Daiwa Securities

Daiwa's View

Impact of Logan speech

➢ 20-year sector, TIPS to normalize due to correction to not "level" but "distortion"

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Impact of Logan speech

20-year sector, TIPS to normalize due to correction to not "level" but "distortion"

In her speech on 8 April, Ms. Lorie Logan of the New York Fed referred to adjustments of QE asset purchases. This speech appears to have had a certain degree of impact on the market. The Logan speech implied not an operation twist but "passive" adjustments of operations that were fully anticipated.

As is well known, the New York Fed is focusing on transparency, competitiveness of purchase prices, and the impact on market functions (market neutrality) in its key principles of operations. It thus seeks to carry out the FOMC directive in an efficient and effective manner by preferentially buying overly undervalued Treasuries in the sector with an advance disclosure of the schedule and the purchase amount.

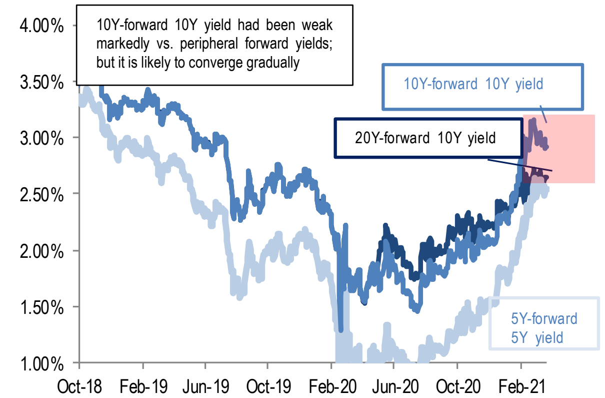
However, we knew that adjustments of operations would be needed sometime soon because of the increase in the outstanding amount of coupon bearing bonds and longer maturity due to the increased issuance since the outbreak of the COVID-19 pandemic. If operations are adjusted in the near future, this would have a relative impact on the 20-year sector, Treasury Inflation-Protected Security (TIPS), and inflation expectations (BEI), all of which have been distorted substantially thus far.

◆**Desk Operations: The New Normal** (8 Apr 2021)

As the Desk considers how to approach operations, we first and foremost seek to carry out the FOMC directive in an efficient and effective manner. In doing so, there are important operational choices to be made. The Desk's approach to these choices is guided by key principles, a few of which I would like to highlight today. First, we aim to be transparent, providing information to market participants and the public to ensure fairness and promote understanding of our purchase operations. We also seek to obtain securities at competitive and appropriate prices for the Federal Reserve, as this will ultimately benefit the U.S. taxpayer. In addition, unless otherwise appropriate for efficient and effective implementation under the directive, we endeavor to operate in a manner that is relatively neutral to the securities available for purchase and in a way that limits the potential for our operations to affect normal market functioning. In practice, we follow this principle by purchasing Treasury securities across sectors in approximate proportion to the universe of Treasury securities outstanding and by concentrating our purchases of agency MBS in recently produced securities. I would like to discuss a few changes that we have made or are planning in the Desk's Treasury, agency MBS, and agency CMBS operations that help us adhere to these guiding principles.

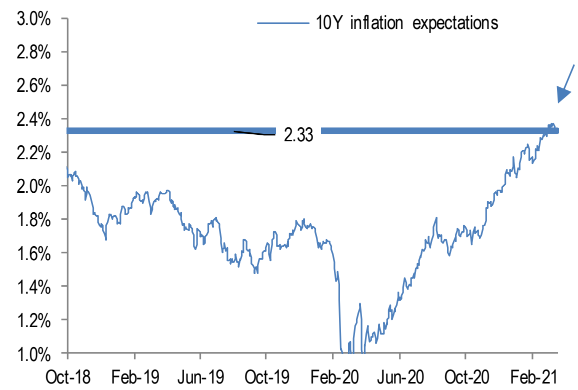
Important disclosures, including any required research certifications, are provided on the last page(s) of this report.

US Treasury Forward Yields



Source: Bloomberg; compiled by Daiwa Securities.

US BEI



Source: Bloomberg; compiled by Daiwa Securities.

