Daiwa's View

We see tapering at end of tunnel

- ➢ We see "soft YCC" at end of tunnel

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Last week, one Fed official said a telling phrase that "we might see a light at the end of the tunnel," expecting to see the normalization of economic activities from mid-2021 when vaccines would be widely available. In addition, we could see "tapering" alongside the "light" at the end of the tunnel, which we pointed out in our 4 December report.

While we could see tapering as early as next year, does this mean a rise in yields? Obviously, this is not a flattening factor. However, the story is not simple enough to say that tapering is a steepening factor. While tapering is a concept "on an asset purchase pace," it lacks a viewpoint regarding the "asset composition" that is often mentioned by Fed officials[1].

In this respect, it is suggestive that the minutes of the November FOMC meeting stated the 28 October case by the Bank of Canada in the section of reviewing asset purchases. On 28 October, the Bank of Canada announced that it would recalibrate the QE program to shift purchases towards longer-term bonds, which have more direct influence on the borrowing rates that are most important for households and businesses, and reduce the pace of asset purchases to C$4bn/week (down C$1bn). The Governing Council judged that, with these combined adjustments, the QE program would provide "at least as much monetary stimulus as before" in total (despite tapering).

◆ **Statement at Oct Governing Council meeting of Bank of Canada** (28 Oct 2020)

The Bank is **recalibrating the QE program to shift purchases towards longer-term bonds**, which have more direct influence on the borrowing rates that are most important for households and businesses. At the same time, **total purchases will be gradually reduced to at least $4 billion a week**. The Governing Council judges that, with these combined adjustments, the QE program is providing at least as much monetary stimulus as before.

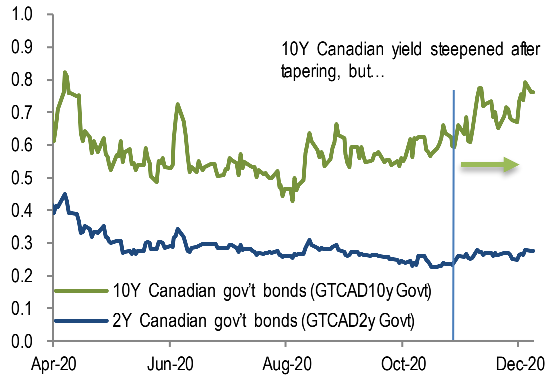
◆ **Minutes of Nov FOMC meeting** (disclosed 25 Nov 2020)

・**Pointing to the recently announced change in the Bank of Canada's asset purchase program**, several participants judged that the Committee could maintain its current degree of accommodation by lengthening the maturity of the Committee's Treasury purchases while reducing the pace of purchases somewhat.

[1] E.g., "appropriate 'pace' and 'composition' of asset purchases" used in minutes of Nov FOMC meeting.

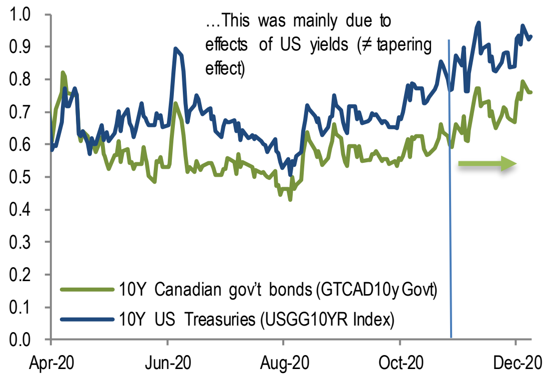
After the announcement of these measures, Canadian yields steepened. However, this was mainly caused by a simultaneous rise in US yields, rather than the decision by the central bank (right-hand chart below). If the Bank of Canada announced only tapering without announcing the shift of purchases towards longer-term bonds, much sharper steepening would have occurred. In other words, the Bank of Canada's announcement of the shift toward longer-term bonds appears to have partially contained a "premature steepening."

Canadian Gov't Bond Yield (2Y, 10Y, %)



Source: Bloomberg; compiled by Daiwa Securities.

Yield of Canadian Gov't Bonds and US Treasuries (10Y, %)



Source: Bloomberg; compiled by Daiwa Securities.

If this shift toward longer-term bonds has the effect of containing the steepening, which is inappropriate for the macro economy, it would actually have a policy effect similar to the yield curve control (YCC) policy even without clarifying the specific maturity and levels like the BOJ. The so-called "soft YCC," like this, can be regarded as an appropriate policy in the current situation where the economy has started to recover after government debt swelled to the wartime level due to the COVID-19 pandemic.

First, YCC boosts an economic recovery and arouses a rise in inflation expectations by containing a rise in yields (decline in easing degree) that should happen by right in the economic recovery stage. This is an effective easing tool for central banks which are facing the effective lower bound.

