drug had been found that is effective against the new coronavirus. Due to this, as well as strong US economic indicators¹, concerns about the virus have diminished. The US economy was also shown to be firm before and after the virus outbreak, leading to further unwinding of risk-off positions. [As pointed out before, the recent inversion of the yield curve can be judged to have been a typical “flight to quality.”](#)

Chart: US Long-term Interest Rate and Effective FF Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Yield Volatility Index



Source: Bloomberg; compiled by Daiwa Securities.

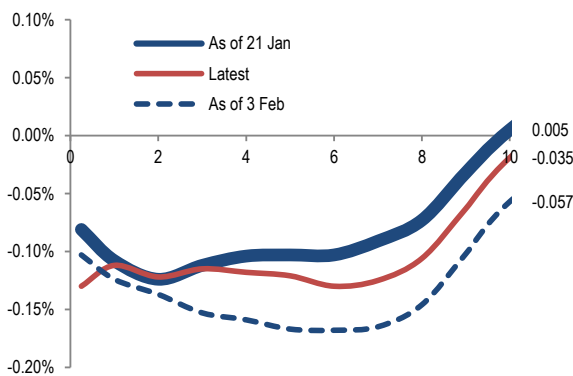
If the suspension of Chinese factory operations is prolonged, the supply of Chinese-made parts could stop. There is thus a risk of suspended operations at worldwide factories (incl. Japan) over the long term. On the other hand, if the period of severity of the outbreak ends in about three months, the new coronavirus outbreak will not have a major impact on the underlying tone of global economic recovery, as Kazushige Kamiyama, Director-general of the BOJ's Research and Statistics Department, stated on 27 January. If it is judged that the probability of finding an effective drug for the virus has increased, widespread unwinding after a “flight to quality” appears reasonable. Particularly so, as the ISM index confirmed the firmness of the US economy before the virus outbreak. [As previously stated, we appear to be gradually getting closer to the worst stage of this situation.](#)

¹ Jan 2020 data released last night: Non-manufacturing ISM index (actual 55.5, estimate 55.1, previous month 54.9) and ADP employment report (actual 291K, estimate 157K, previous month 199K).

Of course, it is true that one background factor behind the yield decline is persistently low inflation, with which Fed chair Jerome Powell has shown his dissatisfaction. However, this is one factor for the Fed's continued accommodative monetary policy. The current situation does not justify an "additional rate cut." The new coronavirus outbreak caused an unexpectedly strong flight to quality, but unless the Fed changes its stance, the yield curve inversion will not continue—i.e., substantial downward revision to our estimated range for US yields will be unnecessary.

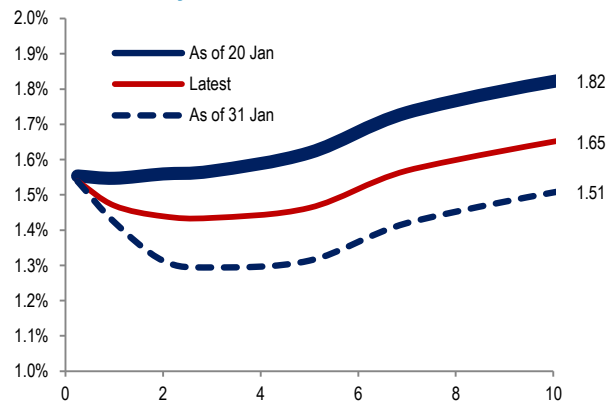
Another focus of attention amid the current coronavirus outbreak is the recovery of the correlation between Japanese and US yields. A characteristic point in the yield curve change from 20-21 January to date (see charts below) is simultaneous progress in the inversion of the 2- to 7-year zone of the yield curve in Japan and the US. The correlation between Japanese and US long-term yields recovered to 20%. In addition, the correlation between the 5-year JGB yield and the 1.5-year forward 3-month US rate (which reflects speculation on Fed rate cuts) was also restored.

