Daiwa's View

Will inflation expectations rise further?

➢ Hurdle high, but some changes should be carefully watched

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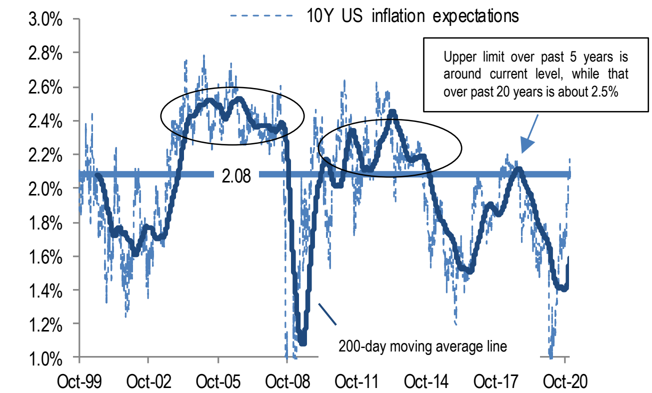
One characteristic of the rise in interest rates in the latter half of last year was that the rise in inflation expectations was in tandem with the nominal interest rate (happy interest rate increase). Inflation expectations are now around 2.1%, but will they continue to rise? In other words, will the happy interest rate increase continue from now on?

First, we confirm the actual results of inflation expectations over the past 20 years. On an average moving basis, the upper limit is around 2.5%, which was seen during the period before the global financial crisis (2004-08) and the final stage of the previous QE led by Ben Bernanke (2013). Meanwhile, looking at the past five-year span, the approximate upper limit is the current level (2.08%) plus 10bp.

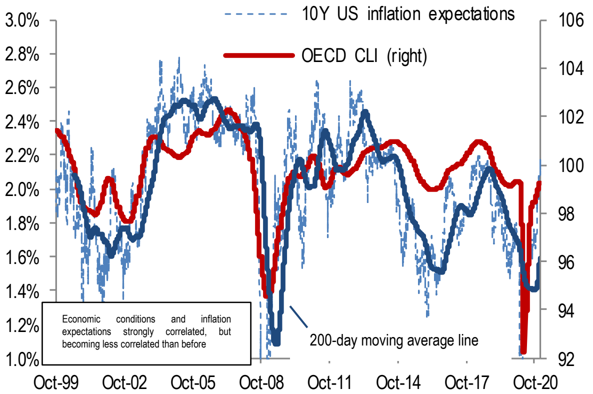
In examining the long-term span, the impact of the economic trend is, of course, strong. In that respect, the observation alongside the OECD Economic Leading Indicator shows that the impact of the economic trend is strong. However, we find that the tendency has become weaker than before (right-hand chart below). In the chart, the economic condition and inflation had been largely correlated before the global financial crisis, but since the crisis we have seen a clear picture of a weaker correlation, which reflects the flattening of the Phillips curve. The flattening of this curve is one of four key economic developments[1] that motivated the Fed to adopt a soft average inflation target at the Jackson Hole symposium and the September FOMC meeting.

10Y US Inflation Expectations, 200-day Moving Average Line



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Inflation Expectations, OECD Composite Leading Indicator



Source: Bloomberg; compiled by Daiwa Securities.

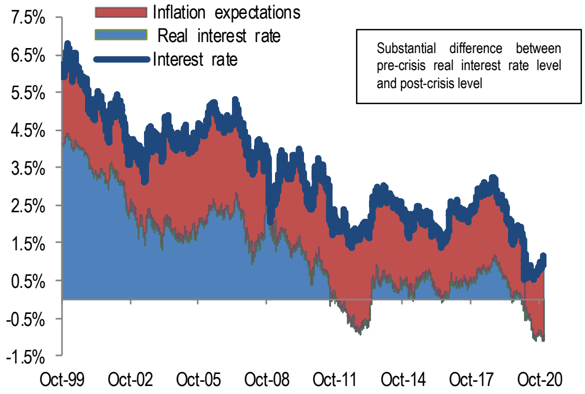
[1] Decline in potential growth rate, decline in equilibrium real interest rate (natural rate of interest) and constraint in effective lower bound, rise in inequality (those who had been left behind), and flattening of Phillips curve.

Currently, the US economy is in the recovery stage from the COVID-19 pandemic. In addition, a temporary overheating is anticipated in the near term, due to the Biden administration's fiscal stance and pent-up demand in reaction to voluntarily restricted activities. In terms of the cycle, the US economy is now definitely in the stage where inflation expectations rise easily.

Meanwhile, we need to pay attention to the fact that such a rise will be seen under a flatter Phillips curve than before. Before the global financial crisis, when inflation expectations had been at above 2.5%, the real interest rate was at 2% and the 10-year interest rate was at 4% (= 2% +2%; Fisher equation). This fact that the Fisher equation was held alone shows a substantial change in the economic structure between then and now.

Of course, it is true even now that the stronger an economic recovery, the higher the inflation expectations. Even if the economy recovers, however, the aforementioned change implies the inappropriateness of us assuming a rise in inflation expectations similar to those before the global financial crisis.

10Y US Interest Rate, Real Interest Rate, Inflation Expectations



Source: Bloomberg; compiled by Daiwa Securities.

For that reason, the Fed announced its intention to change the framework at the Jackson Hole symposium in August 2020. The existence of this "new framework" is an important point to boost inflation more than before, pushing back the rate-hike timing. Under the new framework, Fed officials have become more generous about the rise in inflation than before, creating a structure in which the average value tends to rise compared to the previous one.

◆ **Chicago Fed president Charles Evans** (4 Jan 2021)

- For me, getting inflation moving up with momentum and delivering rates around 2.5% is important for achieving on our inflation objective in as timely a manner as possible.

In addition, a deeper conflict between the US and China shows the twilight of "economic globalization," which had pushed down the price level in advanced nations and helped inequality rise. If we assume China's joining in the WTO in 2001 as a symbol of economic globalization, the current US-China conflict is a symbol of opposite moves. This means that not "benign" but "pernicious" inflation is likely to emerge more easily than before.

Given the aforementioned factors, we can conclude the question at the beginning of this report—the hurdle is high, but there are some changes that should be carefully watched. It is difficult to hope that inflation expectations will remain high, as was the case before the global financial crisis when the economic structure was different from the current one. However, the Fed is hoping for that level and accepts a rise in inflation to around 2.5%. As a result, we may see wavering developments in some cases, as was the case during QE led by Mr. Bernanke.

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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%.

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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- 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.
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