Daiwa Securities

Daiwa's View

A new variant is not the only reason behind the market dive

➢ Disappearance of the Fed put

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Disappearance of the Fed put

US shares took a dive at the end of last week, the largest dive in 2021. Also in the bond market, the 5-year and 10-year UST yields sharply declined from 1.34% to 1.16% and 1.63% to 1.47%, respectively. Market participants appear to think that the dive was caused by the spread of a new coronavirus variant Omicron and low liquidity in the US market over the Thanksgiving holiday.

Of course, it is likely to be true that the new variant triggered the plunge. However, since the outbreak of the pandemic, worsening of the COVID-19 situation has basically led to higher stock prices. Such a rise in volatility occurred irrespective of our experience with the Delta variant wave. The background should not be taken lightly.

The background to this fragility is probably a change in the Fed's stance. In fact, Atlanta Fed President Raphael Bostic showed a stance of not taking the new variant's risk seriously[1], saying that "all of that is predicated on the idea and the notion that the new variant is similar to delta." This comment implies that the Fed put, which had contained market corrections thus far, has already disappeared.

As shown by a sharp drop in the University of Michigan's Consumer Sentiment Index, US consumer sentiment has worsened due to rising inflation. As President Joe Biden took the situation seriously, he said that reversing the trend of inflation was a top priority in his statement announced on 10 November. Both Jerome Powell, who was reappointed as Fed Chair, and Lael Brainard, nominated as Vice Chair, announced their resolution to contain inflation.

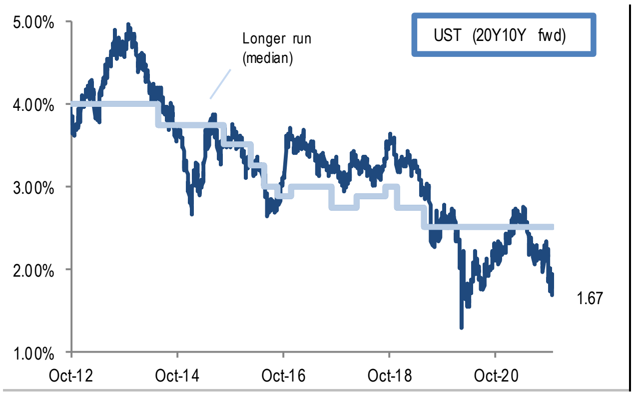
The spread of the Omicron variant and lockdowns/tighter border controls around the world could lead to prolongation of rising inflation due to the supply chain issue (short supply of goods). As the ongoing inflation is caused by two elements (demand growth and supply constraints), more accommodative measures, which lead to demand growth, is no longer an appropriate prescription when the supply side is facing additional pressure.

In other words, the Fed put is weakening in the situation where containing inflation is becoming the most important challenge, leading to a change in the structure, in which negative factors directly lead to a drop in asset prices (approximately equal to a normal structure). We presume that this is the real factor why the market plunge, which was caused by an already experienced topic of a variant strain, was so drastic.

[1] He stated that "I am very open to accelerating the pace of our slowdown in purchases" to keep inflation in check.

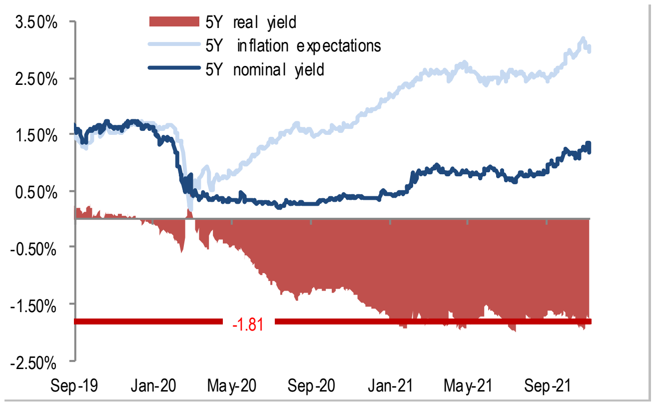
Of course, we observed several "excessive" moves in the market at the end of last week. For example, the 20-year forward 10-year US yield fell to 1.67%, as much as 83bp lower than the longer run. This appears to be too far. In addition, as the 5-year US real yield dropped to –1.81%, the low real yield is making the financial environment excessively accommodative. Although this implies that the dive in stock prices is unlikely to continue, it also implies that the Fed would not easily reverse its rate hike stance.

20Y-forward 10Y UST Yield, Longer Run



Source: Bloomberg; compiled by Daiwa Securities.

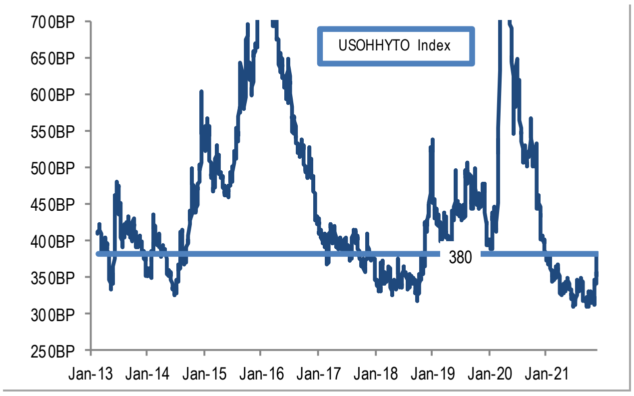
5Y UST Yields (nominal, real, inflation expectations)



Source: Bloomberg; compiled by Daiwa Securities.

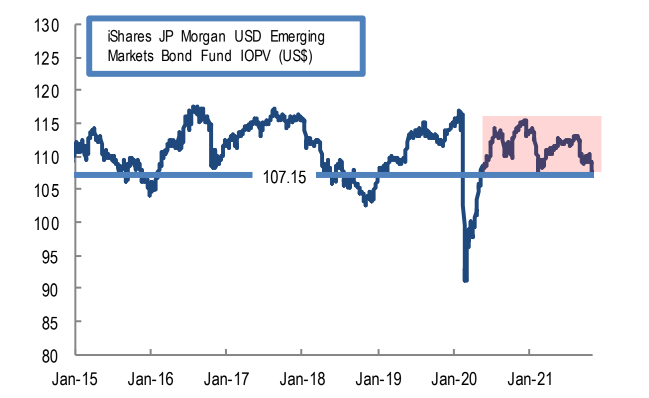
That said, observing the market only via stocks and bonds is insufficient. As the Goldman Sachs Financial Condition Index is currently at 97.2, the most accommodative level in history, the Fed has no need to feel concerned about tightening of the financial condition. However, as the impact of credit on the financial condition is large, the credit market trend warrants close monitoring in the near term. In this regard, the North American high-yield corporate bond spread has widened to 380bp, just 20bp below its market threshold of 400bp (left-hand chart below). The price of emerging market bond ETFs also fell to 107.15, the lowest value since the outset of the pandemic. As such, emerging nations may be hit by a double punch (a rise in short-term/intermediate yields and a wider spread) as their fundraising relies on dollar-denominated bonds (right-hand chart below). As we pointed out before, if a full-scale correction starts in this part, the Fed may be forced to temporarily suspend the rate hike path (as was the case in 2016).

North American High-yield Corporate Bond Spread



Source: Bloomberg; compiled by Daiwa Securities.

Emerging Market Bond ETF Price



Source: Bloomberg; compiled by Daiwa Securities.

As we reported, JGBs tend to steepen in the initial to mid-stage of the flattening of US Treasuries. If flattening of US Treasuries and risk-on market are heading toward the final stage, JGBs may be finally approaching a buying opportunity in terms of the cycle.

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