Daiwa Securities

# Daiwa's View

## Probably a realistic response to economic peak

➢ Supply/demand conditions for bonds are likely to remain solid

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
**Eiichiro Tani, CFA**
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

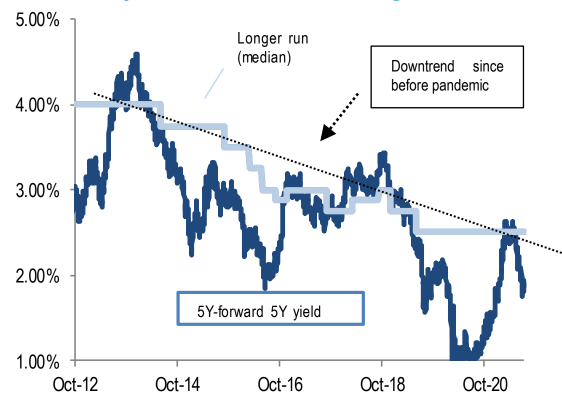
### Probably a realistic response to economic peak

**Supply/demand conditions for bonds are likely to remain solid**

Yesterday, the 10-year US yield maintained a low level at 1.1%. Viewing the 10-year yield by splitting it into the 5-year yield (5Y) and the 5Y-forward 5-year yield (5Y5Y) shows them to be balanced at the moment, with the 5Y at 0.65% and the 5Y5Y at 1.8%. The 5Y5Y has diverged as much as 70bp downwards compared to the longer-run projection for the federal funds rate (median: 2.5%). As the 5Y5Y has declined to almost the same level it was at in the latter half of 2019 when the Fed cut interest rates preemptively, room for further decline is probably limited. Looking back on the past (excl. periods with strong risk-off sentiment, such as the European debt crisis), divergences between the 5Y5Y and the longer–run projection have been within 1%.

Moreover, there have been many cases in which the longer-run projection itself has declined after a substantial divergence between the 5Y5Y and the longer-run projection. With forward real yields falling, we cannot take the projection of 2.5% itself for granted.

**US Treasury 5Y-forward 5Y Yield, Longer Run**




*Source: Bloomberg; compiled by Daiwa Securities.*

Next, we split the current 5Y into two factors, the OIS (policy rate) at 0.56% and the UST-OIS spread at 0.09%. The latter has remained unchanged at 0.09% over the past six months, meaning that the recent downtrend of the 5-year US Treasury yield is caused by a drop in the OIS yield. Plotting the current OIS curve and rate-hike scenarios (timing and pace), we find that the market is currently factoring in two rate hikes in the initial year and one rate hike per year thereafter. This current response appears to be lukewarm in light of the Fed's normalization strategy after tapering, and has diverged greatly from private-sector forecasts (among primary dealers and market participants) in surveys by the New York Fed. Going forward, this could move upward or downward.

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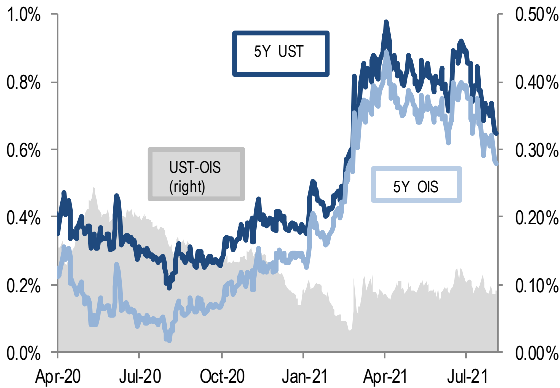
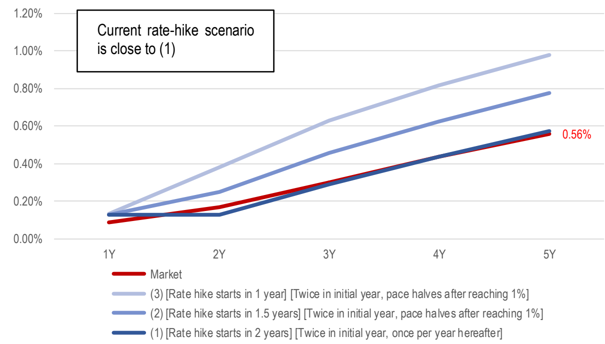
### US Treasury 5Y Yield, OIS 5Y Yield




