Daiwa's View

Decline in US yield to the 2.6% level

- ‘Speeding violation’?

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‘Speeding violation’?

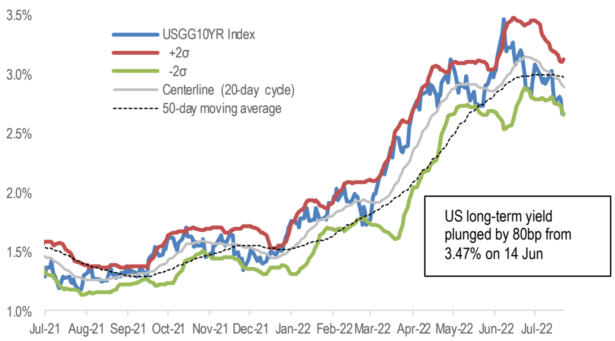
◆ Sharp drop in yields due to technical recession

Yesterday, the US and German long-term yields declined to 2.67% (down 11bp) and 0.82% (down 12bp), respectively, resulting in bull-steepening of the yield curves both in the US and Germany. As the market sensed a narrower difference in relative yields with Japan, where there is no room for rate cuts, the USD/JPY rate slid to the lower Y134 range in one stroke. We saw sharp appreciation of the yen by more than Y2 in a single day. It appears that the market has factored in the negative growth of the US economy for two consecutive quarters, with preliminary data for 2Q FY22 real GDP falling 0.9%, far below the estimate (+0.4%). The possibility of a sharp stall in the US economy and a technical recession had been pointed out in advance, but the market was nevertheless slightly surprised by the GDP data.

That said, yesterday's drop in yields felt like a ‘speeding violation,’ and we have our doubts about whether what was behind the drop will continue. The point that should not be overlooked is the rally in risk assets since the July FOMC meeting in line with the absence of rate-hike pricing. We get the impression that this is cherry picking as the market is factoring in a scenario in which the Fed successfully reins in inflation with smaller-than-expected rate hikes, and the economy is able to make a soft-landing.

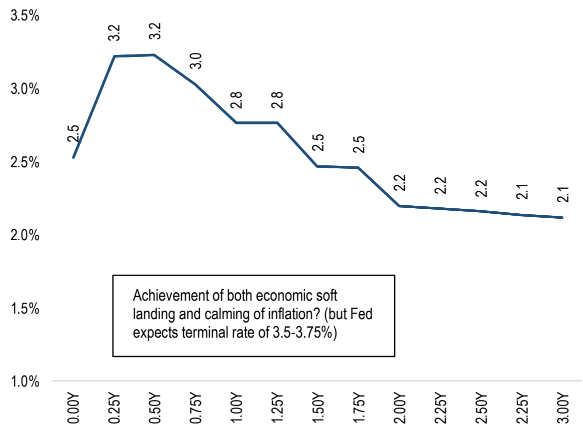
These bothersome price movements reduce the tightening effects in the financial conditions that are indispensable for taming inflation and increase the risk that the public will doubt the Fed's resolve to make justifiable adjustments to its policy stance. Therefore, the Fed may be uncomfortable with market trends since the July FOMC meeting. In the coming days, Fed officials are likely to resume making hawkish remarks. Our opinion in *Daiwa's View* reports that US yields will peak out is unchanged, but current pricing is somewhat excessive. Therefore, we need to remain aware of a certain degree of swing back.

10Y US Yield, Bolinger Bands (20-day cycle)



Source: Bloomberg; compiled by Daiwa Securities.

US OIS Forward Yield (3M)



Source: Bloomberg; compiled by Daiwa Securities.

◆ Speech by BOJ Deputy Governor Masayoshi Amamiya

Yesterday, BOJ Deputy Governor Masayoshi Amamiya made a speech at a meeting with local leaders in Iwate Prefecture in which he gave a thorough explanation about economic/price conditions and monetary policy operations. I think that this served as a good opportunity to reconfirm the view that there will not be policy revisions within FY22. The BOJ already sent a strong signal regarding that view at the July Monetary Policy Meeting (*Outlook for Economic Activity and Prices* report—i.e., *Outlook Report*). Regarding the definition of achieving the price stability target, he again emphasized in the speech that achieving the price stability target did not mean the year-on-year rate of change in the CPI temporarily reaching 2% due to an exogenous increase in import prices. He stated that what was important was to achieve a virtuous cycle where wages and prices rise simultaneously and people's living standards improve amid continued growth in the economy.

Another interesting point in yesterday's speech when considering policy revisions from FY23 onwards is the balance between remarks about overseas economic/price conditions and the BOJ's growth rate projection in the *Outlook Report.* As everyone knows, the BOJ raised its FY23 growth rate projection from 1.9% to 2.0% in the July *Outlook Report,* but it stated that "risks to economic activity are skewed to the downside." In that respect, Deputy Governor Amamiya pointed out overseas economic activity and prices as some of the two major risks to economic projections by using the IMF's *World Economic Outlook*. One point to note is that Japan's CY23 growth rate projection was lowered substantially from 2.3% to 1.7% (-0.6%) in the IMF's *World Economic Outlook*, and the revised direction was the opposite of that in the BOJ's *Outlook Report*[1].

IMF *World Economic Outlook* (Jul)

y/y % chg., % points

	CY 2020	CY 2021	CY 2022 [Forecast]	CY 2023 [Forecast]
World	-3.1	6.1	3.2 (-0.4)	2.9 (-0.7)
Advanced economies	-4.5	5.2	2.5 (-0.8)	1.4 (-1.0)
United States	-3.4	5.7	2.3 (-1.4)	1.0 (-1.3)
Euro area	-6.3	5.4	2.6 (-0.2)	1.2 (-1.1)
United Kingdom	-9.3	7.4	3.2 (-0.5)	0.5 (-0.7)
Japan	-4.5	1.7	1.7 (-0.7)	1.7 (-0.6)

Source: Excerpted from BOJ materials.
Note: Figures in brackets are the differences from the forecasts in Apr 2022 World Economic Outlook.

Projections for Japan's Economic Growth Rate (Jul *Outlook Report*)

y/y % chg.

	FY 2021	FY 2022	FY 2023	FY 2024
July forecasts	Actual +2.2	+2.4	+2.0	+1.3
Apr. forecasts		+2.9	+1.9	+1.1

While IMF substantially cut FY23 estimate, BOJ raised FY23 projection (wishful thinking?)

Source: Excerpted from BOJ materials.

Due to the technical recession in the US and the noteworthy plunge in European/US yields (albeit this felt like a 'speeding violation'), the change in overseas economic conditions has become clear to everyone. Frankly speaking, it is difficult to imagine a situation in which Japan's economy remains solid and the BOJ implements policy revisions (rate hikes) amid serious discussion about a US recession.

Based on the growth rate projection (direction) of the *Outlook Report*, we feel policy revisions within FY23 may be possible. However, when we also consider the IMF's projection (direction), we think the probability of that is not particularly high.

[1] The BOJ produces fiscal-year projections, but the IMF produces calendar-year projections.

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