Daiwa Securities

Daiwa's View

Return of Goldilocks market

➢ Due to the Fed's stance and abundant money, yields are unlikely to rise in the near term

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Daiwa Securities Co. Ltd.

Return of Goldilocks market

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Yesterday, US stocks advanced sharply. The S&P 500 index collapsed the day before yesterday, but it exceeded the pre-collapse level and closed at 3,380pt, just short of its record closing high (3,386pt logged on 19 February 2020). While inflation expectations increased, a rise in the nominal interest rate was stopped, reflecting the solid result of the 10-year Treasury auction, which appears to have led to a recovery of risk sentiment. With real interest rates declining again, the unwinding of consensus trade seen over the past several days may have been relatively short-lived.

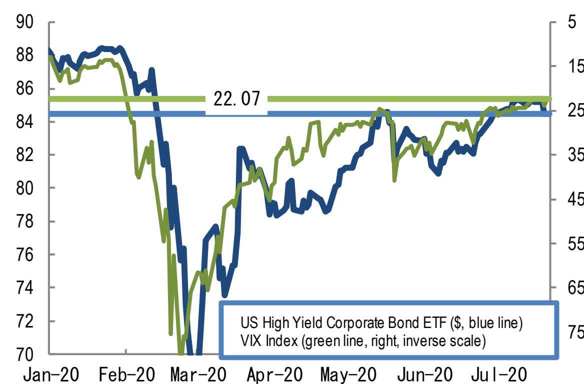
In our renewed forecasts for US stocks and yields, the structure of the Goldilocks market—high stock prices amid a lack of rising yields—is clear (left-hand chart below). The noteworthy point here is that stock prices have already risen close to their record highs, while the VIX Index is hovering at the 20pt level. Going forward, if the VIX Index declines while yields remain low, US stocks are expected to set substantial record highs amid a Goldilocks market. On the other hand, if a sharp rise in yields continues, we project a collapse of the Goldilocks market, a surge in the VIX Index, and a plunge in stock prices.

Which market development is more likely? As a major direction, we anticipate the former scenario[1], the return of a Goldilocks market. This is because yields are unlikely to rise due to (1) the Fed's stance and (2) abundant money.

S&P 500 Index, US 10Y Yield

Source: Bloomberg; compiled by Daiwa Securities.

VIX Index, US High Yield Corporate Bond ETF Price



Source: Bloomberg; compiled by Daiwa Securities.

[1] Of course, we may see a rise in yields and a drop in stock prices on a single day basis (like the day before yesterday).

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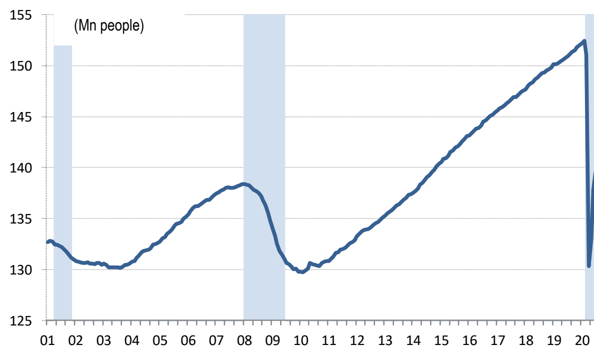
Our senior economist Kenji Yamamoto has explained repeatedly about the first point—the Fed's stance. In short, its accommodative stance is expected to be prolonged because it takes a long time for a recovery of the output gap, which is a precondition for the Fed to achieve its target of sustained inflation.

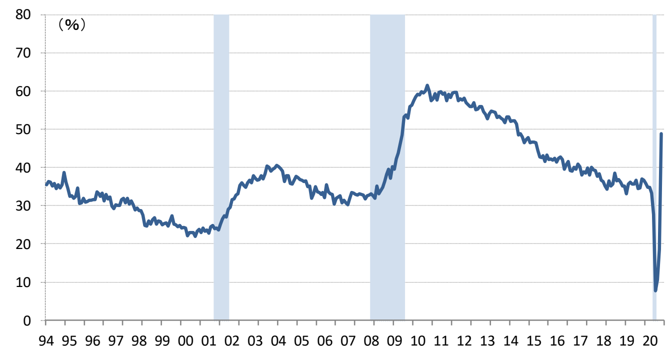
The July US jobs report was better than market estimates, and employment is continuing to recover. Before employment can recover to pre-pandemic levels, however, something will probably have to be done about worrisome signs, such as an increase in long-term unemployment and a decline in the labor participation ratio. Therefore, the jobs report is unlikely to serve as a catalyst that will change the Fed's outlook or monetary policy stance.

Total Nonfarm Payrolls in US



Source: US Department of Labor; compiled by Daiwa Securities.