*Source: Bloomberg; compiled by Daiwa Securities.*

### US OIS Yield Curve, Rate-hike Scenario



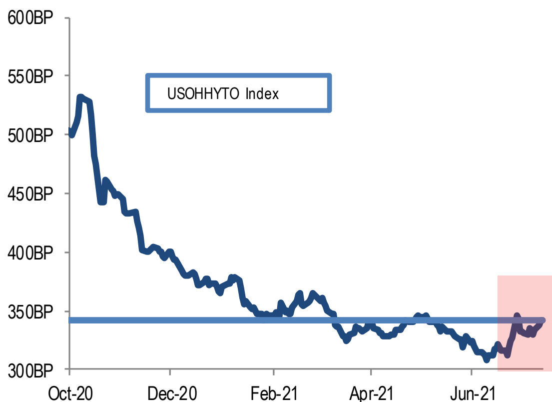

*Source: Bloomberg; compiled by Daiwa Securities.*

Currently, there aren't many comments from Fed officials about the pace of rate hikes. (Most comments focus on tapering.) If comments about the pace of rate hikes turn hawkish going forward, the 5-year OIS is expected to rise from its current level of 0.56% to around 0.8%. Meanwhile, since the Fed's rate-hike stance itself has been firmly factored in by the market, the 5Y yield could decline further if the economy loses steam and the market's rate-hike pricing itself evaporates.

In terms of economic conditions, we are somewhat worried about the fact that a slight correction is taking place in US high-yield bond spreads, from record-low levels. However, this slight correction has not reached a level that would warn of a recession. It appears to be just reflecting the peaking of the economy (the levels themselves are still high).

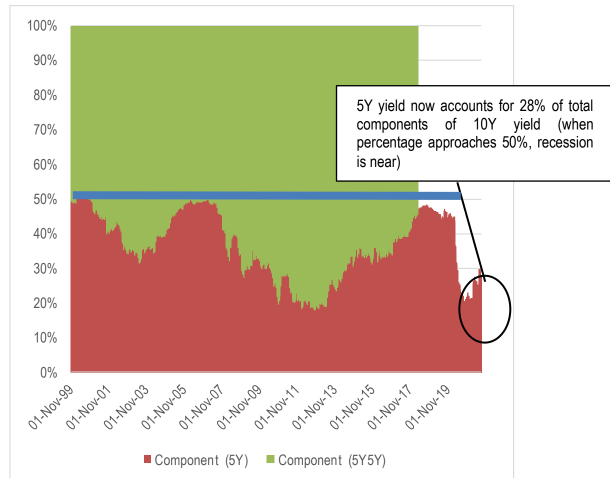
My own recession signal,[1] which uses the 5Y and 5Y5Y that have been the main focus of this report, also suggests that there is still some ways to go before we hit a recession and factors emanating from the US are unlikely to result in the market's rate-hike pricing evaporating. (The situation could change if a shock occurs somewhere other than the US.) The current state of the market can probably be described as a time of imprudent high risk-tolerance ending in anticipation of an economic peak, with investors starting to rebalance their portfolios by moving part of their funds from risk assets at high price levels into safety assets. In this situation, the more investors feel the economy is peaking, the more funds shift to safety assets. Therefore, the supply/demand conditions for bonds are likely to remain solid.

### US High Yield Corporate Bond Spread




*Source: Bloomberg; compiled by Daiwa Securities.*

### Recession Signal




*Source: Bloomberg; compiled by Daiwa Securities.*

[1] The percentage of the 10Y yield made up for by the 5Y yield and 5Y5Y yield. A recession is near when the percentage accounted for by the 5Y yield (the component in the first half of yield curve) approaches 50%.

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