Japan | Fixed Income

15 January 2024
Japanese report:15 January 2024

Daiwa's View

FICC Research Dept

New development of lower volatility → lower bond yields

- Fed staff comments in minutes for Dec FOMC meeting suggest unusual uncertainty since pandemic may be diminishing
- Lower volatility → lower yields possible this year
- Could be painful development for JGB investors who were waiting for yields to rise on BOJ policy revisions

Eiichiro Tani
81-3-5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd

The UST yield curve bull-steepened at the end of last week as the 2-year yield fell to 4.14% (down 11bp from previous day) and the 10-year yield dropped to 3.94% (down 3bp) due to lower-than-expected US PPI and other factors. The 2-year UST real yield dropped to 2% (down 14bp) for the first time since May 2023.

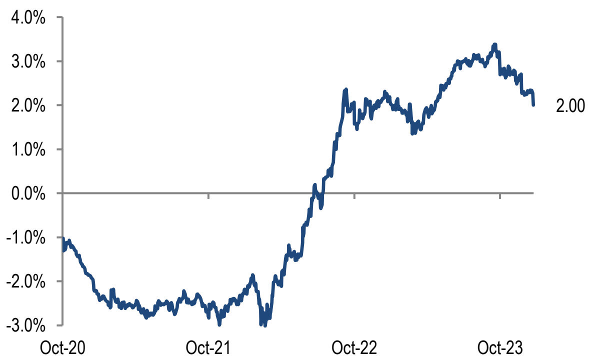
Another emerging issue is "declining volatility." The MOVE (Merrill Lynch Option Volatility Estimate) Index, a key measurement of UST market volatility, declined to 106.5 at the end of last week (see chart below). The MOVE Index rose sharply in mid-2021 in response to increased uncertainty for economic data since the pandemic and significant interest rate hikes from a behind-the-curve Fed. The index has remained above 100 for several years since then.

Declining uncertainty

That said, in this regard it is noteworthy that the Fed staff indicated in the December 2023 FOMC minutes (released on 3 Jan) that, "The volatility of incoming data and staff forecast errors generally had become less pronounced over the past year." Of course, any decline for the Fed forecast errors should lead to a reduction in volatility for the Fed's monetary policy outlook. If the Fed's forecast errors continue to decline for the two key indicators underlying the Taylor Rule (growth and inflation), the unusual post-pandemic uncertainty could reach a turning point.

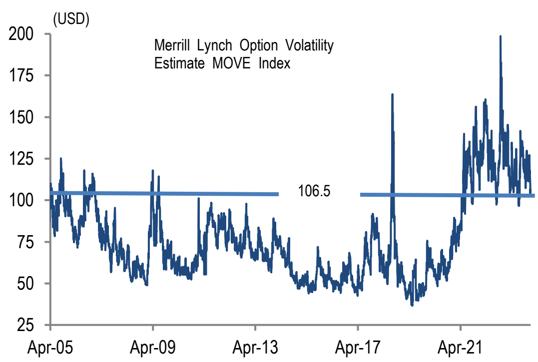
Minutes of Dec 2023 FOMC meeting (disclosed on 3 Jan 2024)
The staff continued to view uncertainty around the baseline projection as elevated, although they observed that **the volatility of incoming data and staff forecast errors generally had become less pronounced over the past year**.

2yr US Real Yield



Source: Bloomberg; compiled by Daiwa.

US Bond Volatility Index: MOVE



Source: Bloomberg; compiled by Daiwa.

FICC

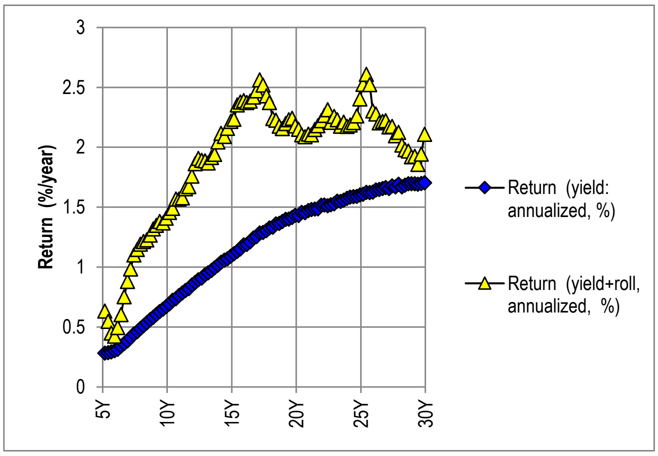
Lower volatility may accelerate development of lower yields
Coincidentally, in this report we forecast that the 10-year UST yield will remain around 4% (3.7-4.2%) for the next one to two months. Our personal impression is that it has been several years since we felt this much predictability (≈ lower volatility) regarding UST yields when formulating our forecasts.

Of course, we must remain on guard as market developments ran counter to some of our expectations over the past few years. Still, as long as the Fed's forecast errors do not shift to an increasing trend, there could be a new development at some point this year in which the MOVE Index breaks below 100, a resistance level that has been in place since mid-2021. In that case, bond investment risk/reward, as measured by the Sharpe ratio and other indicators, could improve and lower volatility could emerge, putting downward pressure on yields.

Some pain for JGB investors
The 10-year JGB yield fell to 0.585% at the end of last week. Considering the higher break-even inflation rate (≈ real interest rate decline), it is difficult to envision the 10-year JGB yield falling much below 0.5%. Meanwhile, in light of speculation about delays for BOJ policy revisions (2-year JGB yield fell to around 0% after 1 Jan Noto earthquake) and the stable outlook for UST yields, it is becoming more difficult to expect a significant 10-year JGB increase above 0.7%. Similar to UST yields, it seems that the 10-year JGB yield is becoming somewhat more predictable in regards to near-term changes.

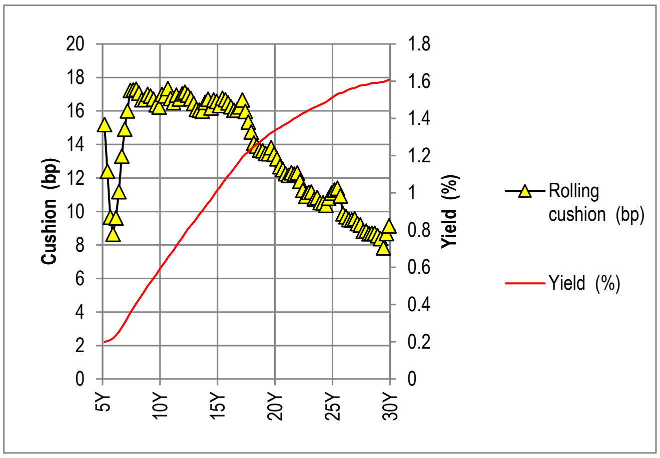
Of course, in the case of JGBs, caution about the inherent source of volatility (BOJ policy revisions) will continue to smolder. Meanwhile, it is also true that, unlike the case for US Treasuries, we can expect a steep JGB yield curve to generate relatively high carry + roll-down returns. For example, in order for carry + roll-down income to break even in the 7-17-year zone, yields would need to increase by around 17bp (lower-right chart: cushion analysis). Of course, while the probability of such a yield increase is not zero, the current state of increased JGB yield predictability reduces the probability of yields increasing significantly. The new story of declining global bond market volatility highlights the carry + roll-down appeal of JGBs and could provide some pain for JGB investors who have been waiting for BOJ policy revisions to lift yields.

JGB Carry & Roll



Source: Bloomberg; compiled by Daiwa.

JGB Cushion



Source: Bloomberg; compiled by Daiwa.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association