

Daiwa's View

Destabilizing US stocks and stabilizing US bonds

- Good reasons for decline in yield volatility

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Daiwa Securities Co. Ltd.

Good reasons for decline in yield volatility

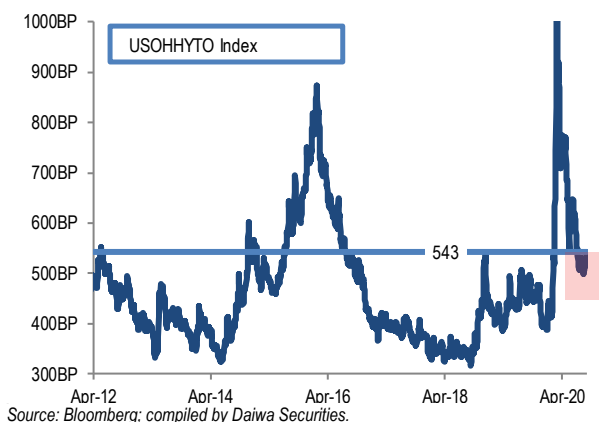
Destabilizing US stocks and stabilizing US bonds

Last night, the DJIA climbed by 140 points, rebounding for the first time in four business days. However, the index is 613 points lower than that before Japan's four-day holiday (last Thursday). The momentum of the rebound is thus not strong. The spread of US high yield bonds (USOHHYTO), a representative risk asset, also continued to worsen yesterday. Compared to the spread before the four-day holiday, it widened by 27bp (516bp → 543bp). The spread between the spot VIX and the VIX futures coming due after the US presidential election ([see our report last week](#)) also continued to widen.

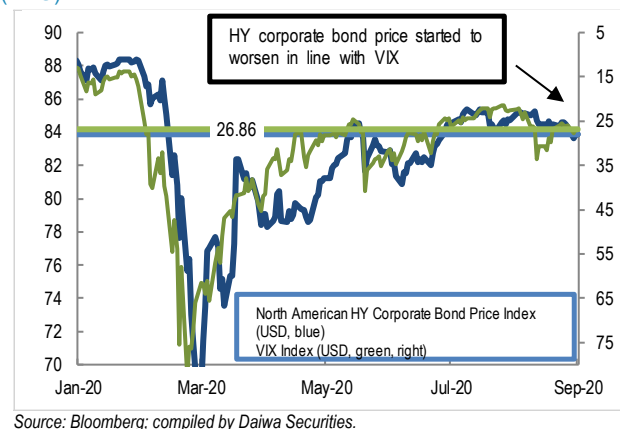
We can point out many negative factors, such as the resurgence of COVID-19 cases in Europe, a delay in US additional economic measures, the US presidential election, the nomination of the Supreme Court justice, and the revealing of money laundering by major banks. The characteristics of recent markets is that many issues are garnering attention as market catalysts. Although the market had weathered negative factors until mid-August, its mode has slightly changed.

We can say that one reason behind the change is the absence of expectations for monetary/fiscal policies. In his post-FOMC interview with Bloomberg, Dallas Fed president Robert Kaplan remarked that "Excessive risk taking ... can create fragilities and other excesses in the financial system" and that he was worried about it. This reminded us of the Fed's stance of "[not wanting further overheating](#)." We will explain the details of remarks by Fed officials in a separate report, but selling on a rally would be more likely in the near term.

North American High Yield Corporate Bond Spread



VIX Index, North American High Yield Corporate Bond ETF Price (HYG)

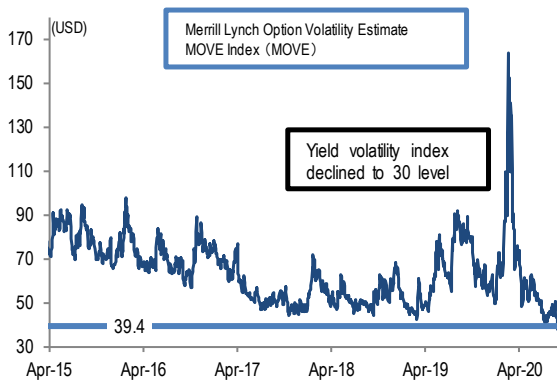


In comparison with unstable US stocks/credit like this, the stability of US bonds is noteworthy. Regarding the US long-term interest rate, the change from the level before Japan's holiday is only 1.6bp. The MOVE Index, which shows implied volatility of US Treasuries, is at the 30 level, and the historical volatility also declined to the 2%pt level. The decline in US bond volatility is clear.

As a background behind this decline, an increase in structural factors is being pointed out. Specifically, the Fed's enhanced forward guidance and the dot chart (released in last week's FOMC) showed that the US 5-year yield would be virtually pegged for the time being. This means a change to the situation where, when we examine the US 10-year US Treasury yield by dividing into the first half (5-year yield) and the second half (5-year forward 5-year yield), variable components of the 10-year yield are virtually limited to the 5-year forward 5-year yield. The variable components of the US long-term interest rate have halved compared to the previous situation.

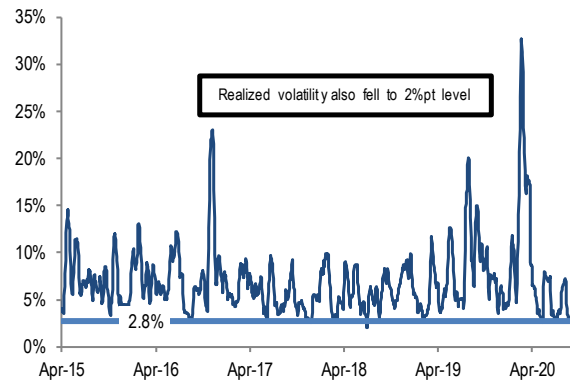
An important point here is that there are good reasons for the newly observed decline in yield volatility. This makes it difficult to expect a cyclical rebound like the one before. It is highly likely that the quality of US yield volatility has changed alongside the disconnection from data thus far. The MOVE Index fell to the 30 level for the first time ever, which may be reflecting such a structural change.

US Bond Volatility Index (MOVE Index)



Source: Bloomberg; compiled by Daiwa Securities.

Realized Volatility (US 10Y Treasury bonds)



Source: Bloomberg; compiled by Daiwa Securities.

The decline in yield volatility makes the carry-and-roll strategy more attractive and promotes a decline/flattening of the entire yield curve. It is not hard to imagine that this will accelerate “search-for-yield” moves by investors and cause “excessive risk taking, which Dallas Fed President Kaplan was worried about. In that sense, we should interpret his warning remark from the viewpoint of “a fight with a bubble” due to excessive risk taking, instead of the existing viewpoint of a “dovish” or “hawkish” stance.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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* 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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