Second, we can expect the aspect of stabilizing the fiscal path (= sovereign credit) by inhibiting the possibility of an unexpected surge in the government's interest payments, as a collateral effect. This was the effect anticipated under the American YCC in the 1940s, including World War II[2]. However, the soft YCC is expected to exhibit the effect of supporting the creditworthiness of issuers also during the current COVID-19 crisis, where debt swelled to the wartime level. Stated in a more modest manner, this is likely to provide necessary support when the government conducts fiscal spending.

As shown by the formula of "government's interest payments = debt outstanding x borrowing rate," a rise in the borrowing rate before the progress of debt reduction entails a heavier burden of interest payments. If the interest payment burden becomes heavy, the government would hesitate to implement fiscal spending (necessary for higher inflation) and adversely incline toward "tax hikes."

In the end, yields, inflation, and public finance are inseparably linked, and therefore the "premature steepening," which damages the macro economy, needs to be controlled. For the purpose of this, soft YCC via the shift to longer-dated bonds and other measures is likely to play a role as a monetary easing tool at central banks in each country. The yield curve is unlikely to easily steepen as sharply as market participants are saying[3].

[2] Refer to our 2 Jul 2020 report: *Daiwa's View—YCC observations series (2): History and implications of American YCC in the 1940s*.
[3] What should be controlled here is not flattening of yield curve but excessive steepening. Central bank officials repeatedly say that marginal easing effect is limited from pushing down already low long-term/superlong yields.

◆ **Statement at Oct Governing Council meeting of Bank of Canada** (28 Oct 2020)

Bank of Canada will maintain current level of policy rate until inflation objective is achieved, recalibrates its quantitative easing program

The Bank of Canada today maintained its target for the overnight rate at the effective lower bound of ¼ percent, with the Bank Rate at ½ percent and the deposit rate at ¼ percent. The Bank is maintaining its extraordinary forward guidance, reinforced and supplemented by its quantitative easing (QE) program. The Bank is recalibrating the QE program to shift purchases towards longer-term bonds, which have more direct influence on the borrowing rates that are most important for households and businesses. At the same time, total purchases will be gradually reduced to at least $4 billion a week. The Governing Council judges that, with these combined adjustments, the QE program is providing at least as much monetary stimulus as before.

The global and Canadian economic outlooks have evolved largely as anticipated in the July Monetary Policy Report (MPR), with rapid expansions as economies reopened giving way to slower growth, despite considerable remaining excess capacity. Looking ahead, rising COVID-19 infections are likely to weigh on the economic outlook in many countries, and growth will continue to rely heavily on policy support.

In the United States, GDP growth rebounded strongly but appears to be slowing considerably. China's economic output is back to pre-pandemic levels and its recovery continues to broaden. Emerging-market economies have been hit harder, especially those with severe outbreaks. The recovery in Europe is slowing amid mounting lockdowns. Overall, global GDP is projected to contract by about 4 percent in 2020 before growing by just over 4 ½ percent, on average, in 2021–22.

Oil prices remain about 30 percent below pre-pandemic levels. Meanwhile, non-energy commodity prices, on average, have more than fully recovered. Despite continued low oil prices, the Canadian dollar has appreciated since July, largely reflecting a broad-based depreciation of the US dollar.

In Canada, the rebound in employment and GDP was stronger than expected as the economy reopened through the summer. The economy is now transitioning to a more moderate recuperation phase. In the fourth quarter, growth is expected to slow markedly, due in part to rising COVID-19 case numbers. The economic effects of the pandemic are highly uneven across sectors and are particularly affecting low-income workers. Recognizing these challenges, governments have extended and modified business and income support programs.

After a decline of about 5 ½ percent in 2020, the Bank expects Canada's economy to grow by almost 4 percent on average in 2021 and 2022. Growth will likely be choppy as domestic demand is influenced by the evolution of the virus and its impact on consumer and business confidence. Considering the likely long-lasting effects of the pandemic, the Bank has revised down its estimate of Canada's potential growth over the projection horizon.

CPI inflation was at 0.5 percent in September and is expected to stay below the Bank's target band of 1 to 3 percent until early 2021, largely due to low energy prices. Measures of core inflation are all below 2 percent, consistent with an economy where demand has fallen by more than supply. Inflation is expected to remain below target throughout the projection horizon.

As the economy recuperates, it will continue to require extraordinary monetary policy support. The Governing Council will hold the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. In our current projection, this does not happen until into 2023. The Bank is continuing its QE program and recalibrating it as described above. The program will continue until the recovery is well underway. We are committed to providing the monetary policy stimulus needed to support the recovery and achieve the inflation objective.

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[Standard & Poor's]

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[Moody's]

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[Fitch]

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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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