Daiwa Securities

Daiwa's View

Is the Japan/US rate spread too small?

- Implied forward rate spread is narrower than the nominal GDP gap

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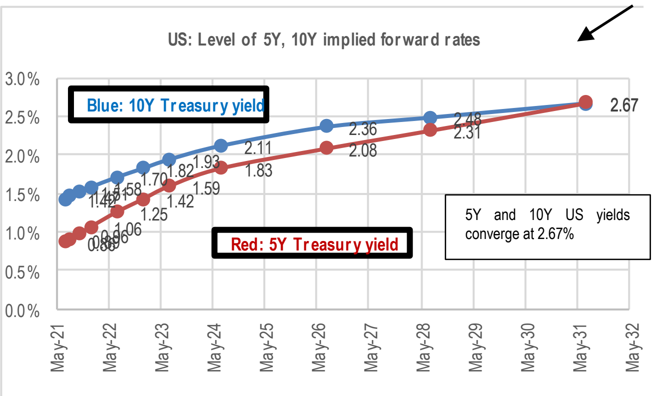
Is the Japan/US rate spread too small?

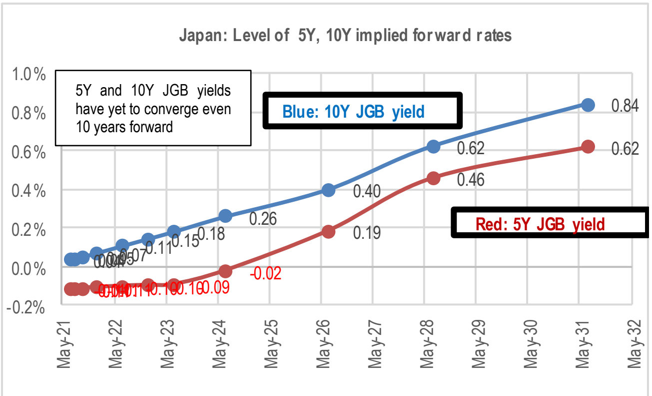
Implied forward rate spread is narrower than the nominal GDP gap

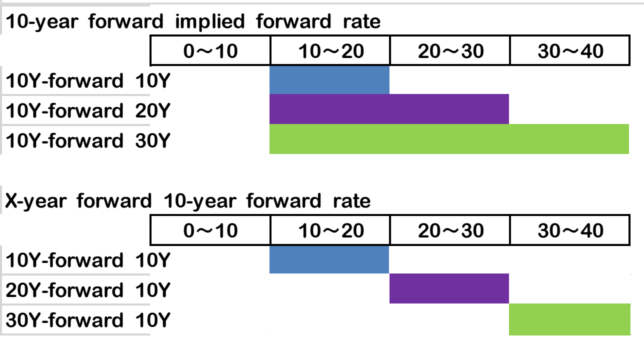
Implied forward rates tend to converge to a single point (thought to be what the market understands as the neutral rate + a bit). Looking at the 10-year forward 5-year and 10-year yields in Japan and the US using implied forward rates, the 5-year and 10-year yield in the US are converging at 2.67%, while the 5-year and 10-year yield in Japan have yet to converge, even 10 years forward (Chart below).

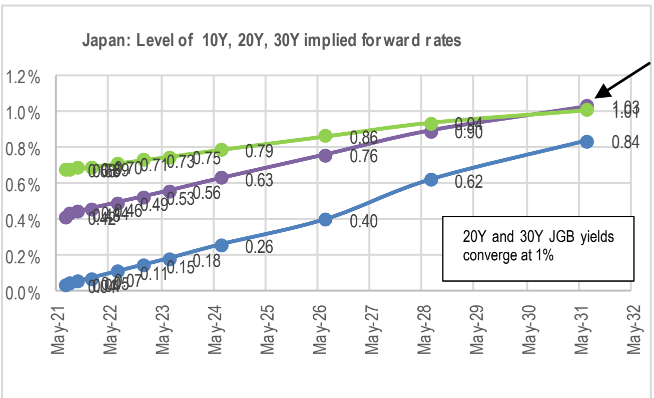
Looking farther out the implied forward rate curve, the 10-year forward 20-year and 30-year yields are converging at around 1% (Chart below). This suggests the possibility that the market currently understands Japan's neutral interest rate to be around 1%. The question is whether a 1% yield in Japan makes sense with the US yield at 2.6% (a rate differential of 1.6ppt).

