Daiwa's View

Simultaneous dollar depreciation and yield flattening

➢ Probably product of recovery in Europe and Fed's QE

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During a four-day weekend in Japan, the dollar weakened (euro strengthened) and yields declined (flattened) simultaneously. At the end of last week, the Dollar Index (DXY) sharply declined to 94.3, a level unseen since September 2018. On the other hand, the 30-year US yield fell to 1.23%, far below the threshold of 1.30%. I will leave detailed examinations about what is behind the dollar depreciation to forex specialists. However, I can point out the following three factors from the perspective of yields and macro-economics.

Factors behind weaker dollar/stronger euro

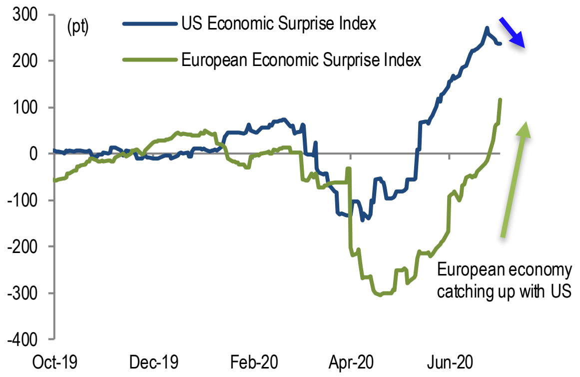
(1) Falling US yields and rising inflation expectations (decline in real interest rate a factor behind weak dollar)
(2) Agreement on the euro recovery package (re-valuation of euro zone a factor causing stronger euro)
(3) Rebound of European economic indicators (catching up with the US a factor behind euro appreciation)

The third factor was seen for the first time during the four-day weekend.[1] Specifically, the July euro zone PMI (announced at the end of last week) recovered to 51.1, which implies an economic expansion. Due to the stronger-than-expected reading, the European Economic Surprise Index sharply rebounded from 66 to 117. Meanwhile, the US is suffering from a resurgence of COVID-19 cases after the early reopening of the economy. Thus, the US Economic Surprise Index is peaking out. As witnessed by the Economic Surprise index, the contrast between the US and European economies appears to be reinforcing the ongoing trend towards a weaker dollar and stronger euro (right-hand chart below).

Dollar Index (DXY)

Source: Bloomberg; compiled by Daiwa Securities.

Economic Surprise Index in US and Europe



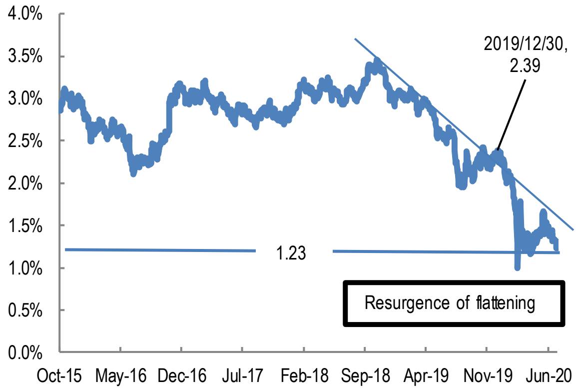
Source: Bloomberg; compiled by Daiwa Securities.

[1] We touched on the second factor in our report dated on 22 July.

Surprisingly, bull flattening of US yields continued despite the sharp depreciation of the dollar. Usually, currency depreciation boosts inflation expectations and eventually puts upward pressure on the nominal interest rate. Therefore, we rarely see the combination of currency depreciation and a yield downtrend (bull flattening).

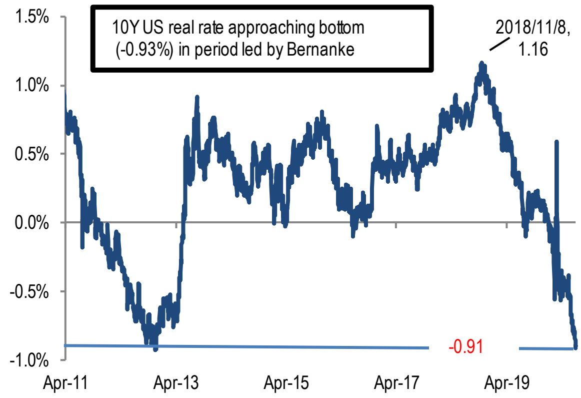
In fact, market-based inflation expectations are currently rising in line with theory, and the 10-year US breakeven inflation rate recovered to 1.5%. What is extraordinary is that the nominal interest rate is continuing to decline, despite the rise in inflation expectations. At the end of last week, the 10-year and 30-year US yields moved in the direction opposite of the rise in inflation expectations, falling below the threshold levels of 0.6% and 1.3%, respectively. As a result, the 10-year US real interest rate slid to −0.91%, close to the lowest level (−0.93% recorded in December 2012) during QE by then-Fed chair Ben Bernanke. In comparison with its peak (1.16%) in November 2018, the rate has plunged by more than 2 percentage points. This level of movement would likely have an impact on currency exchange rates.

US Treasury Yield (30-year)



Source: Bloomberg; compiled by Daiwa Securities.

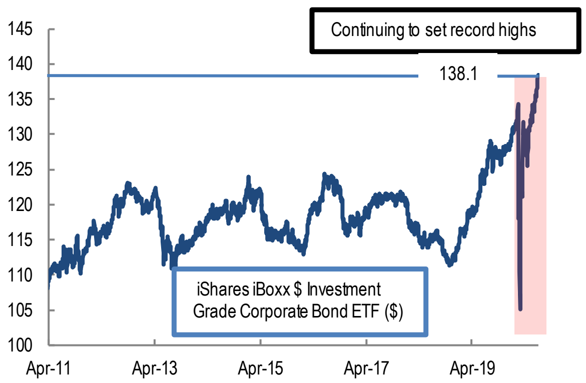
10Y US Real Interest Rate



Source: Bloomberg; compiled by Daiwa Securities.

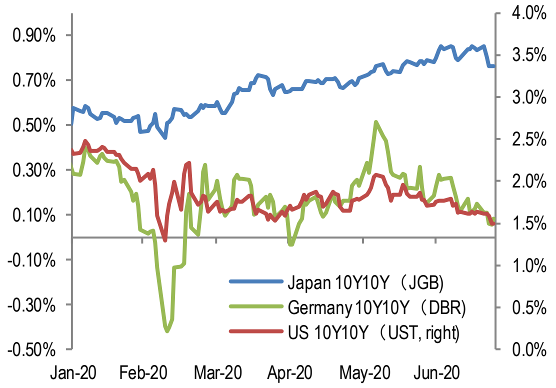
Reflecting stronger effects of monetary easing due to the decline in the real interest rate, the price of US Investment Grade Corporate Bond ETF rose to $138.1, setting record highs for consecutive days. Given the corporate bond price, it would be difficult to say that the recent decline in US yields is caused by risk-off sentiment due to concerns about US-China relations. The factor behind the recent odd simultaneous dollar depreciation and yield flattening is probably the Fed's QE and the resulting constrained term premium. Regarding JGBs, we expect steepening pressure to let up given (1) the global correlation of the term premium and (2) constrained inflation expectations caused by appreciation of the yen to Y106 in the face of the weak dollar.

Price of US Investment Grade Corporate Bond ETF



Source: Bloomberg; compiled by Daiwa Securities.

10Y-Forward 10Y Interest Rate in Japan, US, and Europe



Source: Bloomberg; compiled by Daiwa Securities.

Daiwa Securities

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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February 2020

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1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies.
As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter's outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.

2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Daiwa Securities Living Investment Corporation (8986).

3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.

4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of Y10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.

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- 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.
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