Daiwa Securities

Daiwa's View

Why real yields have risen sharply in the US

- One cause may be concerns over the pressure from rising valuations

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

Why real yields have risen sharply in the US

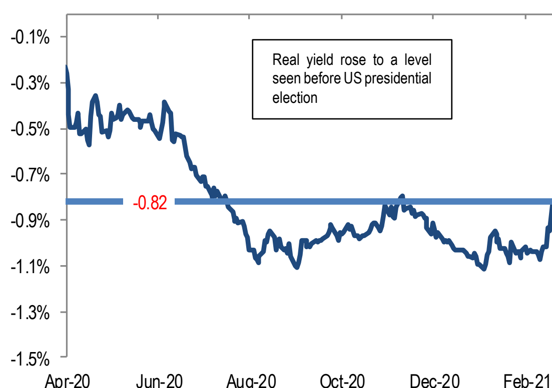
One cause may be concerns over the pressure from rising valuations

The 10yr Treasury yield rose to 1.36% at one point last week. This rise in interest rates is of a different nature than the welcome rise in rates that occurred in 2H 2020. On Friday, nominal yields rose but inflation expectations (BEI) declined to 2.1%. This caused a substantial increase in real yields relative to the week prior, up 20bp to -0.82% for the 10-year and up 19bp to 0.02% for the 30-year. There was also a sharp increase in the MOVE index, from 47 to 60, its highest level since the US presidential election.

New York Fed President John Williams commented on Friday that rising Treasury yields "reflect greater optimism in the economy." By expressing the view that the recent rise in yields reflects fundamentals he was signaling that the Fed does not intend to take action, and this of course further fueled the rise in interest rates. On the other hand, his comment could also be termed reflationary, and this cannot explain the fact that there was a relatively larger decline in inflation expectations (BEI) in the latter half of last week.

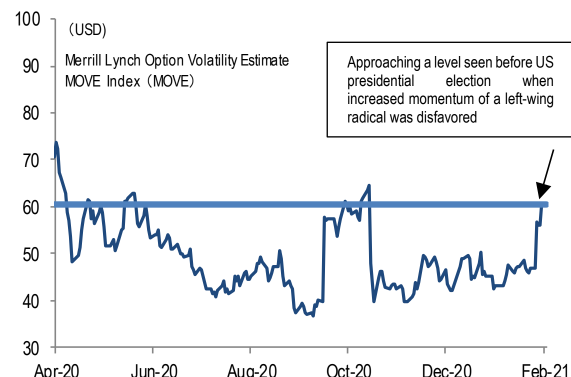
It was former US Treasury Secretary Larry Summers who focused more on the relationship with declining inflation expectations with his comment in a Bloomberg interview that Fed officials are likely to be forced to raise rates, "perhaps as early as next year." If there is a rate hike next year when tapering is not completed under the existing outlook, it would either cause an overshoot of inflation or a popping of the bubble. We suspect it may be concerns over the economy overheating that explain why there was a relatively large increase in real rates even while inflation expectations (BEI) were falling.

10Y US Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

US Bond Volatility Index (MOVE)



Source: Bloomberg; compiled by Daiwa Securities.

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US 10Y Yield, 10Y Inflation Expectations

Source: Bloomberg; compiled by Daiwa Securities.

The minutes for the Fed's January FOMC meeting released last week revealed stronger concerns among Fed staff about financial stability than shown by Fed Chair Jerome Powell in his post-meeting press conference. Specifically, some participants recognized elevated pressures on asset valuations as the biggest risk and noted that overall weakness merited a closer look. It is probably no coincidence that real rates started gaining upward momentum around the time that these FOMC minutes were released. Although a number of Fed officials have stated that the high volatility of individual stocks, including the sharp rise in GameStop's shares, would not affect monetary policy, we suspect that the market may have started pricing in the view that elevated valuation pressures will wind up being a barrier that makes strong monetary accommodation unsustainable.

Former IMF chief economist Olivier Blanchard's tweet, shown in the box below, may be the truth, i.e. that "the $1.9 trillion program could overheat the economy so badly as to be counterproductive." Mr. Blanchard was referring only to the American Rescue Plan, a $1.9 trillion relief package announced on 14 January, and did not include a second Biden plan for increased spending on infrastructure investment that a growing number of observers have started expecting over the last few weeks.

