Daiwa's View

Outlook of mini taper tantrum

➢ "Tapering" and "earlier rate-hike expectations" started to move together

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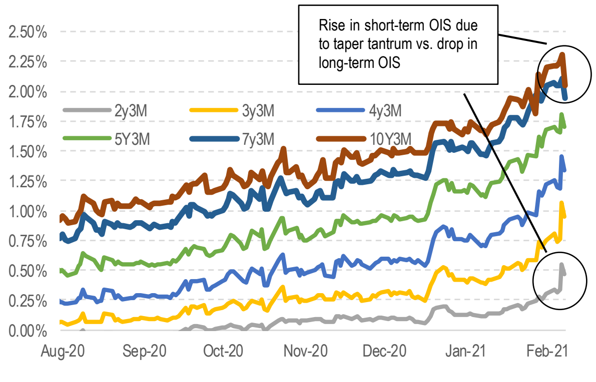
"Tapering" and "earlier rate-hike expectations" started to move together

After the 10-year US yield surged to 1.61% at one point last Thursday, it closed at 1.41% at the end of the week. However, we should not downplay this move just as "a round trip." Short-term 3-month yields (such as 2-year forward 3-month yield) surged to around 0.6%, and the level was unchanged on Friday. This means that the market has factored in two rate hikes by two years and three months out (= 1H 2023). Although the market had believed until recently that the Fed's rate hike was far off, the surge in yields shows a collapse of the belief.

Why did the long-term yield fall back to 1.41% despite earlier rate-hike expectations? There are two reasons. The first is a pullback of long-term OIS rates (left-hand chart below). This reflects the outlook that room for long-term rate hikes by the Fed will be sacrificed due to early rate hikes. The second is a decline in inflation expectations (breakeven inflation rate: BEI).

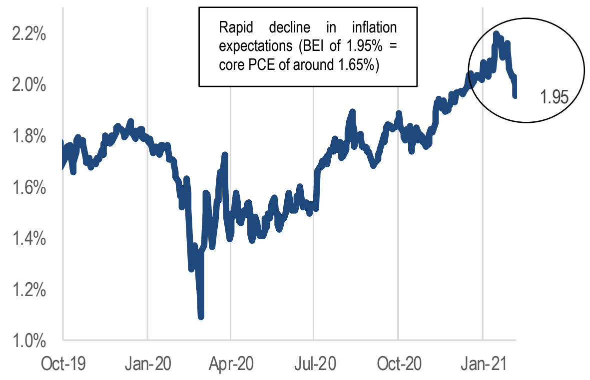
Last Friday, the 5-year forward 5-year BEI declined to 1.95% (corresponding to core PCE of 1.65%). The core PCE in the 1.6% level is almost the same as the average over the past ten years (1.61% during Jan 2011-Jan 2021). We can say that the market is factoring in the picture that the path to anchoring 2% inflation will be derailed by President Joe Biden's fiscal program which would overheat the economy, and the Fed's early rate hikes to cope with the overheating.

US 3M Forward OIS – Effective FF Rate



Source: Bloomberg; compiled by Daiwa Securities.

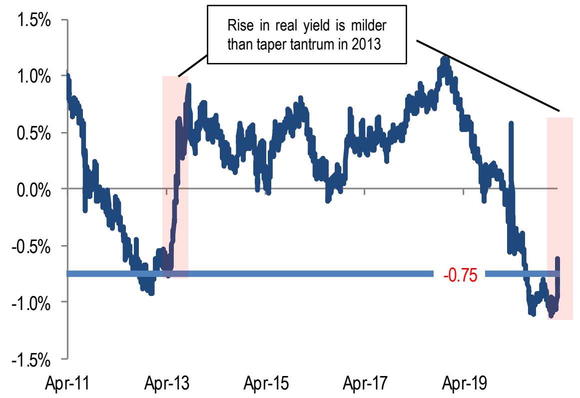
US 5Y-forward 5Y BEI



Source: Bloomberg; compiled by Daiwa Securities.

Thus far, the Fed has focused on decoupling of "tapering" and "rate-hike expectations," given the lesson from the taper tantrum in 2013. Such measures had been largely successful. However, if the Fed is struggling to decouple them, we can say that the situation is approaching a taper tantrum. That said, the real yield surged in the 1.5-2.0% range as of the taper tantrum in 2013. This time, as the rise in the real yield is just around 0.4%, we cannot say that the taper tantrum is full scale.