Number of Unemployed (15 weeks and over)



Source: US Department of Labor; compiled by Daiwa Securities.

Secondly, money appears to be quite abundant. This throws into question the sustainability of the intuitive assumption made by many that additional issuance of government bonds equates to higher yields.

In fact, the 1970s had a financial system in which the government and the private sector vied for money amid a shortage of funds. When the government increased the issuance of government bonds under this system, the government needed to pay higher interest rates than before, and the private sector needed to attract funds at additionally higher interest rates. This caused the so-called 'crowding-out effect,' which resulted in a decline in the economic growth rate and inflation.

Meanwhile, a comparison of today's system with that of the 1970s shows that it is roughly the opposite—rather than money being in short supply, it is abundant, and the economy is falling into a 'liquidity trap.' As money velocity has declined remarkably, expansion of money supply is bringing about an increase in funds held (idle money), instead of expansion of nominal GDP. This implies that the system is different from that in the 1970s, when yields jumped substantially due to additional issuance of government bonds.

Looking at examples in Japan, according to the BOJ's loan and deposit data, loans have increased by Y28tn from February to July of 2020, while deposits have gained by Y54tn, leading to a net increase in deposits of Y26tn. On an individual level, for example, the Y100,000 benefit per person has increased deposit balances. Meanwhile, more than 80% of additional issuances of JGBs, which fund fiscal expenditures for such benefits, will be absorbed by the BOJ, leading to an increase in funds held on a net basis.

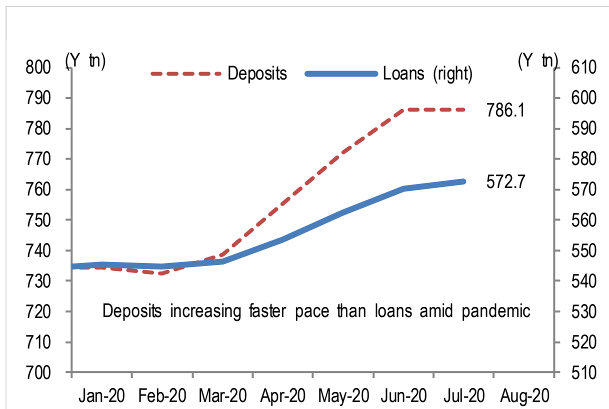
Of course, if money velocity increases, this will not be the case. However, the aforementioned examples in Japan imply that past ideas that additional issuance of government bonds equates to higher yields (crowding out-effect), which is a holdover from the 1970s, is wrong.

If the issuance of additional JGBs leans towards the long-term zone, the supply/demand balance in the long-term zone will worsen (despite an increase in the total amount of money allocated for investment) because depository institutions prefer short-term investment. Accordingly, the bias towards the long-term zone will steepen the yield curve in the short term. Due to a change in its operational stance, the BOJ intentionally gave impetus to this effect, which has steepened the curve further.

Meanwhile, if the total amount of funds held increases, the search for yields caused by abundant money will flatten the entire yield curve (risk premium) from the front-end of the curve over time. If we assume that other conditions are fixed, the issuance of additional JGBs (and accumulated deposits) will cause (1) bear steepening, (2) twist steepening, and (3) bull flattening, in that order.

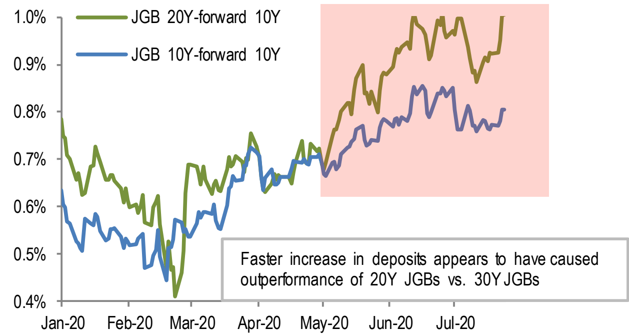
In fact, according to the developments of JGB forward yields since June, across-the-curve bear steepening has been observed as an initial reaction after the COVID-19 pandemic. Since June, outperformance of 20-year JGBs vs 30-year JGBs has been confirmed. This phenomenon reflected an increase in funds at investors (depository institutions) who are investing mainly in 20-year JGBs. The aforementioned stage may have shifted from (1) to (2). If so, this is a justified price action in the context of the Goldilocks market, and this would serve as the basis for recommending a buy-on-dip for 20-year JGBs going forward.

Deposit and Loan Trends



Source: Bloomberg; compiled by Daiwa Securities.

JGB Forward Yields (10Y-forward 10Y, 20Y-forward 10Y)



Source: Bloomberg; compiled by Daiwa Securities.

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[Moody's]

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February 2020

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