Daiwa's View

Removal of bulwark against tapering of easing

- FOMC minutes included discussion of possible decline in longer run
- Change in BOJ's wording regarding risk assessment a 'first step' with long-term significance

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Removal of bulwark against tapering of easing

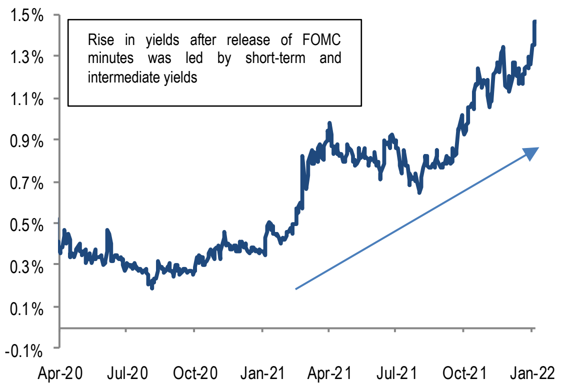
FOMC minutes included discussion of possible decline in longer run

The FOMC minutes, released yesterday, had a big impact on the market across the board. Another highlight was that the minutes included discussion of a possible decline in the longer run rate (neutral interest rate). In his press conference after the December FOMC meeting, Fed Chair Jerome Powell pointed out the uncertainty of the neutral interest rate in response to a question about the long-term interest rate, which has, mysteriously, not been rising. However, it was confirmed that the minutes used the wording "lower" regarding the neutral interest rate (and potential growth rate). As the longer-run rate is a benchmark of forward yields, it plays a major role in discussion regarding the ceiling of rate hikes. Therefore, it cannot be ignored by bond investors.

Minutes of Dec FOMC minutes (5 Jan 2022)
・…, some discussed the potential for COVID to become endemic, possibly resulting in modestly lower potential growth over time and a lower long-run neutral level of the federal funds rate..

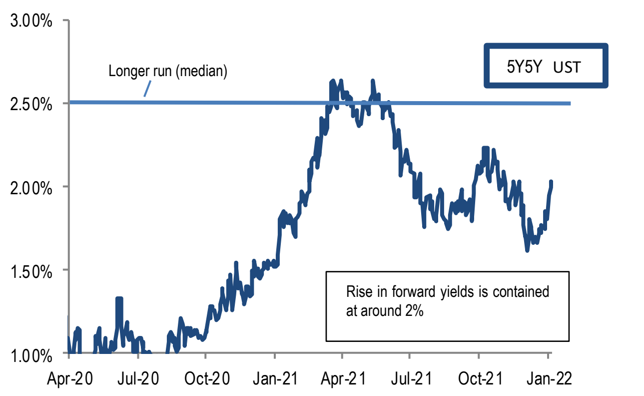
In fact, the upward momentum of the 10-year US Treasury yield increased towards the mid-1.7% level after the release of the minutes. However, price movements were mostly driven by a rise in the 5-year yield on the back of expectations of rate hikes. The 5-year forward 5-year yield stood at 2.03%, without rising, surprisingly (= flattening of the yield curve). If investors' stronger conviction about the drop in the longer run is one factor behind the lack of the rise in forward yields, despite unfavorable supply/demand conditions for bonds, it has major implications for future developments. This means that the potential for higher yields is not strong, and there is a greater possibility than previously expected for (1) the emergence of an inverted yield curve due to rate hikes and (2) policy mistakes.

5Y US Treasury Yield



Source: Bloomberg; compiled by Daiwa Securities.

5Y5Y US Treasury Yield, Longer Run



Source: Bloomberg; compiled by Daiwa Securities.

◆ Removal of bulwark against tapering of easing

Yesterday, the 10-year JGB yield rose to 0.12%. Of course, the aforementioned rise in US yields since the release of the FOMC minutes contributed greatly to this rapid rise. On this particular occasion, however, Japan-specific factors appear to be included.

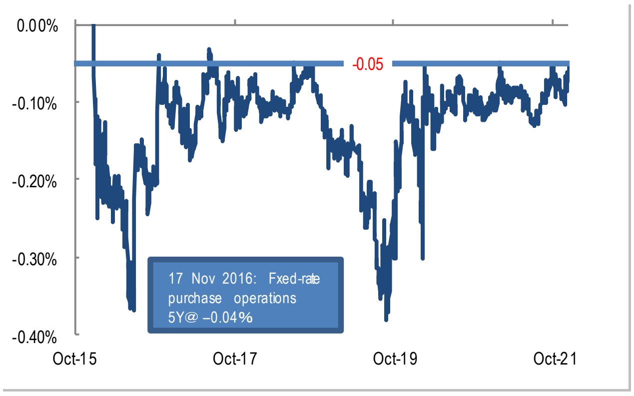
As we reported at the beginning of the year, the BOJ signaled a possible change in the assessment of risks to prices in the January *Outlook for Economic Activity and Prices* (*Outlook Report*) by using the sensitive wording "examine." In addition, in the late afternoon of 5 January, we confirmed several media articles stating that, according to those in the know, the BOJ would consider a change in risk assessment at the January Monetary Policy Meeting (MPM). This has further increased the possibility of such a change. The BOJ has been pointing out downside risks regarding prices since October 2014. If a change towards raising prices were to actually occur, it would be the first such change in seven years and three months.

Of course, the BOJ's concrete policy actions are strictly controlled by forward guidance, and, therefore, a change in the wording regarding risk in the *Outlook Report* will not necessarily lead to an immediate policy change. However, in that it would mean the removal of one of the bulwarks against tapering for the first time in seven years and three months, it can be said to be 'a first step,' the significance of which cannot be taken lightly.