Chart: JGB Yield Curve



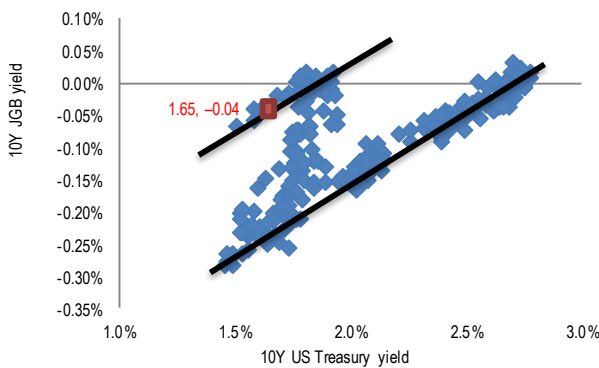
Source: Bloomberg; compiled by Daiwa Securities.

Chart: US Treasury Yield Curve



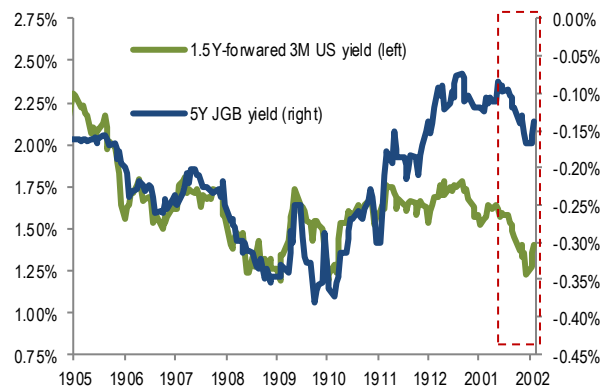
Source: Bloomberg; compiled by Daiwa Securities.

Chart: 10Y US Treasury and JGB Yields



Source: Bloomberg; compiled by Daiwa Securities.

Chart: 1.5Y-forward 3M US Yield and 5Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

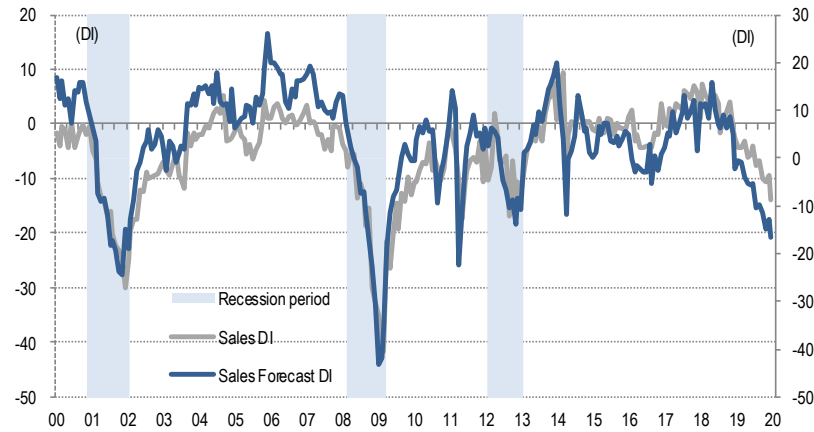
Reflecting the overnight rise in US yields, we expect JGB yields to rise mainly in the 5- to 7-year zone where the curve is partially inverted. If JGB yields rise only slightly today, the cause will be gradually increasing speculation about additional easing by the BOJ.

[In yesterday's speech](#), BOJ deputy governor Masazumi Wakatabe emphasized the downside risk of the baseline scenario, showing the stance of not hesitating to take additional easing measures if needed. It is possible that the impact of the new coronavirus on Japan will be greater than on the US, considering Japan's geographical proximity to the outbreak. Japan also has the unique downside factor of implementing a consumption tax hike.

In fact, the sales forecast DI in the SME business sentiment survey by the Japan Finance Corporation, which is a constituent of the leading CI of the Business Condition Index and can also be substituted for BOJ Tankan readings, was even worse than the level in 2012 when authorities formally recognized an economic recession. If downward pressure due to the new coronavirus is added on, the pace of SME bankruptcies could pick up. This will likely boost credit cost, particularly at regional financial institutions.

Putting aside the question of whether it will take the form of a deepening of negative interest rates, we would not be surprised if the government/BOJ takes some form of additional measures in the current situation. Although the possibility of such action actually being taken is small, speculation about additional easing by the BOJ may linger for the time being.

Chart: Sales DI and Sales Forecast DI in SME Business Sentiment Survey



Source: Japan Finance Corporation; compiled by Daiwa Securities.

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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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