Daiwa Securities

Daiwa's View

Tremendously strong demand

- I. Factors behind yield declines are shifting?
  II. Decline in overseas yields is spreading to Japan

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I. Factors behind yield declines are shifting?

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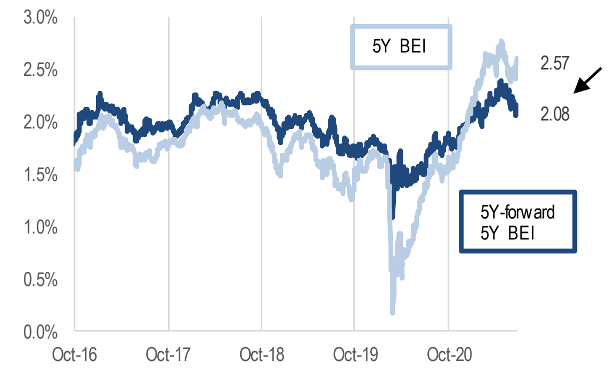
Tremendously strong demand

Yesterday, the 10-year US Treasury yield fell below 1.3% again. One week ago, we pointed out that a level of 1.2% was quite excessive for the 10-year yield and that further declines were unlikely. However, the yield returned to that level. While the 5-year breakeven inflation rate (BEI) bounced back to 2.57% reflecting strong CPI, the 5-year forward 5-year BEI fell back to 2.08% (approximately equal to 1.78% on PCE basis). Therefore, concerns are still growing that the response to near-term inflation will expose long-term inflation expectations to risk.

That said, the 5-year forward 5-year yield fell to 1.9% yesterday, and the 20-year forward 10-year yield fell by 62bp from 2.76% on 12 May to 2.14%. Given the decline in these long-term forward yields, we are observing a situation in which the factors behind yield declines are changing from the narrative of lower inflation expectations due to the Fed's hawkish stance to a decline in the longer run target federal funds rate.

One of the things Fed chair Jerome Powell has recently stopped talking about is the fall in the number of jobs compared to pre-pandemic levels. Yesterday, he stated that there should be more ways to raise the labor force participation rate. This also shows that he is more concerned about the possibility that the labor force participation rate may not recover due to structural factors such as early retirement. If the current yield downtrend were not simply short-covering but a reflection of a decline in the natural rate of interest caused by such structural factors, yields would not reverse easily.

US Breakeven Inflation Rates (5Y, 5Y-forward 5Y)



Source: Bloomberg; compiled by Daiwa Securities.

20Y-forward 10Y Yield, Longer Run

Source: Bloomberg; compiled by Daiwa Securities.

At any rate, demand for bonds is very strong. Looking at this strength, we are forced to consider that one aspect to this could be that, triggered by the COVID-19 crisis, stock effects from the cumulative bond purchase amounts via major central banks' global QE have started to spill over. Depletion of risk-free assets is one reason behind the decline in the natural rate of interest, which has been pointed out by Mr. Lawrence Summers in the secular stagnation theory, and also serves as a factor in lowering the longer-run target federal funds rate.

If this were caused by the stock effects, the situation would be unlikely to improve even if the Fed started tapering (reducing the purchase amount), and a full-scale change would be unlikely before the Fed started to reduce its balance sheets. Until then, if the issuance amount of Treasuries shifts towards reduction due to a recovery in tax revenues, we could even see a situation in which bonds face tighter supply/demand conditions.

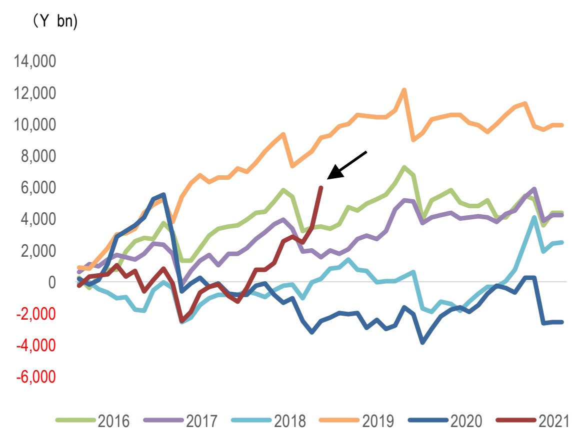
◆ **10-year JGB yield declined to 0.01%, with 20-year yield falling below 0.4%**

In the JGB market as well, the 10-year yield declined to the 0.01% level yesterday and the 20-year yield fell below the threshold of 0.4%. What we found surprising was the *International Transactions in Securities* which showed that weekly net purchases reached Y2,567.8bn, the highest among available data since FY01. With net purchases by foreign investors over the past two weeks amounting to as high as Y3.45tn, the pace of this year's purchases was the second fastest over the past five years.

With the 10-year JGB yield approaching the threshold of 0%, Japanese players should temporarily consider selling on rally. Meanwhile, it is true that it is becoming harder for us to assert that the decline will definitely stop at 0%, given (1) purchases by overseas investors (investment in JGBs) and (2) the undervalued level of 10-year JGBs from the viewpoint of the 5-year/7-year/10-year butterfly. 10-year JGBs are becoming cheap amid a rise in futures prices in tandem with lower overseas yields as well as a decline in the 7-year yield to a level below –0.1%. Therefore, one aspect to this is that the decline in overseas yields is spreading to Japan after a time lag.

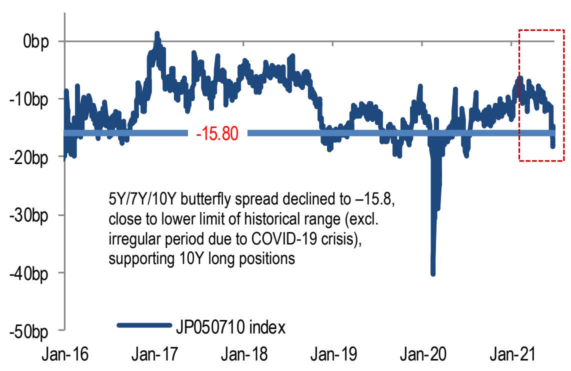
The causes of lower overseas yields may be changing from simple short-covering to deep-rooted structural factors, and, therefore, it is difficult to tell what will happen. Once JGBs show that this has happened, a 20-year yield of 0.38% (10-year/20-year spread of 37bp) will still look relatively attractive. If overseas yields do not rise, we should be aware of the possibility that the upper limit of the 20-year JGB yield has shifted to 0.4%.

Portfolio Investment Liabilities (Long-term debt securities)



Source: Bloomberg; compiled by Daiwa Securities.

JGB 5Y/7Y/10Y Butterfly Spread



Source: Bloomberg; compiled by Daiwa Securities.

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