Daiwa Securities

Daiwa's View

Structural reasons why long-term rates are not rising

- Deposits continue to grow in Japan, the US, and Europe
- Are changes in corporate behavior keeping rates from rising?

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Structural reasons why long-term rates are not rising

Deposits continue to grow in Japan, the US, and Europe

Many factors are putting upward pressure on interest rates, including the BOJ cutting its JGB purchases and expectations of a large supplementary budget ahead of the upcoming election in Japan, as well as accelerating inflation in the US and the Fed inching its way toward tapering. Despite this, long-term rates globally have been in a declining trend since April. In our Daiwa View report dated 5 July, our economist Yamamoto noted the possibility that declining labor force participation in the US may be contributing to a flattening of the Treasury yield curve by lowering the potential growth rate. In this report, we consider the possibility that other structural factors, namely pandemic-induced changes in corporate behavior, are putting downward pressure on long-term rates through growth in bank deposits.

The BOJ's report on the Deposits and Loans Market released 8 July showed more than a Y100 trillion increase in deposits at the city banks and regional banks combined since before the pandemic, from Y732 trillion in February 2020 to Y834 trillion in June. The increase in lending during that period was only about Y27 trillion, and it was broadly understood that the resulting expansion of the deposit-loan gap fueled potential demand for investing in bonds by deposit-taking institutions. We think income transfers from the government to the private sector in the form of cash subsidies were instrumental to this growth in deposits. The important topic in bond market is how the private sector will use or keep saving money in deposits they have accumulated.

Like Japan, the US also had a sharp inflow of deposits into its banking sector from March 2020 as a result of the pandemic. The interesting point here is that even with populations getting vaccinated and economies rebounding strongly in terms of GDP, employment, and prices, that trend of sharply rising deposits has not only not reversed but appears to be accelerating (the most recent data is for June 2021). Consequently, US banks' holdings of Treasury and agency securities have increased by over $1 trillion (about Y110 trillion) since February 2020, from $3.03 trillion to $4.18 trillion.

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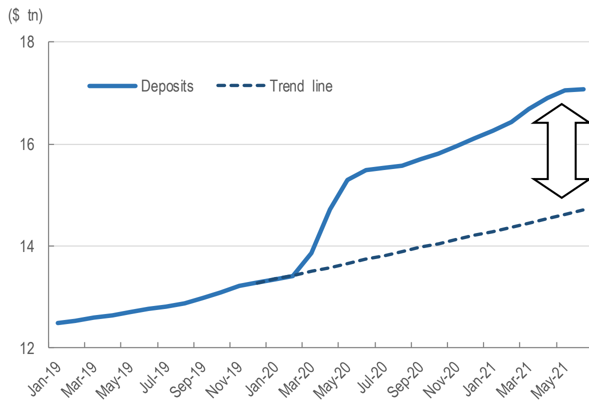
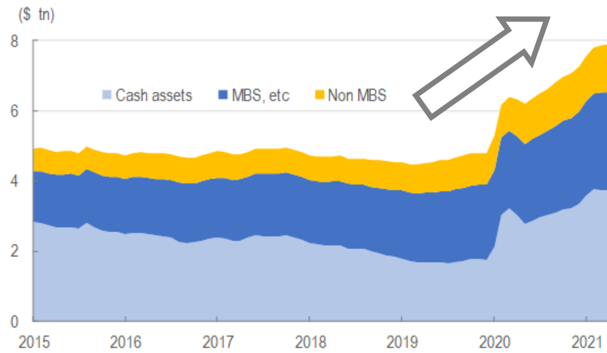
Deposits at US Commercial Banks (balance sheet liabilities)



Source: Fed; compiled by Daiwa Securities.

Cash Assets, Treasury and Agency Securities at US Commercial Banks (balance sheet assets)

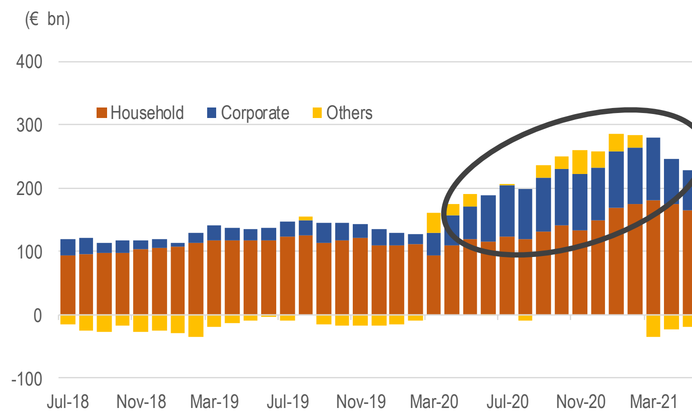


Source: Fed; compiled by Daiwa Securities.

Are changes in corporate behavior keeping rates from rising?

There are two channels in which private-sector actors are adding to their deposits without using their cash. One is the household channel caused by the deferral of consumption and receipt of cash benefits. The other is the corporate channel due to the buildup of liquidity on hand and restraints on capex. In Europe, deposits are reported in the macro data by major sector. Using Germany as an example, households account for about 70% of total deposits and the corporate sector accounts for about 20%, and in addition to a stable inflow of funds from the household sector, cash inflows from the corporate sector since spring 2020 have been fueling the growth in bank deposits.

Increase in Deposits by Sector in Germany (y/y)



Source: Euro-Area-Statistics; compiled by Daiwa Securities.

Accordingly, in addition to the trend among households, a key determinant of whether this deposit growth continues will be the incentive of corporations to hold cash. There has been much research noting that uncertainty in the macroeconomy has made corporations more cautious with their fund raising[1], while others have noted that the rising trend in corporations' cash holdings may have been accelerated by the pandemic[2]. Assuming there is a broad underlying trend of management moving from an ROE-centric approach to a "cash is king" mentality, there is unlikely to be any reversal of this trend toward deposit growth anytime soon.

[1] For more on this, see the BOE Staff Working Paper No. 753 by Smietanka et al: *Business investment, cash holding and uncertainty since the Great Financial Crisis* (2018).

[2] See *How will the COVID-19 crisis affect the trend in corporate saving?* by Demary, et al, Econstore (2020).

In February 2005, Alan Greenspan called the decline in long-term rates while the Fed was hiking rates a "conundrum." Based on your author's recollection[3], this conundrum was caused by structural changes, specifically the collapse of the Cold War world order, disinflation brought by globalism, and a surplus of savings, primarily in emerging markets. Fast forward to today, 16 years later, and inflation (the PCE core reading) is up to 3.4% but the long-term rate has declined, even with the Fed moving toward an exit strategy. The 2021 version of this conundrum of interest rates not rising may be attributable in the not so distant future to pandemic-induced changes in corporate behavior and the surplus savings that causes.

[3] See *The Age of Turbulence: Adventures in a New World*, by Alan Greenspan, Chapter 20, Conundrum.

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