Daiwa's View

Good opportunity to buy on dips

- Buying on dips recommended for both JGB and UST yields

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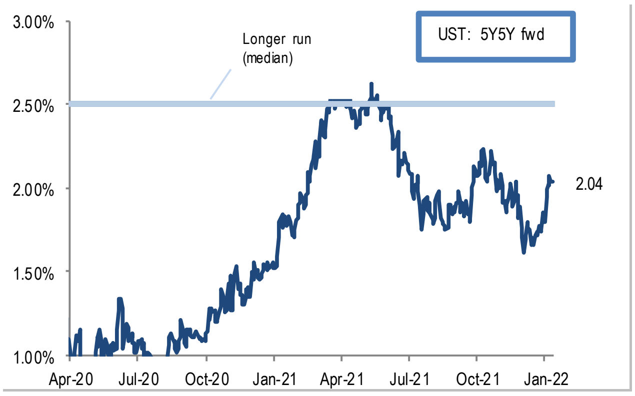
◆ Forward yields are not rising

Last night, the US market saw important movements: (1) a pause in the rise of short-term/intermediate yields, (2) bull flattening led by forward yields, (3) a rebound in stock price indices, and (4) a pause in reversals of value/growth rotations. Of note is that the forward yield stayed at the fair level of around 2%, without rising, while the number of expected rate hikes in 2022 has already reached about four rate hikes, approaching the limit at this stage. This appears to have led to the pause in rising yields, particularly the 10-year real yield.

The 5-year/30-year UST yield spread has now flattened to around 56bp. The 2-year/10-year UST yield spread also tightened to about 19bp in light of the 2-year forward 2-year/10-year spread (2-year forward yields mirror the future forecast). This warns that a recession may occur within three years if the Fed accelerates the pace of rate hikes beyond the currently-priced level (although the time frame is, of course, not limited to end-2022). Based on past experience during previous periods of rate hikes, the Fed is unlikely to ignore signals from the yield curve, which is a reliable leading indicator. Given forward yields, which are not currently rising, we think the Fed will probably focus on balance sheet reduction (QT), rather than on rate hikes, in tapering easing measures.

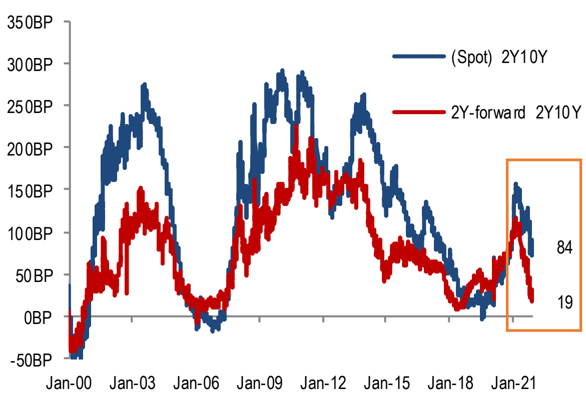
Also key is whether QT will cause a rise in forward yields. The market is confident (?) of a rise in forward yields, but if that does not happen, the uptrend in US yields will let up.

5Y5Y UST Yield



Source: Bloomberg; compiled by Daiwa Securities.

2Y10Y UST Spreads



Source: Bloomberg; compiled by Daiwa Securities.

◆ The rise in JGB yields will also let up

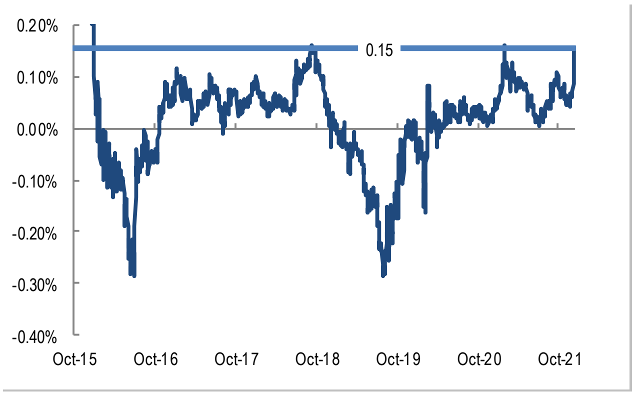
Yesterday, the 10-year JGB yield rose to 0.15%. We recommend buying on dips for the following three reasons.

The first reason is currency exchange rates. Currency exchange rates fluctuate when the market factors in expectations of rate hikes, not actual rate-hike actions (this applies to yields, as well). As mentioned above, assuming that rate-hike pricing in short-term/intermediate US yields is letting up, the possibility of a sharp depreciation in the yen will decline. This is likely to diminish the possibility that the BOJ will aggressively take a hawkish stance to prevent excessive depreciation of the yen.

The second reason is the consistency with which large-lot selling of JGB futures has taken place immediately before the close of the session, which has been observed recently several days in succession. If we can say that this pronounced movement is in line with overseas/equity market trends, such as reversals of value/growth rotations, which have also been remarkable, this selling flow may let up soon (although we can't say for sure that the selling ended yesterday).

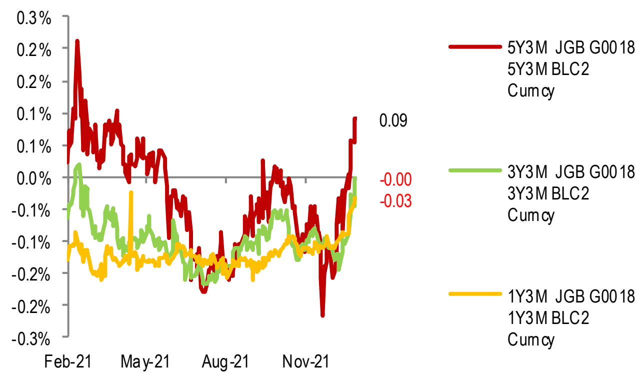
The third reason is how the level feels (rate-hike pricing). The 10-year JGB yield has now reached 0.15% (with a 5-year yield of –0.03% and 5-year forward 5-year yield of 0.33%). Given that the 10-year yield has been 0.05% at cruising speed thus far (with a 5-year yield of –0.1% and 5Y5Y yield of 0.2%), we can say that the current yield level has fully factored in a 10bp hike in the 10-year yield target. Moreover, as shown by the fact that the 3-year forward 3-month JGB yield and the 5-year forward 3-month JGB yield have risen to 0% and 0.09%, respectively (right-hand chart below), short-term yields have also fully factored in the removal of zero interest rates within five years, as well as the removal of negative interest rates within three years.

10Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Forward 3M JGB Yields



Source: Bloomberg; compiled by Daiwa Securities.

While it is highly likely that a change in wording regarding risk assessment by the BOJ in January's *Outlook for Economic Activity and Prices* report will be a first step towards removing one of the bulwarks against tapering of easing, at the moment, I am skeptical about the need to price in further rate hikes beyond the current level, which has already factored in one rate hike. In short, if the current yield level is partly formed by the aforementioned flow of JGB futures driven by overseas factors, we can recommend buying on dips before the selling of futures is reversed. If the 10-year yield changes course after rising to around 0.175%, its peak logged in Feb-Mar 2021, we recommend speeding up the pace from the small-lot buying level and considering front-loaded investment by using budget earmarked for next fiscal year.

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