Daiwa Securities

Daiwa's View

A return to reflation trade is not the only reason behind US yield steepening

- We should not expect JGBs to steepen like USTs

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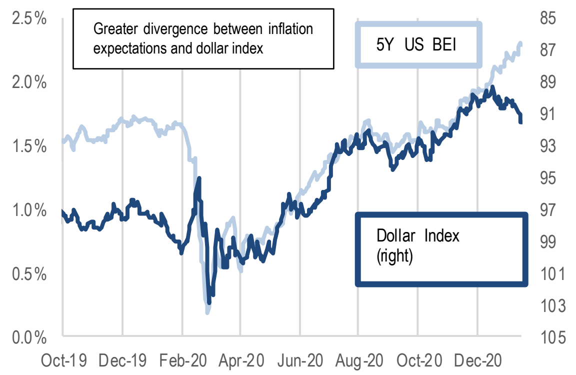
A return to reflation trade is not the only reason behind US yield steepening

◆ Return to reflation trade?

It is true that the US 5-year/30-year spread has steepened to 147bp for the first time in around five years. However, I am somewhat unconformable with describing this as 'reflation trade' probably because the currently observed market is not a return to the market seen during August-December 2020.

A confirmation of trends in inflation expectations and foreign exchange rates shows a clear difference between then and now. Inflation expectations and the Dollar Index had been strongly correlated since the outbreak of the COVID-19 pandemic. However, the dollar is now strengthening despite the continued rise in inflation expectations, as shown by yesterday's rise in the Dollar Index to 91.5. Something is definitely changing.

US 5Y Breakeven Inflation Expectations, Dollar Index



Source: Bloomberg; compiled by Daiwa Securities.

Probably, what is currently happening is a situation in which the US economy is the only winner among advanced nations. A comparison of the PMI and unemployment rate shows a clear difference between the US and other nations. While remarkable improvement in the US economic outlook is raising inflation expectations in a straightforward way, the structure appears to have changed to one in which the relative strength of the US economy is easily leading to appreciation of the dollar (correction of dollar depreciation). If we assume that we have come to a stop in 'dollar depreciation,' which has supported US inflation expectations thus far, a yield uptrend from now on will be driven by the real interest rate more than before.

As we mentioned before, the upper limit of the 10-year yield during a stage of 'fortunate' increases in interest rates is around 1%. If the yield rises beyond this level, we will shift to a different stage. Since the simplistic term 'reflation trade' masks this difference, that wording appears to be causing a sense of unease.

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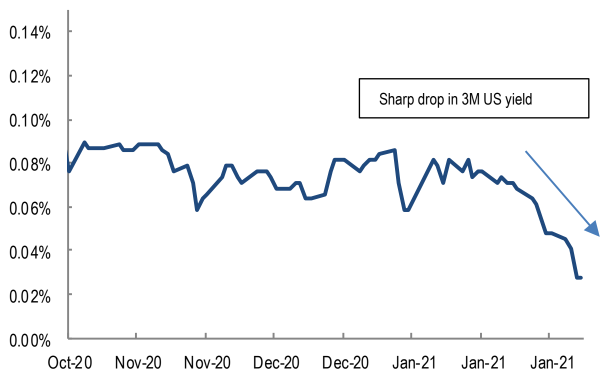
◆ TGA has finally started to have an impact

Another point is that steepening of the US yield curve has been exaggerated by a technical factor. We would like to point out the reason why we should not expect JGB yields to steepen like US yields.

The 3-month US yield has now declined sharply to the 0.02% level, probably because of the impact of the Treasury General Account (TGA), which accounted for a part of the Fed's balance sheet. The Treasury Borrowing Advisory Committee (TBAC) announced projections that the TGA, now worth $1.6tn on the Fed's balance sheet, would decline to $800bn by the end of March and $500bn by the end of June 2021. As this TGA decrease is to be covered by T-bill redemption, (short-term) Treasury bonds will decrease drastically in the market at exactly the same time as a surge in excess reserves due to the TGA decline. This will lead to tighter supply/demand conditions.

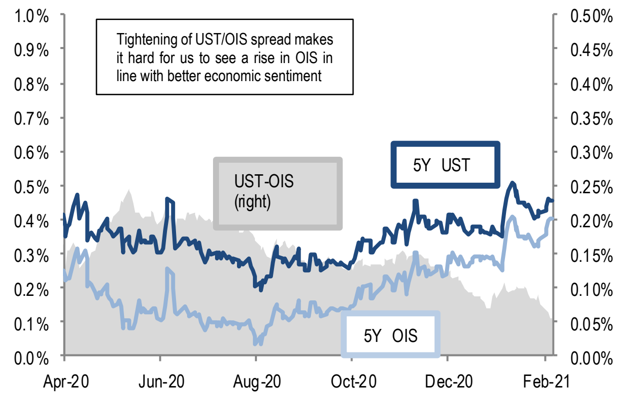
The impact of this is also emerging in short-term/intermediate Treasury bonds. For example, the UST/OIS spread has tightened to 6bp, setting a record low for the past three years. As this tightening happened almost at the same time as the decline in the 3-month yield, the above-mentioned factor appears to have brought repercussions.

3M US Yield



Source: Bloomberg; compiled by Daiwa Securities.

5Y US Yields (UST, OIS, UST-OIS)



Source: Bloomberg; compiled by Daiwa Securities.

From the standpoint of the long-term/short-term yield spread, these phenomena can be explained as follows.

In short, the entire OIS curve has been lifted by concerns about the Fed's exit strategy due to improvement in US business sentiment. However, as the UST/OIS spread in the short-term/intermediate zone has tightened to an unsustainable level due to the aforementioned tightening of supply/demand conditions, it is highly possible that the widening of the long-term/short-term yield spread has been exaggerated by the tightening of the UST/OIS spread in the short-term/intermediate zone. For example, the 5-year UST/OIS spread over the past year and over the past three years averages at 16bp and 22bp, respectively, while the current level is 6bp. We, therefore, think that steepening of the 5-year/30-year curve is exaggerated by around 10-15bp.

The TGA decline is likely to have a full-scale impact from now on. In particular, if there should be a resurgence of the debt ceiling problem this summer, the TGA may be forced to decrease more drastically than the TBAC projects (expects). (The TGA may decline substantially to a level of less than $0.5tn towards the end of July when an extended debt ceiling expires.) If that should happen, this summer's debt ceiling issue could have a different impact on the bond market from the past due to the change in the TGA, which has increased to an enormous scale.

It is misleading to say the least to expect JGB yields to steepen like US yields, which are different in terms of business sentiment and technical factors, as mentioned above. In terms of fundamentals, it is now easy to buy US Treasuries in the short-term/intermediate zone and JGBs in the long-superlong zone.

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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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