Implied Forward Rates









Source: Bloomberg; compiled by Daiwa Securities.

One possible rough breakdown of Japan's 1% yield could be a natural interest rate of 0% and expected inflation rate of 1%.

The median FY23 forecasts of policy board members according to the BOJ's April 2021 *Outlook for Economic Activity and Prices* report *(Outlook Report)* were a real GDP growth rate of 1.3% and inflation rate of 1%, for a total (i.e. nominal GDP growth rate) of 2.3% (the final year's data in *Outlook Report* tends to be revised downward). The other day, the BOJ announced that Japan's potential growth rate is 0.10%.

Meanwhile, according to the Fed's Summary of Economic Projections, the 2023 outlook in the US is for real GDP growth of 2.4% (1.8% for the longer-run) and inflation of 2.2% (2.0%), for a total of 4.6% (3.8% for the longer run). Based on these numbers, the Japan/US nominal GDP growth rate (real GDP growth + inflation rate) gap is 2.3ppt for 2023 and 2.7ppt for the longer run. Assuming this nominal GDP growth rate gap to be indicative of the neutral interest rate differential, a Japan/US interest rate differential of 1.6% is too small.

Forecasts for Nominal GDP Growth Rate (%)

	US		Japan	
	CY2023	Long-term	FY2023	Long-term
Real GDP growth rate	2.4	1.8	1.3	0.1
Inflation rate	2.2	2.0	1.0	1.0
Nominal GDP growth rate	**4.6**	**3.8**	**2.3**	**1.1**
		Japan/US gap	**-2.3**	**-2.7**

Source: BOJ, Fed; compiled by Daiwa Securities.
Note: Concept of GDP deflator is different from that of PCE deflator (US) and CPI (Japan). However, we regard that "nominal GDP growth rate" is approximately equal to "real GDP growth rate + inflation rate" to gain simplified forecasts.

Furthermore, implied forward rates in the US had converged above 3% until mid-May, but since mid-June as the yield curve has flattened, that convergence point has declined by about 0.5ppt. Why did this happen? Although just one possibility, this may just reflect that the near-term equilibrium interest rate momentarily rose because of fiscal stimulus, but then started declining and converging on the long-term equilibrium rate as stimulus effects faded over time. Fiscal stimulus does temporarily worsen government bond supply-demand and narrow the output gap, but it is possible that the long-term impacts on government bond supply-demand are smaller than the short-term impacts because the strong economy raises tax revenues while encouraging increased savings in preparation for future tax hikes. In fact, Japan collected record-high tax revenues in FY20, and this is now expected to offset several trillion yen of new JGB issuance.

In that sense, it is also possible that the currently too small Japan/US interest rate differential can be attributed to differences in how far along each country is in recovering from the pandemic. Specifically, while the US has already reached the next stage of the short-term equilibrium rate rising and converging on the long-term equilibrium rate, it is possible that Japan, which has been slower to recover, has just now reached the stage of the short-term equilibrium rate rising. If the expectation is that this will converge on the long-term equilibrium rate in the future, now would be a good time to buy[1].

A *Nikkei* article dated 5 July, titled "Fed's rate forecast way off the mark; central bank fantasy risks disrupting markets," quoted a private sector economist who thinks that the Fed's estimate of the US natural rate of interest at 0.5% was too high. Whether or not this argument rings true, if 0.5% is too high of an estimate of the US natural rate of interest and that rate is actually around 0%, it seems hard to justify the assumption that Japan's natural rate of interest is 0%.

[1] This would be even more true if a poor showing by the LDP in the Tokyo Metropolitan elections raises expectations of pork-barrel spending and causes the yield curve to steepen.

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[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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- 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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