Daiwa's View

What elements will influence coming developments?

➢ Long-term issues of inflation and US-China relations

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Daiwa Securities Co. Ltd.

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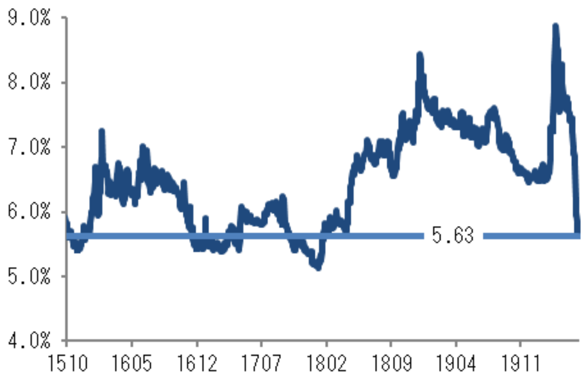
Global stock prices have experienced a historic rebound, recovering by more than 30% over the past two months since hitting bottom in late March. But, the rebound appears to have finally run its course. The BOJ-focused TOPIX earnings yield also dropped sharply from the unusual level of around 9% to the mid-5% level (see chart below). From this perspective, as well, we can say that the recent rapid rebound has ended.

The media is reporting that the market is in risk-off mode prior to the press conference by US President Donald Trump to be held tomorrow. However, since yesterday saw the US long-term interest rate rise alongside the tightening of spreads, it would be unreasonable to conclude that the market is in risk-off mode. It is likely that the press conference was used in large part as a trigger for profit-taking.

The US market is simultaneously posting tightening of high-yield corporate bond spreads and a recovery of prices of leveraged loans. In Europe, as well, the spreads of Italian government bonds are continuing to tighten. Although the unwinding of excessively pessimistic positions has run its course, the market tone is solid. Conditions are likely conducive to dip-buying.

Chart: TOPIX Earnings Yield



Source: Bloomberg; compiled by Daiwa Securities.

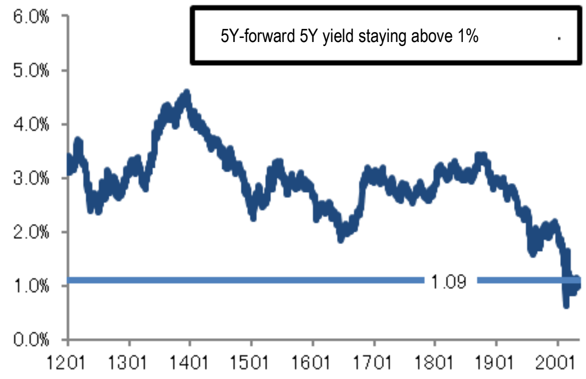
We are focusing on two elements that will influence coming developments. The first is inflation expectations (concerns about deflation), and the second is the US-China issue.

Given current employment conditions, inflation is unlikely to rise in the near term. Some point out that supply constraints will lead to inflation. However, inflation caused by supply constraints entails impoverishment, which weakens demand. Therefore, inflation will stop as the output gap is adjusted with the contraction in GDP. Unless wage hikes are observed, it is difficult to realize sustainable inflation, the mandate of central banks.

What about the future? It is highly likely that the forward guidance (and yield cap) expected to be adopted by the Fed will focus on the short-term/intermediate zone. Accordingly, the shape of the yield curve up to the 5-year sector is losing its meaning[1] even in the US Treasury market. However, the yield curve with a starting point five years ahead is still thought to contain effective economic information. Confirming the levels of yields with starting points five years ahead, the 5-year forward 5 year yield stands at 1.09%, the 5-year forward 5 year inflation expectations is 1.48%, and the 5-year forward 5 year real interest rate (= the former minus the latter) is -0.39%. These figures factor in the outlook for the future—i.e., that the US interest rate will recover to 1% due to a recovery of the inflation rate to around 1.5% amid continued monetary easing.

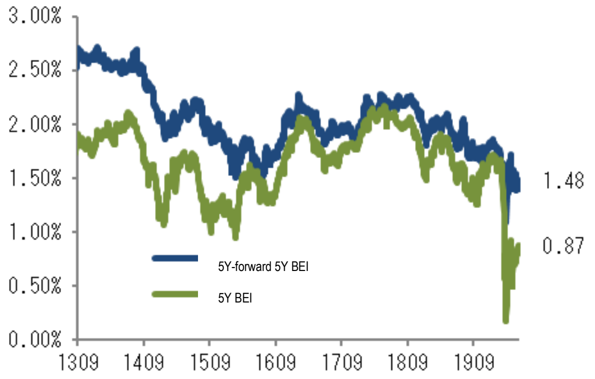
As shown by the initial 5-year inflation expectations of 0.87%, the near-term five-year inflation outlook is severe. However, it would be excessive to assume that this severity will be permanent. We should draw a lesson from equity investors who incurred substantial losses due to an overly pessimistic outlook based on deterioration of near-term earnings expectations.

Chart: US 5Y-forward 5Y Yield



Source: Bloomberg; compiled by Daiwa Securities.

Chart: US Inflation Expectations (5Y, 5Y-forward 5Y)



Source: Bloomberg; compiled by Daiwa Securities.

Going forward, the US-China issue will garner more attention. This is because the issue has been drowned out by the unwinding of excessively pessimistic positions thus far and such positions appear to have been largely squared.

The situation in Hong Kong has been worsening again, triggered by a national security bill. It has become another flash point in US-China relations, which have seen marked conflict recently regarding the coronavirus. We have little choice but to wait anxiously for President Trump's press conference tomorrow. However, from the viewpoint of the market, it is important to confirm what the consensus has been thus far and how much it has changed.

[1] This is similar to how information contained in the JGB yield curve up to the 10-year sector is becoming less effective.

In his 2007 book *The Age of Turbulence: Adventures in a New World*, Alan Greenspan wrote the following.

◆ ***The Age of Turbulence: Adventures in a New World*** **by Alan Greenspan (Nov 2007)**

・When China reestablished its sovereignty over Hong Kong in 1997, I did not hold much hope for the survival of Hong Kong capitalism. The notion that China would honor its pledge that Hong Kong would remain a bastion of capitalism for fifty years seemed to me rather naive. Capitalism and Communism side by side under the same sovereign authority was just not credible. But the decade of Deng's "One Country, Two Systems" has turned out quite differently than I feared.

Of course, the situation is nothing to be optimistic about, but the current turbulence in Hong Kong may essentially be the realization of what was anticipated by thoughtful people like Mr. Greenspan in 1997, albeit a bit latter than expected. If so, we should regard this as the realization of the phenomenon of conflict between capitalism and communism, which, in the historical context, was to be expected, and finally became manifest after about 20 years, which is close to the margin of error in historical terms.

Accordingly, careful consideration is needed regarding whether we should deem the current Hong Kong issue a near-term selling factor based only on the primary idea that "US-China conflict = risk off." If the long-term issue of expected confliction between capitalism and communism serves as a factor, how long should we continue to sell? This is a very big, long-term issue that differs qualitatively from near-term issues, and needs to be dealt with after careful consideration.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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Daiwa Securities

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