Since the introduction of the yield curve control (YCC) policy, the only time the 10-year JGB yield has exceeded 0.15% has been when the following two conditions were met: when there has been a surge in US Treasury forward yields and the policy stance of the BOJ has wavered. In this case as well, with the latter condition regarding the BOJ being fulfilled, the 10-year JGB yield temporarily topped 0.1%. Therefore, we are not uncomfortable with this movement.

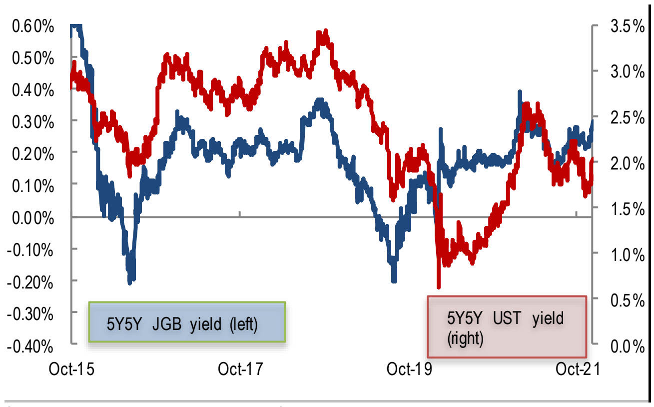
That said, we have not yet seen a surge in the 5-year forward 5-year US Treasury yield, which is the other condition. In addition, unlike the meeting in July 2018, when the fluctuation range of the long-term interest rate was widened, or the meeting in March 2021, when the fluctuation range was clarified, it is unlikely that widening of the fluctuation range will attract attention at the upcoming meeting. Although this change in the wording regarding risk assessment is a first step that has long-term significance, if we assume that the negative interest rate policy is unlikely to be removed in the near future, it will be difficult for the 5-year yield to surface to positive territory from the current –0.05%. Also, if we assume that the 10-year yield target is unlikely to be raised in the near future, it will be difficult for the 5-year forward 5-year yield to rise to 0.4% (from the current 0.3%) and stay at that level. If this is the case, the risk/reward would probably not be bad from a buy-on-dip stance against a 10-year yield of 0.12% achieved through a balance between a 5-year yield of around –0.05% and a 5-year forward 5-year yield of about 0.3%. We recommend buying on dip, aiming for a point of reference of 0.15%.

5Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

5Y5Y JGB Yield, US Treasury Yield



Source: Bloomberg; compiled by Daiwa Securities.

10Y JGB Yield Level Under Balance of 5Y Yield and 5Y5Y Yield (%)

		5Y yield								
		-0.15	-0.13	-0.11	-0.09	-0.07	-0.05	-0.03	-0.01	0.01
5Y5Y yield	0.15	0.00	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08
	0.17	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
	0.19	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09	0.10
	0.21	0.03	0.04	0.05	0.06	0.07	0.08	0.09	0.10	0.11
	0.23	0.04	0.05	0.06	0.07	0.08	0.09	0.10	0.11	0.12
	0.25	0.05	0.06	0.07	0.08	0.09	0.10	0.11	0.12	0.13
	0.27	0.06	0.07	0.08	0.09	0.10	0.11	0.12	0.13	0.14
	0.29	0.07	0.08	0.09	0.10	0.11	0.12	0.13	0.14	0.15
	0.31	0.08	0.09	0.10	0.11	0.12	0.13	0.14	0.15	0.16
	0.33	0.09	0.10	0.11	0.12	0.13	0.14	0.15	0.16	0.17
	0.35	0.10	0.11	0.12	0.13	0.14	0.15	0.16	0.17	0.18
	0.37	0.11	0.12	0.13	0.14	0.15	0.16	0.17	0.18	0.19
	0.39	0.12	0.13	0.14	0.15	0.16	0.17	0.18	0.19	0.20
	0.41	0.13	0.14	0.15	0.16	0.17	0.18	0.19	0.20	0.21
	0.43	0.14	0.15	0.16	0.17	0.18	0.19	0.20	0.21	0.22
	0.45	0.15	0.16	0.17	0.18	0.19	0.20	0.21	0.22	0.23
	0.47	0.16	0.17	0.18	0.19	0.20	0.21	0.22	0.23	0.24
	0.49	0.17	0.18	0.19	0.20	0.21	0.22	0.23	0.24	0.25
	0.51	0.18	0.19	0.20	0.21	0.22	0.23	0.24	0.25	0.26
	0.53	0.19	0.20	0.21	0.22	0.23	0.24	0.25	0.26	0.27
	0.55	0.20	0.21	0.22	0.23	0.24	0.25	0.26	0.27	0.28
	0.57	0.21	0.22	0.23	0.24	0.25	0.26	0.27	0.28	0.29
	0.59	0.22	0.23	0.24	0.25	0.26	0.27	0.28	0.29	0.30
	0.61	0.23	0.24	0.25	0.26	0.27	0.28	0.29	0.30	0.31
	0.63	0.24	0.25	0.26	0.27	0.28	0.29	0.30	0.31	0.32
	0.65	0.25	0.26	0.27	0.28	0.29	0.30	0.31	0.32	0.33

Source: Compiled by Daiwa Securities.

Of course, there are some points to keep in mind. One concern is that we are seeing some opinions expressing disfavor regarding excessive depreciation of the yen in the latest speech by BOJ Governor Haruhiko Kuroda and the Summary of Opinions at the BOJ's December MPM, etc. This implies that the BOJ is shifting its stance from prevention of excessive appreciation of the yen to prevention of excessive depreciation of the yen. If the yen weakens further to far above Y120/$, the government/BOJ may send out additional messages (possibly related to forward guidance?). If so, we need to slightly raise the point of reference for buying on dip. Therefore, we need to carefully watch whether the US yield uptrend will continue, as it causes a weaker yen by widening the difference of relative yields.

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