

Daiwa's View

Will dollar depreciation cause surge in inflation?

- Term premium has room to decline by around 8-10bp

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Daiwa Securities Co. Ltd.

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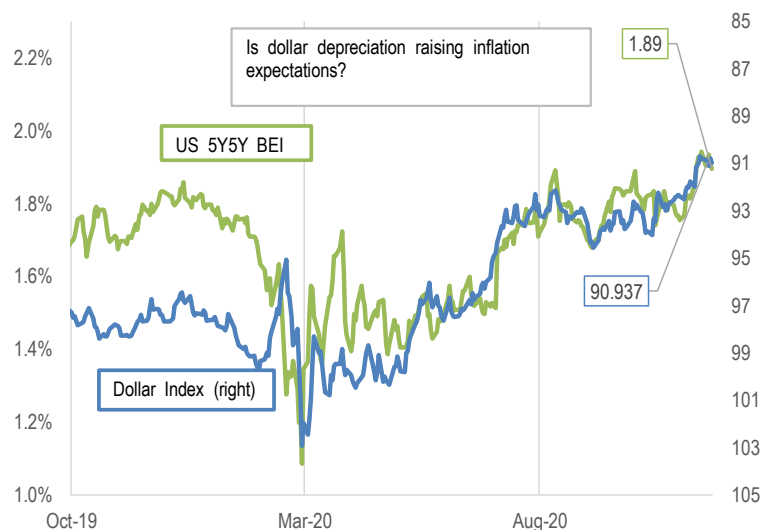
Will dollar depreciation cause surge in inflation?

Since March 2020 when the COVID-19 crisis became serious, the US 5-year forward 5-year breakeven inflation rate (5Y5Y BEI, hereafter in this report) has been rising in line with the Dollar Index (DXY). Given this fact, we attribute the rise in market-based inflation expectations since the outbreak of the pandemic mainly to the contribution from "dollar depreciation."

In fact, the 5Y5Y BEI reached 1.94% at one point alongside an accelerated depreciation of the dollar since the beginning of December (slid to 1.89% at end of last week). The average for the 5Y5Y BEI since the beginning of December stood at 1.91%, around 12bp above the average for January 2020 (1.79%).

If we interpret this data straightforwardly, the market currently anticipates not only a recovery in inflation to the pre-pandemic level, but also a rise beyond the pre-pandemic level. In addition, if we assume that this relationship between the two continues going forward¹, the weak dollar trend would continue next year, and in the case of the Dollar Index of below 89pt, it is calculated that the 5Y5Y BEI will be boosted to the level above 2%.

US 5Y5Y BEI, Dollar Index

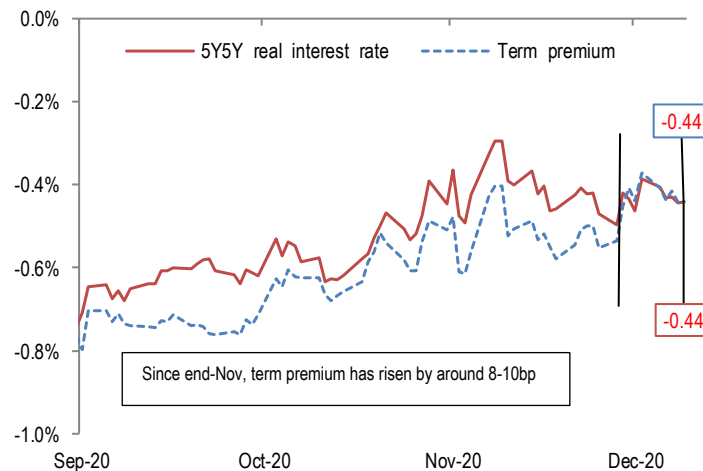


Source: Bloomberg; compiled by Daiwa Securities.

¹ Given aspect that rise in inflation expectations is accelerating dollar depreciation, causal relationship between the two unclear. In addition, historical correlation between the two not as strong as currently observed level.

I leave full-fledged discussions on the outlook for the weaker dollar to FX analysts, but an interesting point is the movements of the 5Y5Y real interest rate and term premium. Usually, a strong correlation can be observed between the two data. Since the end of November, however, the term premium has risen, filling the gap that had existed between the two data, which served as upward pressure on the US long-term interest rate.

US 5Y5Y Real Interest Rate, 10Y Term Premium (ACM model)



Source: Bloomberg; compiled by Daiwa Securities.

Generally, the interest rate is analyzed by dividing it into the “real interest rate” and “inflation expectations.” Similar to this, the term premium is divided into “a part belonging to the real interest rate” and “that belonging to inflation expectations (= inflation risk premium).” Based on this breakdown, the fact that the degree of rise in the term premium since the beginning of December was higher than that of the 5Y5Y real interest rate implies a rise in inflation risk premium. Putting aside whether the actual inflation will rise, if inflation risk premium has risen since the beginning of December, there might have been a certain degree of concern about the possibility (tail) that the weak dollar will cause a surge in inflation, in our view.

While market participants appear to be aware of the possibility of a spike in inflation, we think that this does not coincide with the Fed’s recognition at least. On 23 November 2020, Chicago Fed president Charles Evans stated that inflation was unlikely to reach the Fed’s 2% target until late 2022 or even 2023. This remark suggests that there will be no major change in inflation projections in the Summary of Economic Projections to be released at this week’s FOMC meeting. If so, a major change in the dot chart is not expected either. Needless to say, the Summary of Economic Projections and the dot chart are important points at this week’s FOMC meeting.

◆ Chicago Fed President Charles Evans (23 Nov 2020)

We are not expecting the funds rate to be raised before 2023—probably late, maybe even 2024 in my opinion. Inflation is unlikely to reach the Fed’s 2% target until late 2022 or even 2023.

In addition, the aforementioned BEI and inflation risk premium that belongs to the BEI represent the concept for “residual.” What are actually traded in the market are two products of US Treasuries and Treasury inflation-protected securities, and the BEI is calculated as a residual of the two products. Of course, the residual includes “other” elements. However, as “other” elements reverse to the mean (zero) in the long term, they are not regarded as independent terms. In other words, if the rise in inflation risk premium that appears to have occurred since the end of November belongs to “other” elements, this would disappear over time. All in all, we can calculate that the term premium of the US long-term interest rate has room to decline by around 8-10bp from the current level of -0.44%.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")

The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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[Fitch]

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Other Disclosures Concerning Individual Issues:

- 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 ¥10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.
- 5) Daiwa Securities Group Inc. and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group Inc. is to acquire up to 5.01% of Credit Saison's total common shares outstanding (excl. treasury shares; as of 31 Jul 2019).

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- 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.

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Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

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