Daiwa Securities

Daiwa's View

Widening of trading band to be postponed; inflation expectations exaggerated?

➢ Widening of trading band to be postponed

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In my second-year challenge, I gained the third position in the Nikkei Veritas Analyst Ranking (fixed income analyst section). Your support is deeply appreciated.

Widening of trading band to be postponed; inflation expectations exaggerated?

Widening of trading band to be postponed

In his answer at Friday's Committee on Financial Affairs of the House of Representatives (around 12:13 p.m.), BOJ governor Haruhiko Kuroda stated that he does not think that it necessary to widen the trading band. It is true that he has repeated that "it is important to keep the yield curve low and stable amid the COVID-19 pandemic." The remark was made at a timing when the state of emergency was extended for Tokyo and the surrounding three prefectures. That said, due to a denial of the widening of the trading band, which had become market consensus, JGBs in the afternoon session surged and the 10-year yield sharply declined from 0.15% to 0.085%. The price of long-term JGB futures spiked from Y150.86 to Y151.88 by around Y1 at one point, closing at Y151.50. It was a shocking day.

That said, even if the widening of the trading band is postponed, the BOJ still needs "to enhance sustainability of yield curve control and purchases of assets, such as ETFs, through the flexible conduct and be prepared so that it can respond effectively to possible changes in economic activity and prices as well as financial conditions." Operations are likely to become more flexible. If the upper limit of the trading band is maintained, the 10-year yield level of above 0.15% would be strongly supported. However, the yield is unlikely to aim for 0% at a jump amid increasing inflation expectations around the globe. In the near term, a core range is expected at 0.05-0.15%.

◆ **Press Conference by BOJ Governor Haruhiko Kuroda** (Committee on Financial Affairs of House of Representatives on 5 Mar 2021)

- (Regarding the 0% target of the long-term yield,) I do not think that it is necessary to widen the trading band. Our recognition is unchanged that now it is important to keep the entire yield curve stably low by maintaining the stability of the bond market. It is correct to make ETF purchases flexible, depending on the market situation. I would like to give full consideration to financial risks. We should be fully on alert against a bubble and respond to it.

◆ Regarding yield target, controlling shorter-term maturity may be desirable?

I would like to give a brief comment on this turmoil. The BOJ is not a micro but a macro entity. I completely trust that the BOJ uses all its energy to make Japan's economy better. I also recognize that the economy is activated by distortion (correction) of the market via the essence of monetary policy.

Important disclosures, including any required research certifications, are provided on the last page(s) of this report.

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I also understand that the degree of the power to distort the market is inevitably increasing amid the lessening scope for monetary easing and flattening of the Phillips curve. Still, I had mixed feelings about the Y1 spike in the JGB futures price alongside a decline in liquidity. As the BOJ is not a player but a rulebook for the JGB market, a frequent change in the rule prevents fostering of good players.

Although Australia has also adopted the yield curve control (YCC) policy, it controls a shorter maturity. It appears that the market function is maintained at a higher level, while the yield curve is controlled. Of course, although the maturity is not the only issue, controlling a shorter maturity may be desirable if the BOJ continues to follow the YCC policy. There is no need to recommend speculative investment. However, if the YCC picks an important signal in the market, there would be room for improvement.

◆ Operation Twist kept as response for panicky situation?

Regarding Operation Twist, St. Louis Fed president James Bullard said on 5 March that "I don't see that as an option right now." Although the market attributed this to the steepening, it appears to have also reconfirmed that Operation Twist is kept as a policy tool for panicky situations (such as taper tantrum) due to the phrases of "right now" and "something that looks panicky."

The market recognition that powerful tools are kept for later use would contribute to market stability (boosting of dip buying by market participants) when the exit strategy is conducted in the future. This results in a decline in the possibility of the need to actually implement Operation Twist. The aforementioned remarks by Mr. Bullard are deep like a chess move. In the sense of market stability, they seem to contain an aspect of "mild YCC." They would not be shallow ones like those that simply accept the steepening.

◆ **St. Louis Fed president James Bullard** (Interview with Wharton Business Radio 5 Mar 2021)

- As a central banker I am always concerned if there is disorderly trading or something that looks panicky. That would catch my attention. But I think we are not at that point. (Regarding Operation Twist), I don't see that as an option right now. So it's not just matching up right now that we have to do anything to be even more dovish than we are. A lot of that (rising Treasury yields) is very natural. It is natural for them to be going higher as growth prospects are improving -- not just improving, really, but going very, very strong growth expected in 2021 and beyond and inflation risks moving up.

