Daiwa Securities

Daiwa's View

Can Fed realize ideal virtuous cycle?

- Rise in inflation expectations creating "economic stimulus effects", "dollar depreciation"

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Daiwa Securities Co. Ltd.

Can Fed realize ideal virtuous cycle?

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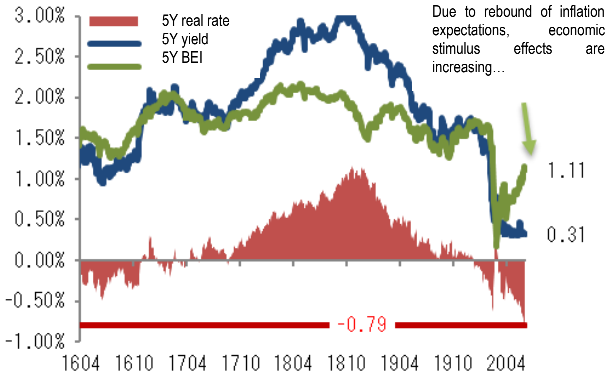
We continue to see the "equilibrium market supported by central banks." Besides a COVID-19 second wave, there are many factors that could disturb the market, such as the US presidential election and US-China and US-Europe trade friction. However, the existence of some negative factors, rather than the lack of them, actually leads to a more dovish stance at central banks. This conversely stabilizes the "equilibrium market supported by central banks."

Although it will take some time before the market breaks out from equilibrium, the scenario appears to have come in sight. Due to a clear rebound of the global economy and a recovery of inflation expectations due to the weak dollar, the 10-year US inflation expectations rose to 1.36% for the first time since 5 March 2020. The recovery of inflation expectations is driven by (not 5-year forward 5-year inflation expectations) 5-year inflation expectations, meaning that excessive pessimism about near-term prices is diminishing due to the faster-than-expected pace of economic recovery.

Under the circumstances, what should also be noted is the fact that the 5-year nominal interest rate level has been almost fixed, supported by expectations for the Fed's forward guidance. Therefore, the wider divergence between inflation expectations and the nominal interest rate directly leads to a decline in the real interest rate. The 5-year real interest rate has now declined to around the –0.8% level, which is creating the economic stimulus effects and dollar depreciation (left-hand chart on next page).

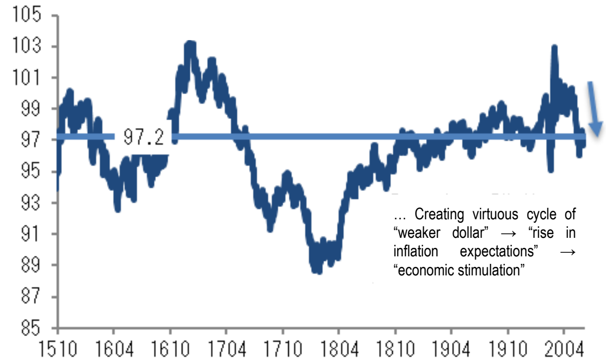
It is also notable that this depreciation of the dollar has the effect of creating a positive loop of "a further rise in inflation expectations → economic stimulus effects." This virtuous cycle of "fixation of the nominal interest rate" + "boosting of inflation expectations" ⇒ "pushing down of the real interest rate" is exactly the policy effect pursued by the BOJ since the introduction of the yield curve control (YCC) policy. We need to watch whether this virtuous cycle will continue, but we have actually started to see signs that the Fed will realize the BOJ's long-standing wish ahead of the Japanese central bank.

Chart: US Inflation Expectations and Real Interest Rate (5Y)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Dollar Index

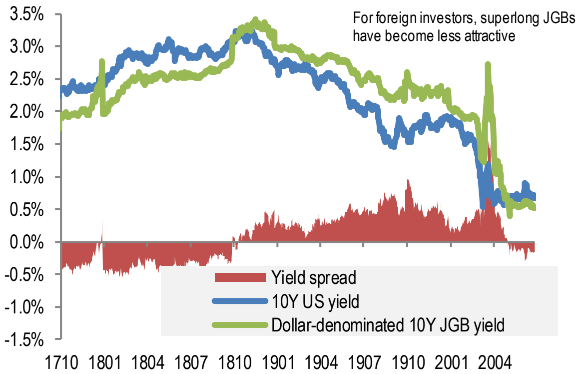


Source: Bloomberg; compiled by Daiwa Securities.

Amid this situation, a 20-year JGB auction is to be held today in the JGB market. Recently, JGB yields have been steepening driven by global factors and a supply/demand factor due to concerns about issuance increases. The auction is likely to be held at a yield level of close to 0.4% and a 10-year/20-year spread of around 38bp.

In fact, there are many steepening factors. Despite the start of substantial increases in JGB issuance from July, the 10-year JGB yield has been stable at around 0.01%. Therefore, the need is limited for the BOJ to increase the offer amount of superlong JGBs in its purchase operations[1]. In addition, it is difficult to expect purchases by foreign investors because the spread between dollar-denominated 10-year JGB yield and US Treasury yield has been in negative territory. In the statistics of the trading volume of OTC bonds released on 22 June as well, foreign investors' weak stance toward the superlong sector was confirmed (Y28.3bn in net buying in May). Moreover, a recovery trend of inflation expectations is emerging in the US, as mentioned above. We thus anticipate further steepening toward the latter half of the year, depending on developments from now on.

Chart: Spread Between Dollar-Denominated 10Y JGB Yield and 10Y US Yield



Source: Bloomberg; compiled by Daiwa Securities.

Chart: US Long-term/short-term Yield Spread and 10-year Forward JGB Yields

Source: Bloomberg; compiled by Daiwa Securities.

However, we can say that the existence of a lot of factors has enabled the JGB yield curve to steepen to that degree. Looking at 10-year forward JGB yields, the 10-year forward 10-year JGB yield and the 20-year forward 10-year JGB yield have now risen to 0.79% and 0.94%, respectively. Regarding the 10-year forward 10-year JGB yield, which is important when thinking of the yield level of 20-year JGBs, the yield does not appear overvalued even in comparison with US Treasuries (5-year/30-year spread; see chart above). In addition, the absolute level of 0.8% does not seem overvalued either.

[1] If rise in 20-year yield starts to have negative impact on 10-year yield target, offer amount of superlong JGBs in purchase operations would be raised substantially.

In terms of the 10-year/20-year/30-year butterfly, some point out that the 20-year sector is expensive on the curve. However, given the fact that (1) the 10-year JGB yield has been pegged by the YCC policy and (2) the 20-year forward 10-year yield is approaching the threshold of 1%, it is appropriate to interpret that these facts simply show the cheapness of 30-year JGBs (and risk premium). In this steepening phase, the short distance from the "10-year" sector that is pegged by the YCC has great merit.

Of course, it is difficult to expect a short-term rally, given the existence of many steepening factors. From a medium/long-term viewpoint, however, we are unable to miss the merit of accumulating positions at this level. We recommend buying at today's 20-year JGB auction, although there are conditions—unless there are extreme bidding-up activities in today's morning session.

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February 2020

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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.
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