10Y US Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

In addition, it appears that the Fed does not welcome earlier rate-hike expectations (+ lower inflation expectations) at least for now. We will thus likely see Fed officials' remarks that will push back market expectations. So far, however, we have seen only remarks that accepted the rise in long-term yields. Few remarks touched on the key issue of earlier rate-hike expectations.

There may be an aspect that the Fed is concerned about skyrocketing valuations of assets (such as stocks) due to its action of easily committing to low interest rates. Perhaps Fed officials were not able to prepare for remarks partly because earlier rate-hike expectations have appeared quite recently. As they had time to fully summarize their opinions on the weekend, today's speech by New York Fed president John Williams is garnering attention.

◆ **St. Louis Fed president James Bullard** (25 Feb 2021)
I think the rise in yields is probably a good sign so far because it does reflect better outlook for US economic growth and inflation expectations which are closer to the committee's inflation target.

◆ **Kansas City Fed president Esther George** (25 Feb 2021)
First, most of the rise in the ten-year Treasury this year appears to reflect an increase in the real yield, that is the interest rate controlling for inflation compensation. Much of this increase likely reflects growing optimism in the strength of the recovery and could be viewed as an encouraging sign of increasing growth expectations. If this is indeed the reason that yields are increasing, they are unlikely to rise to the point of smothering the optimism that led to their increase in the first place, and measures of real yields remain deeply negative and only a touch off all-time lows.

Of course, if we see a rapid change in the Fed's stance toward an early rate hike, this would mean that the situation is moving to an excessively overheated economy and much earlier rate hikes, which were pointed out by Lawrence Summers and Olivier Blanchard. If so, the bigger the fiscal policy, the earlier the rate-hike expectations. As this raises concerns about killing inflation, the yield curve is likely to flatten (bear flattening). Prices since the latter half of last week have moved in line with this trend.

◆ 5-year JGB yield may take root at 0%?

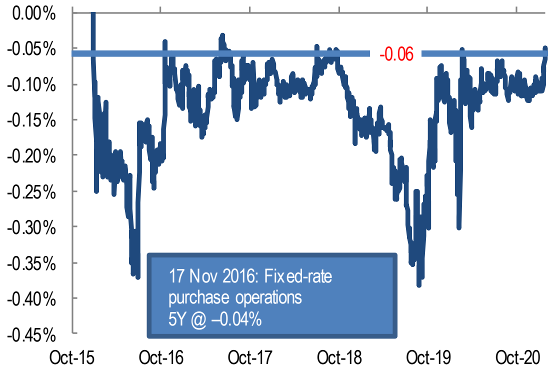
Regarding JGB yields, market attention is on the fact that the 10-year yield momentarily rose to 0.175%, the highest value since the introduction of the yield curve control policy. However, a noteworthy point would be rather the 5-year yield rising to –0.03%, higher than the BOJ's fixed-rate purchase operation level (–0.04%) conducted in November 2016.

Of course, the market appears to have been aware of the possibility that fixed-rate purchase operations would not be conducted at the same level as five years ago because the trading band of the long-term interest rate widened in July 2018, unlike the case in

2016. Still, last week's movements clarified a high possibility that the band to control the yield curve widened in not only the long-term zone but also in the intermediate zone[1]. In this case, if the trading band widens further at this month's assessment meeting, we would naturally see a further widening of the allowable fluctuation range of the 5-year yield.

At the assessment meeting, the balance may be held by tightening of the front end of the curve due to the strengthening of forward guidance, alongside the widening of the trading band. If this is not the case, we cannot say from now on that the 5-year yield will not rise to 0%. In these cases, if investment demand from depository institutions is very strong in positive territory, a point of reference of the upper limit of the 5-year yield would be 0% plus something extra. In other words, not the 10-year yield but the 5-year yield may take root at around 0%, depending on the findings at the assessment meeting.

5Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

[1] Also in Monthly Schedule of Outright Purchases of Japanese Gov't Bonds (Competitive Auction Method) for Mar 2021 (released at end of month), operation schedule unchanged.

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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.

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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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- 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.

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