Daiwa Securities

Daiwa's View

Outlook of "equilibrium market supported by central banks"

➢ Correlation between sock prices and yields may return to positive in next risk-on phase

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Daiwa Securities Co. Ltd.

Outlook of "equilibrium market supported by central banks"

Correlation between sock prices and yields may return to positive in next risk-on phase

The market has recently been trading in a narrow range. I think it stands to reason. Currently, central banks are in a transition period from crisis responses. If risk assets become substantially overheated, central banks should remove crisis-response measures. On the other hand, if risk-off sentiment grows due to concerns about a COVID-19 second wave, extraordinary crisis-response measures would be reinforced. Under the structure of this "equilibrium market supported by central banks," the market is unable to substantially move up or down. The market is likely to remain range-bound until end-June at the earliest or mid-September at the latest.

Here, we explain the details. If the economy worsens drastically due to a second wave of infections, the market would be temporarily covered by risk-off sentiment. However, it is highly possible that we will see a recovery in a short period of time due to extraordinary monetary measures/fiscal spending. Of course, this partially depends on how serious the authorities are about such issues. However, we are only a little concerned about this point, given their awareness of the crisis. On the other hand, in the case of improvement in the coronavirus crisis, removal of easing measures would serve as a factor to suppress the market in the near term. However, the market is likely to overcome this problem at some point. In short, next time when the market gets away from this equilibrium condition, both stock prices and yields may see an upside breakout (yield steepening), although this will not necessarily happen soon.

As a driver for such a move, the maturity composition in the New York Fed's operations is attracting attention. Although the New York Fed had purchased only short-term bonds, it started purchases on a pro-rata basis on 13 March to address a liquidity crisis amid the COVID-19 pandemic, saying that "the Desk will conduct purchases across a range of maturities to roughly match the maturity composition of Treasury securities outstanding." At that time, the purpose was to maintain market functions. Since then, the New York Fed has been consistently maintaining this pro-rata method even after reducing the purchase amount in line with a recovery of market functions (see chart on next page).

Will this method to buy Treasuries return to the previous one amid a trend of withdrawal of crisis-response measures? As this issue needs to be discussed together with Fed's considerations on the yield curve, the conclusion will not be found today or tomorrow. However, the discussions may reach a certain level of conclusion by around September when the Fed is expected to announce next-stage monetary easing. One thing I can say here is that the yield curve will face steepening pressure in the case that the maturity composition in this asset purchase program returns to the previous one (pro-rata → short-term oriented).

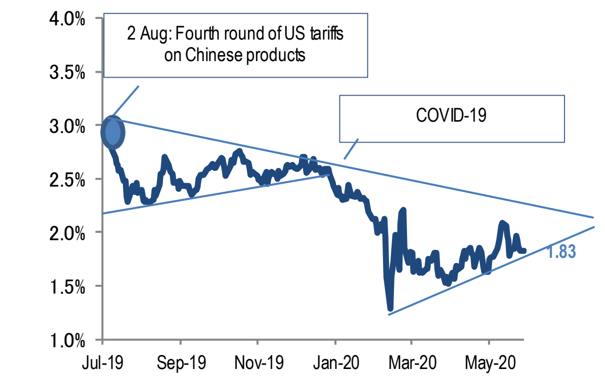
Chart: Treasury Purchase Pace at NY Fed—reduced purchases on pro-rata basis across entire yield curve thus far (prorating in line with outstanding amount)

($ bn)	Residual maturity (years)	(4 business days) Week from 6 Apr	Week from 13 Apr	Week from 20 Apr	Week from 27 Apr	Week from 4 May	Week from 11 May	Week from 18 May	(4 business days) Week from 26 May	Week from 1 Jun	Week from 8 Jun	8 Jun vs. 6 Apr
Coupon bonds	0-2.25	63.0	47.0	24.0	16.0	13.0	11.00	9.5	6.5	7.0	6.5	**10.3%**
	2.25-4.5	42.0	31.0	16.0	11.0	8.0	7.00	6.0	4.0	5.0	4.0	**9.5%**
	4.5-7	30.0	22.0	11.0	7.0	6.0	5.00	4.5	3.0	3.5	3.0	**10.0%**
	7-20	20.0	15.0	7.0	5.0	4.0	4.00	3.0	2.0	2.0	2.0	**10.0%**
	20-30	25.0	20.0	10.0	3.0	2.5	2.25	2.0	2.5	3.0	2.5	**10.0%**
TIPS	1-7.5	10.0	7.5	3.5	2.5	2.0	1.75	1.5	1.0	1.0	1.0	**10.0%**
	7.5-30	10.0	7.5	3.5	2.5	2.0	1.75	1.5	1.0	1.0	1.0	**10.0%**
	Weekly total	200.0	150.0	75.0	47.0	37.5	32.75	28.0	20.0	22.5	20.0	**10.0%**

Source: Bloomberg; compiled by Daiwa Securities.

The Fed has released a dot chart that implies a zero interest rate over the next several years, and it is expected to clarify or reinforce its forward guidance in September. This means that the focus of US monetary easing will also shift to "strengthened sustainability" going forward, unlike monetary easing to date where responses were required within a short period. For example, in the case that the Fed shares a lesson learned from Japan—the issue of side effects at financial institutions caused by the combination of "prolonged easing" and "excessive flattening," we would not be surprised if it will reconsider Treasury purchases on the pro-rata basis that leads to a decline in the term premium in the long-term zone (consistent with BOJ's passive stance toward purchase operations in superlong zone).

Chart: US Treasury Forward Yield (10Y forward 3M)



Source: Bloomberg; compiled by Daiwa Securities.

There is one chart to be noted. The US 10-year forward 3-month yield had fallen toward March due to the COVID-19 pandemic. Since then, it has been rising. This short-term trendline is expected to cross the long-term trendline around September 2020. I wonder whether the next triangle formation will also see a downward breakout.

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[Standard & Poor's]

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