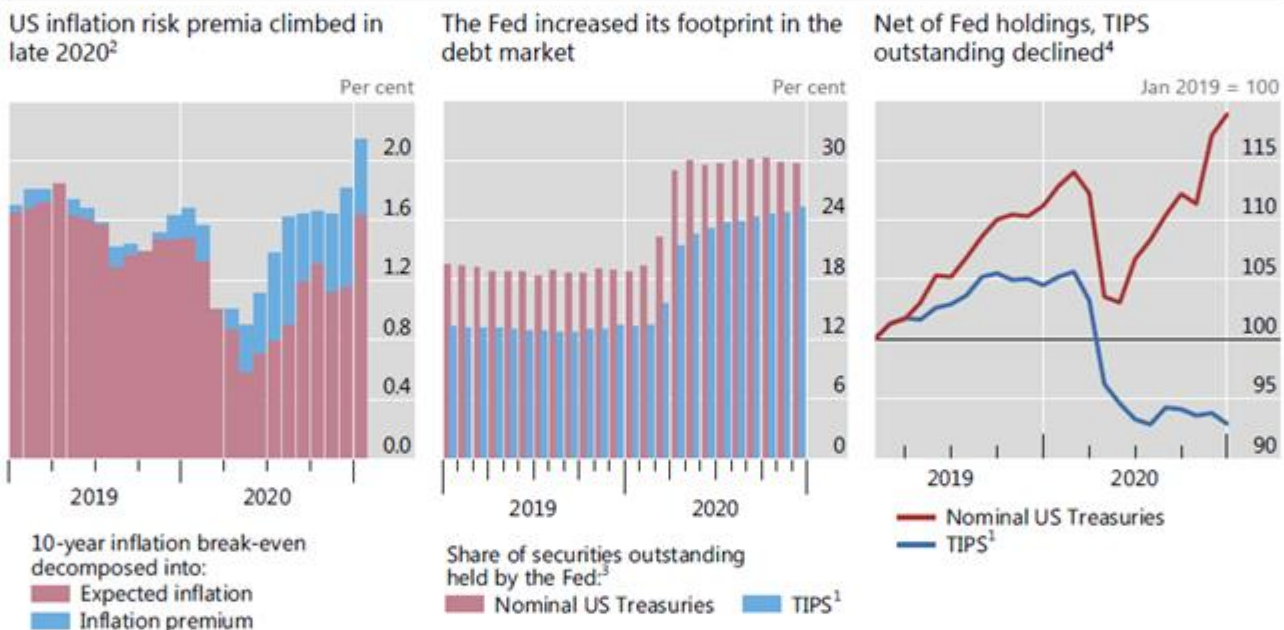
◆ Inflation expectations exaggerated? (*BIS Quarterly Review)*

In the March *BIS Quarterly Review*, the factors that drove a recent rise in US inflation expectations (BEI) are examined (BOX D). As the background to the sharp rise in the BEI since early 2019, the review pointed out a large contribution from a rise in inflation risk premium (up about 50bp) since early 2019, although there was also a contribution from a recovery of "given inflation expectations."

In a simple textbook setting, the rise in inflation risk premium reflects a risk against a surge in inflation. However, it was concluded that further issuance of Treasuries and the resultant improvement in the TIPS supply/demand conditions contributed to the higher measured inflation risk premium. As a result of further issuance of Treasuries since the outbreak of the COVID-19 pandemic and the Fed's QE, the net outstanding amount of Treasuries in the market increased by more than 15%, while that of TIPS declined by more than 5% (see chart later in this report).

The above-mentioned BIS conclusion is largely in line with my understanding. Recently, we have seen a rare case of a decline in the long-term BEI (such as 5Y5Y) while a risk of a surge in inflation is being pointed out. This likely reflects the outlook that distorted TIPS supply/demand conditions (which caused widening of inflation risk premium thus far) will be normalized earlier than expected due to an early end to QE. As the BEI is just a concept of "residual" that is calculated by "nominal Treasuries – TIPS," it does not necessarily reflect given inflation expectations.

Chart: Factor Analysis of Inflations Expectations, Outstanding Amount of Nominal Treasuries, TIPS



Source: Extracted from BIS Quarterly Review.

◆ BIS Quarterly Review (Mar 2021)

The overall increase in the break-even rate is likely to have reflected a variety of indications that US inflation could be higher in the near term. On the back of the Federal Reserve's new monetary policy framework, progress in the distribution of vaccines, higher commodity prices and a potentially substantial fiscal impulse were likely drivers of higher inflation expectations. But what could have contributed to the high inflation risk premium?

In a simple textbook setting, the inflation risk premium would only reflect the compensation that investors demand for holding nominal Treasuries, over and above the compensation for expected inflation. In this case, the only drivers of the risk premium would be investors' perceptions of risk and their risk appetite. In practice, however, the measured inflation risk premium can also reflect a variety of additional drivers. In the US case, these include imbalances between the demand for and supply of Treasuries and TIPS, or the relative liquidity of the underlying markets.

The net supply of Treasuries and TIPS to private investors stems from the interaction of US Treasury issuance patterns and Federal Reserve purchases. As the US central bank swiftly expanded its holdings of TIPS and Treasuries in response to the Covid-19 emergency, the corresponding bond amounts available to investors dropped substantially in the first quarter of 2020 (Graph D, centre panel). From mid-2020, however, issuance of Treasuries picked up, with auction sizes increasing by between 20% and more than 50% by the end of 2020, depending on the tenor. At the same time, the auction sizes of TIPS remained stable. Since the Federal Reserve maintained a relatively large and steady pace of purchases that somewhat exceeded TIPS issuance but not the expanded issuance of Treasuries, the amount of Treasuries available to investors recovered quickly (Graph D, right-hand panel, red line), while the corresponding TIPS volume stagnated (blue line).

This combination of higher supply of Treasuries and lower supply of TIPS is likely to have contributed to the higher measured inflation risk premium. To the extent that the appetite for inflation hedging remained constant or rose, which appears likely given the macroeconomic and policy backdrop, investors would bid down the yield on the limited amount of TIPS available. The relatively low liquidity of the TIPS market would amplify this effect. At the same time, investors would ask for an increasingly higher compensation to hold the quickly expanding amount of Treasuries. All these mechanisms would contribute to the rise of the break-even rate for given inflation expectations, thus boosting the measured inflation risk premium.

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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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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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* 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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