◆ **Former IMF chief economist Olivier Blanchard** (6-7 Feb 2021)

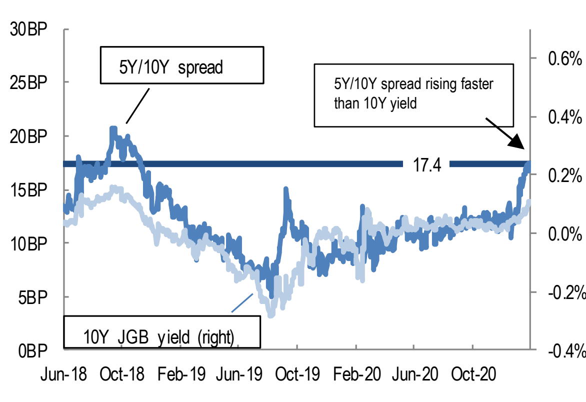
- I am known as a dove. I believe that the absolute priority is to protect people and firms affected by covid. Still, I agree with Summers. The 1.9 trillion program could overheat the economy so badly as to be counterproductive. Protection can be achieved with less.
- If it (Biden's fiscal plan) were to happen, it would lead to strong inflation (not the 2.5% that some predict, but potentially much more), and , likely a strong reaction of the Fed to limit the overheating, a very large increase in interest rates, again far more than is currently priced in.

If government spending is made that much bigger by a second Biden plan, this will substantially raise concerns over the economy overheating. This would be consistent with expectations of that future rate hikes will cause the bubble to burst. If the government forces through an expansion of a fiscal spending plan that had already ignored Republican wishes, it could exacerbate disruptions from the debt ceiling, the suspension of which expires at end-July this year, and there is concern that this may make fiscal stimulus impossible. Either way, if the recent rise in real rates can be attributed to underlying Fed concerns over valuation pressures, it may become necessary to consider the possibility that the current pattern of rising share prices may change (via a rebound in value stocks through a value-growth rotation). The SKEW index has risen back above 140 and the shape of the distribution of future returns is once again becoming distorted.

It was under these conditions that the 10-year JGB yield, in step with the rise in Treasury yields, broke above 0.10% for the first time in three years. Although it is still about 5bp away from reaching its peak three years ago of 0.15%, back then the 5-year yield had also risen to around -0.05% at the same time that the 10-year yield was rising, but this time the 5-year/10-year spread has been widening faster than just the level of the 10-year yield would suggest because of a divergence (at least for now) between expectations that the allowable trading band for the 10-year yield target of 0% will be widened vs. expectations of negative interest rate policy being abandoned. The 5-year/10-year spread has widened to a level just around 2.5bp narrower than its peak of 20bp following the BOJ making its policy more flexible in July 2018 (lower left chart).

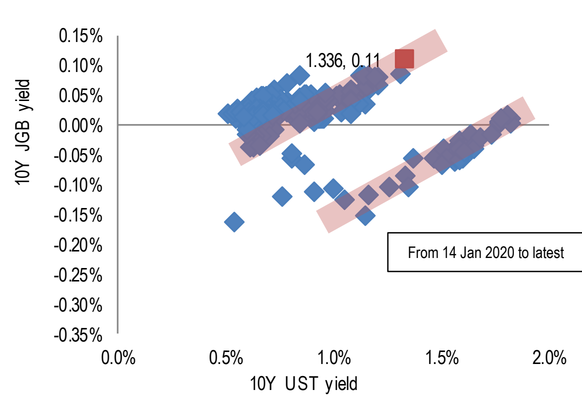
Because this latest increase in JGB yields occurred in the context of a rise in Treasury yields, it is in some respects a positive to the extent that market functionality has been restored (lower right chart). On the other hand, because economic conditions are much different in Japan than they are in the US, there is probably reason to doubt whether JGB yields can continue rising in step with the rise in US yields, given that the latter reflects conditions in the US. As already noted, the US Treasury market is becoming more volatile. If JGB yields start fully reflecting the volatility of (or disruptions in) the Treasury market, it will represent a slight departure from the conditions suggested by BOJ Governor Kuroda's remarks at his 21 January press conference, where he said he recognized the importance of keeping the yield curve low and stable during the pandemic.

JGB 5Y/10Y Spread, 10Y Yield



Source: Bloomberg; compiled by Daiwa Securities.

10Y JGB Yield, US Treasury Yield (scatter graph)



Source: Bloomberg; compiled by Daiwa Securities.

◆ **Press Conference by BOJ Governor Haruhiko Kuroda** (21 Jan 2021)

- It remains an issue that excessive declines in superlong yields have made it difficult for insurance companies and pension funds to meet their investment goals. However, we also recognize the importance of keeping the yield curve low and stable during the pandemic.

Daiwa Securities

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[Standard & Poor's]

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[Moody's]

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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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- 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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