Daiwa's View

Return to reflation trade?

➢ Correction to speed of flattening

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Correction to speed of flattening

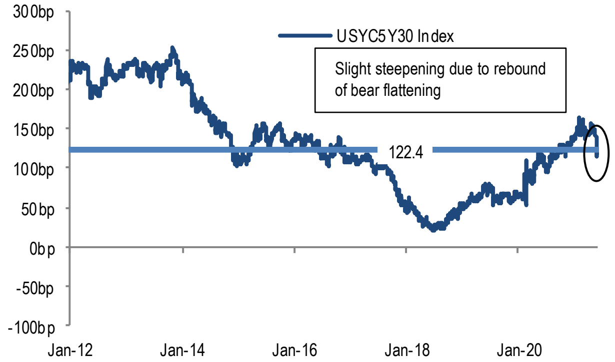
At the end of last week, US inflation expectations (BEI) rebounded slightly, leading to steepening of the 5-year/30-year spread from 118.3bp to 122.4bp (left-hand chart below). While the DJIA rose, the NASDAQ Index fell slightly reflecting higher yields. In one sense, this could be a setup anticipating the jobs report, but price movements on a single day basis showed a return to reflation trade.

Thus far, reflation trade had been caused by low short-term/intermediate yields and a rise in long-term yields (incl. concerns about inflation) due to the combination of an overheated macro economy and the Fed's stance falling behind the curve. Since the June FOMC meeting, the market has been very aware that the Fed is not falling behind the curve that much. Therefore, the overheating of the macro economy (and market) tends to increase speculation about a faster exit strategy by the Fed.

Under this new structure, concerns about overheating lead directly to a rise in short-term/intermediate yields and suppression of inflation expectations. We should therefore interpret the steepening seen at the end of last week as a correction to the speed of flattening, rather than a return to reflation trade.

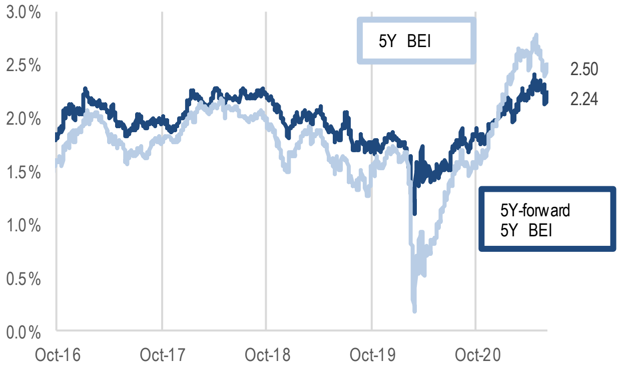
The 5-year/30-year spread flattened by 32bp from 140bp on 16 June (before the announcement of FOMC results) to 108bp on 21 June. At the end of last week, it recovered about half (=124bp). That said, the flattening of the 5-year/30-year spread started on 17 March, and its peak was 161bp. If it recovers about half of the 53bp flattening over the three months since 17 March, around 135bp would be a point of reference.

US 5Y/30Y Spread



Source: Bloomberg; compiled by Daiwa Securities.

US Breakeven Inflation Rate



Source: Bloomberg; compiled by Daiwa Securities.

Since the outbreak of the COVID-19 crisis, things have been moving at a faster-than-expected pace. This is just me thinking out loud, but, with the pace of developments being so fast, the time frame until the arrival of the next recession may be shorter than expected.

At the initial stage of the pandemic, the very pessimistic forecasts by economists completely failed to predict the current situation. Looking at it the other way around, we could say that current economist forecasts may be unreliable[1]. When consensus forecasts weaken excessively, policy support expands. This in turn leads to an overheated economy, making it easier for economist forecasts to veer from the actual data. Conversely, when the consensus becomes bullish in all aspects as currently seen, this induces reduction of policy support (scaling-down of fiscal programs, faster-than-expected exit strategy). I am afraid that this could unexpectedly cool the economy.

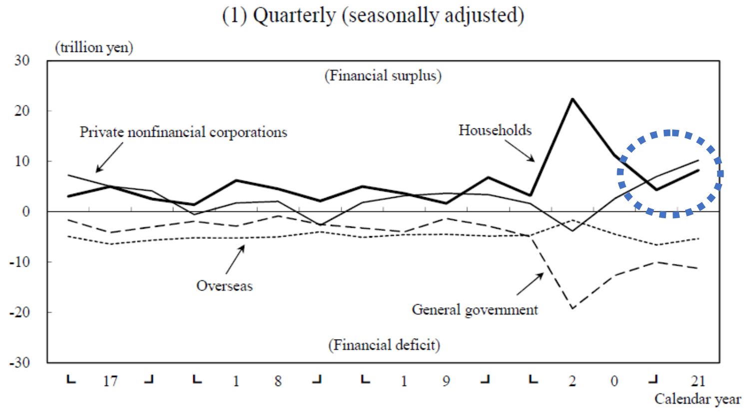
Amid the dominance of bullish forecasts, the market consensus has already become that there will be a rate hike in 2022. There are media reports saying that some pointed out a possible liftoff before the completion of tapering. If we continue to see the economy overheat and an earlier-than-expected exit strategy by the Fed at this fast pace, the economic cycle may proceed at double the speed.

Our senior economist Kenji Yamamoto pointed out that the Fed's normalization process may be suspended if we see signs of a US economic recession and serious global risk-off moves as seen in 2015-16. The chance of this happening may not be as low as one might think.

◆ "Flow of Funds" statistics showed financial surplus in private sector

On 25 June, the BOJ announced the "Flow of Funds" statistics for the Jan-Mar 2021 quarter, which confirmed that households and companies are in financial surplus. In the case of households, the downtrend reversed course mainly due to 'forced savings' in line with the declaration of the state of emergency, raising expectations of a recovery after progress has been made with vaccinations. On the other hand, a worrisome point is the financial surplus at private nonfinancial corporations (hereafter, corporations). An uptrend has been observed since the beginning of the COVID-19 pandemic. Combined with the diminishing need for bank loans, this financial surplus at corporations could easily lead to speculation about a wider loan-deposit gap at depository institutions, resulting in more investment in yen bonds. In the current JGB market, a performance gap can be seen between the 20-year sector and below and the 30-year sector and above. The latest "Flow of Funds" statistics can explain part of the reason behind this.

Flow of Funds: Financial Surplus and Deficit by Sector



Source: Extracted from BOJ materials. Blue circle added by Daiwa Securities.

[1] Supposedly, no consensus among economists in the past 50 years has ever managed to forecast a recession a year in advance.

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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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- 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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