Daiwa's View

US yield fell below 1.2% due to supply/demand and risk-off factors

- I. Risk-off scenario is troubling
  II. 10-year JGB yield finally testing 0%

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Daiwa Securities Co. Ltd.

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With US stocks falling 2%, the US high-yield bond spread, the so-called canary in the mine, also widened sharply by 20bp yesterday. The long-term yield fell back to the 1.1% level, hitting a record low since the beginning of FY21 due to risk-off sentiment in addition to structural supply/demand factors.

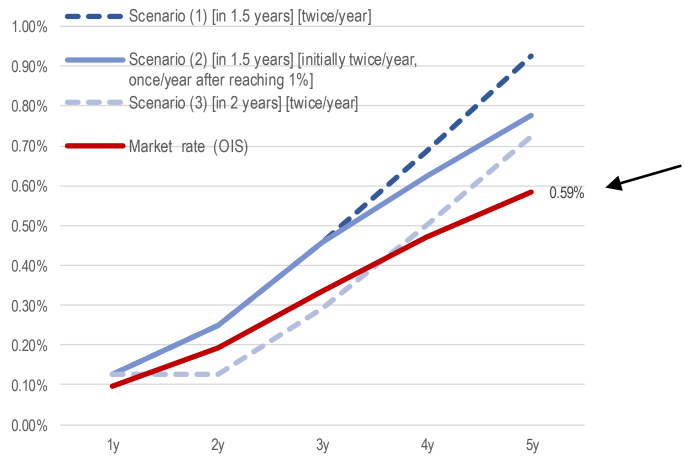
When the US long-term yield hit 1.25% on 8 July, I stated in our report that "unless a serious risk-off scenario occurs, it is probably okay to view current yield declines as approaching an end."[1] I said "unless a serious risk-off scenario occurs" because I thought that a risk-off scenario at this stage would be quite troubling. Although the Fed and market consensus are factoring in tapering and rate hikes assuming a rosy future without recessions or serious risk-off (which is always wondering), this outlook can change due to a serious risk-off scenario, as our senior economist Kenji Yamamoto pointed out.

If the market priced in rate hikes, of course, room for lower yields would be generated. In fact, the 5-year OIS yield has declined to the 0.5% level, diverging downwards from my simulation scenario in the past. Looking at the divergence trend, the yield appears to be pricing in a slowdown in the pace, rather than rate-hike timing (right-hand chart below). We can say that the pace is slowing, but a rate-hike scenario itself has not collapsed. Conversely, if thinking about the rate-hike timing also recedes, we could say that there is room for a further decline.

US 10Y Treasury Yield

Source: Bloomberg; compiled by Daiwa Securities.

5Y OIS Yield: Scenario by Rate-hike Timing and Pace



Source: Bloomberg; compiled by Daiwa Securities.

[1] Refer to Daiwa's View *Quite Excessive* issued on 9 Jul 2021.

Will risk-off sentiment intensify due to further widening of the high-yield bond spread? I will leave the details regarding the outlook for corporate bond spreads to credit analysts/strategists. However, in light of the close relationship between the ISM Index and spreads, the spread will be sustained unless the economy collapses. That said, if peaks are high, valleys are low, and if valleys are low, peaks are high. Therefore, economic cycles from now on may become shorter, as our senior economist Kenji Yamamoto pointed out, given a V-shaped recovery led by fiscal policies since the beginning of the COVID-19 pandemic. At this point, we think that a level below 1.25% is excessive, but the economy faces downside risk. Given the structure of abundant money, as well, bond purchases are likely to remain preferable in the near term.

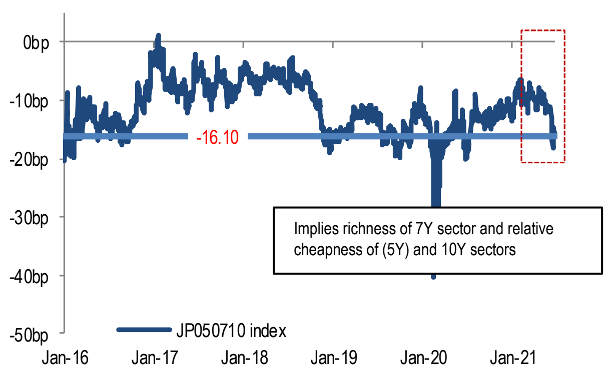
◆ **10-year JGB yield finally testing 0%**

Meanwhile, the JGB yield curve is continuing to steepen in contrast to European and US curves. Under the assumption that the hurdle would be high for the 10-year yield to fall below 0%, the consensus among Japanese investors is likely that a 20-year yield of below 0.4% would be overshooting. That said, as we have already seen a decline in swap rates and a rise in bond futures in tandem with global market trends, the divergence appears to have widened close to the limit of the tolerance range, which warrants attention.

For example, the 5/7/10 butterfly spread deepened to –16bp, making it easy to build long positions vs. the 7-year sector. Given the fact that JGB futures rose to Y152.45 in the night market, the 10-year yield is expected to approach 0% today. If we focus on Japanese factors alone, the yield is unlikely to stay in negative territory. However, we need to pay attention to inward flow. Once existing assumptions collapse, it is usual in the market for the existing support level to become the new resistance level.

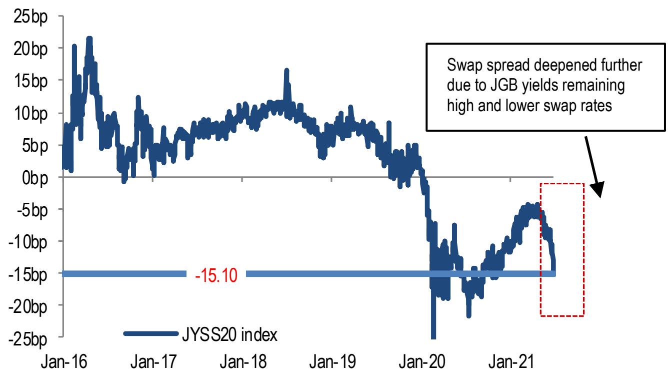
While the 20-year JGB yield remains high at around 0.4%, the swap rate fell to about 0.24%. As a result, the JPY swap spread also deepened into negative territory beyond –15bp. The spread widened while the 20-year LCH-JSCC basis stayed at –0.1bp, almost zero, meaning that this was not driven by an overseas flow. However, this occurred in a situation in which the BOJ has been offering a generous IOER (on current accounts) to depository institutions in line with the high priority put on measures to address side effects. Therefore, there may be an increasing tendency for Japanese investors to adjust interest rate risk via swaps, which do not require a funding burden. In any case, putting aside whether it is led by overseas factors, it is true that JPY swap rates are still moving in line with USD swap rates after all. If –15bp is close to the limit when the JPY swap spread deepens, it may be easy for the 20-year JGB yield to decline. It is difficult to imagine that the yield will rise in contrast to global yields, to put it mildly.

JGB 5Y/7Y/10Y Butterfly Spread



Source: Bloomberg; compiled by Daiwa Securities.

JPY Swap Spread (20Y)



Source: Bloomberg; compiled by Daiwa Securities.

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