Daiwa's View

Background behind sharp rise in US yields

➢ Similar to June market (rise in OIS and term premium)

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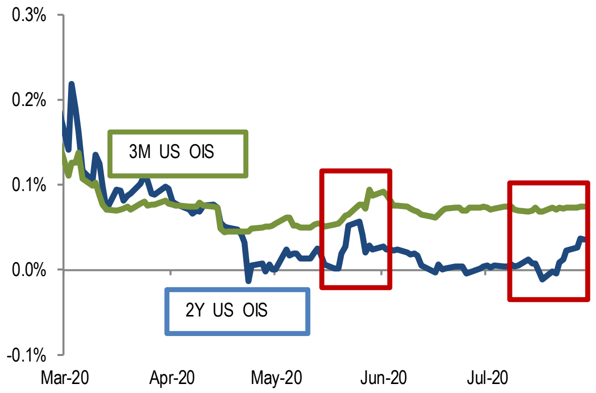
Yesterday, the market saw a decline in stocks, bonds, corporate bonds, and commodities. US stock prices topped recent highs on expectations of higher sales of Chinese automobiles, a capital gains tax break implied by President Donald Trump, and approval of a new COVID-19 vaccine in Russia. Immediately afterwards, however, yields surged, which cooled risk sentiment. After the 10-year US yield rose from 0.58% to 0.66% at one point, it temporarily declined to 0.62% in line with the plunge in stocks, and closed at 0.64%.

I think this sharp rise in yields resembles the short-term surge in yields seen in early June in terms of the following two points.

The first point is that there was a change in OIS trends, which indicate the outlook for the federal funds rate. The 2-year forward US OIS rate rose by 5bp during two weeks from -0.01% at the end of July to 0.04%. This implies that the market's outlook for the policy interest rate has changed slightly (smaller possibility of adoption of negative interest rates). Of course, Fed officials have repeatedly denied adopting negative interest rates. Nevertheless, market prices partially factored in the adoption of negative rates, and therefore correction in market prices is a natural consequence. However, it is also the case that the drop in yields due to such excessive market responses was an underlying cause of the overheating of gold prices and the NASDAQ Index. Therefore, this correction served as a driving force to reverse the recent consensus trade[1].

US OIS Rate



Source: Bloomberg; compiled by Daiwa Securities.

[1] Dollar depreciation, advance in gold prices, and rise in high-tech issues.

Important disclosures, including any required research certifications, are provided on the last page(s) of this report.

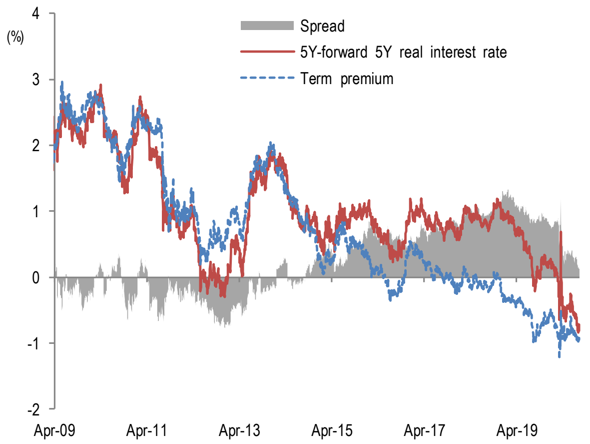
The second point is that the current rise in the 10-year yield appears to be accompanying a rebound of the term premium. The term premium in the near price range appears to have risen as the 5-year forward 5-year US real interest rate rose by around 7bp yesterday. One aspect regarding the surge in US yields in June was that concerns about tapering were induced by intermittent reduction in the New York Fed's operations. This time around, however, the cause would simply be the impact of an increase in supply (issuance).

Last week, the US Treasury Department announced the size of additional issuance of long-term US Treasuries, which exceeded market estimates. As one background factor behind this, some have pointed out the department's long-term strategy of monetizing low term premium. Of course, if the yield decline is regarded as a temporary phenomenon, we can agree with the efficacy of the national strategy that utilizes the term premium, which is now at a low level. Meanwhile, if the government makes a full-scale adjustment to the issuance of long-term bonds based on the term premium, the US Treasury Department's issuance plan has implications similar to yield curve control. If the New York Fed's ACM model is used to measure the term premium, a term premium of -1% would be one point of reference in increasing the issuance of long-term US Treasuries going forward.

In any case, we think the rise in term premium was caused by an anticipated increase in the issuance of long-term US Treasuries following the announcement of the supply plan, coupled with a duration supply due to large-scale issuance of corporate bonds.

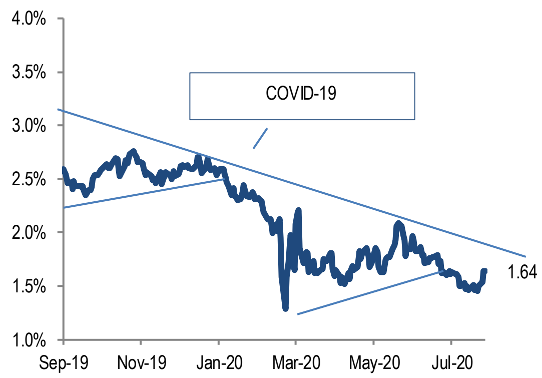
In June 2020, when we saw yields surge, the 10-year forward 3-month US yield rose to 2% at one point. After that, however, it was pushed down by a yield downtrend. Since this yield downtrend was driven by a fall in the natural rate of interest, it is difficult to assume that the current surge in yields has changed the yield trend itself, although the term premium has now rebounded. In our view, there is no need to change a buy-on-dip stance in itself.

5Y-forward 5Y US Real Interest Rate, Term Premium of 10Y Treasury Bonds



Source: Bloomberg; compiled by Daiwa Securities.

10Y-forward 3M US Yield



Source: Bloomberg; compiled by Daiwa Securities.

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[Standard & Poor's]

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[Moody's]

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[Fitch]

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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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