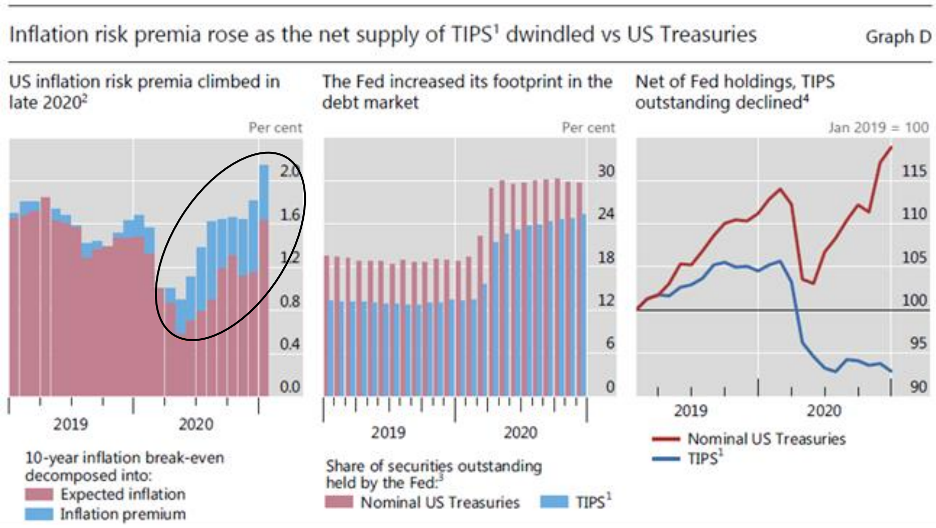
◆ **20-year sector**

It was somewhat surprising that Ms. Logan mentioned the specific "20-year" sector in the speech. That said, the weakness of the 20-year (10-year forward 10-year yield) has been marked thus far relative to peripheral forward yields (left-hand chart above). As this sector resumed issuance after the outbreak of the pandemic, it was probably referred to as a good example of sectors that need supply/demand adjustments. Due to the distortion of supply/demand conditions, the 10-year forward 10-year yield is now at a high level of 2.92%. This is expected to converge to the direction of the 5-year forward 5-year yield (2.54%) and the 20-year forward 10-year yield (2.65%).

◆ **Treasury Inflation-Protected Security (TIPS) and inflation expectations (BEI)**

As the BIS Quarterly Review pointed out in the past, the market outstanding amount of (coupon-bearing) US Treasuries has increased by 15%, while the amount of TIPS declined by more than 5% amid the increase in Treasury issuance and operations since the COVID-19 crisis. The tighter supply/demand conditions for TIPS lowered the real yield, which appears to have consequently exaggerated inflation expectations (BEI). However, as the aforementioned Logan speech mentioned the TIPS sector, relatively tight supply/demand conditions for TIPS since the COVID-19 crisis are likely to ease. This is likely to lead to less exaggeration of the BEI, which is calculated as the residual between the yield of coupon-bearing bonds and that of TIPS. As the supply/demand factor is realized as an "inflation premium" in the BIS's trial calculation (chart below), this premium may move toward previous levels.

Factor Analysis of Inflation Expectations, Market Outstanding Amount of Nominal US Treasuries and TIPS



Source: Extracted from BIS Quarterly Review.

■ ◆**Desk Operations: The New Normal** (8 Apr 2021)

Treasury Purchase Operations

Last March, when conditions were highly disrupted in the U.S. Treasury market, we purchased a wide range of securities to address broad market dysfunction—and, at times, we weighted purchases more heavily toward sectors in which conditions were especially strained. Adjustments made to the size and composition of purchases were announced in the Desk's purchase calendars, often released multiple times a week.

As market conditions stabilized, we adjusted purchase allocations to be roughly proportional to the amounts outstanding across the nominal Treasury coupon and TIPS coupon curves, and we lengthened the purchase calendars to provide more predictability in our planned operations.

As our Treasury purchases transitioned to a more proportional allocation, there were still sectors of the curve that we refrained from purchasing. For example, the Desk generally has avoided purchasing bills, both to avoid increasing scarcity value in these securities arising from strong investor demand and because bill purchases have relatively little impact on financial conditions.

Even in this steadier operating regime, we continue to adjust our purchase approach consistent with our principles. For example, we conduct periodic reviews of our allocations across purchase sectors and make modest changes in response to the evolving market environment. During the past year, issuance of Treasury securities has increased markedly as the U.S. Treasury has sought to fund pandemic-related fiscal stimulus expenditures. Even with this new issuance, the distribution of Treasury coupons outstanding has been fairly stable given the large outstanding stock of Treasury debt. However, modest shifts have occurred. In particular, the introduction of the 20-year Treasury bond has increased amounts outstanding around the 20-year maturity point. In addition, the pace of increase in TIPS issuance has been slower relative to nominal coupon securities. With net issuance expected to remain high in the near term, we anticipate that the composition of outstanding supply will continue to evolve. As a result, we plan to make minor technical adjustments to our purchase sectors and increase the frequency at which we update purchase allocations to remain roughly proportional to the outstanding supply of nominal coupon securities and TIPS. We expect to announce these as a part of a normal purchase calendar release in coming months.