Daiwa's View

Factors behind decline in real yields

➢ Probable causes are decline in term premium and technical factors

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Probable causes are decline in term premium and technical factors

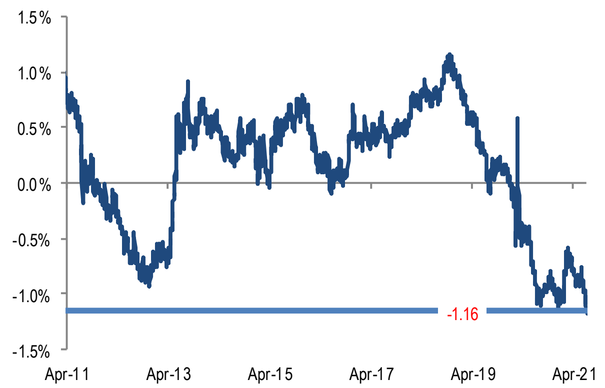
Yesterday, the US long-term yield rose to 1.27%. It surfaced slightly from below 1.25%, which I view as within the overshoot range. However, the MOVE Index declined from 70 to 62, which is a sign that the yield may take root at around the current level. While stock indices are chasing higher prices, yields aren't bouncing back very well.

The thing attracting attention recently is the decline in real yields (in addition to nominal yields, of course). With yesterday's rise in yields being driven by inflation expectations, the real yield—Treasury Inflation-Protected Security (TIPS) yield—stayed at the extraordinary level of –1.16%. Real yields remain surprisingly low, despite the Fed having clearly mentioned progress towards tapering in a statement.

One factor behind this may be found in the term premium. In Jan-Mar 2021, the term premium surged by around 150bp, which was almost the same as during the taper tantrum when the Fed was led by Ben Bernanke. However, it recently fell back halfway to where it had been, serving as a factor in lowering US yields.

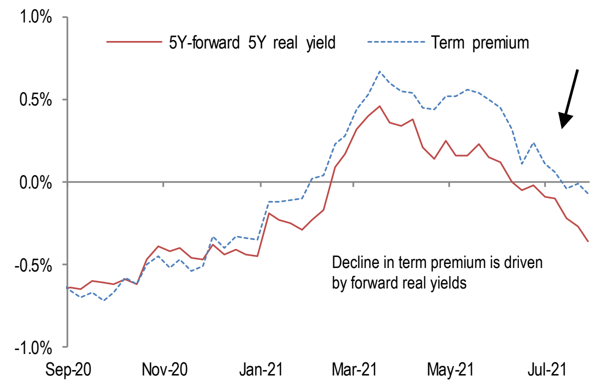
Since the term premium has been declining in tandem with the drop in forward real yields, it is very possible that the decline is driven by the term premium on real yields. The background behind the drop in forward real yields has already been explained by our senior economist Kenji Yamamoto. In the words of Treasury Secretary Janet Yellen, "Investors haven't forgotten the pattern of secular stagnation."

US 10Y Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

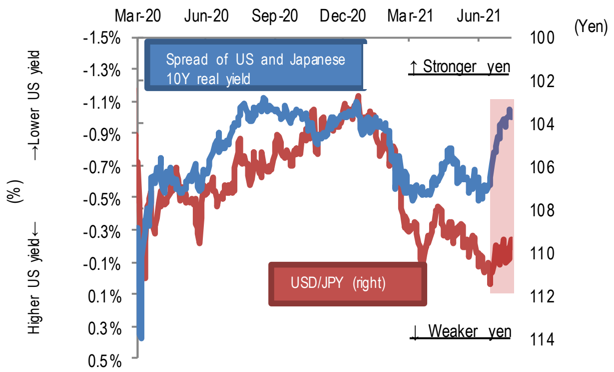
US Treasury 5Y-forward 5Y Real Yield, Term Premium



Source: Bloomberg; compiled by Daiwa Securities.

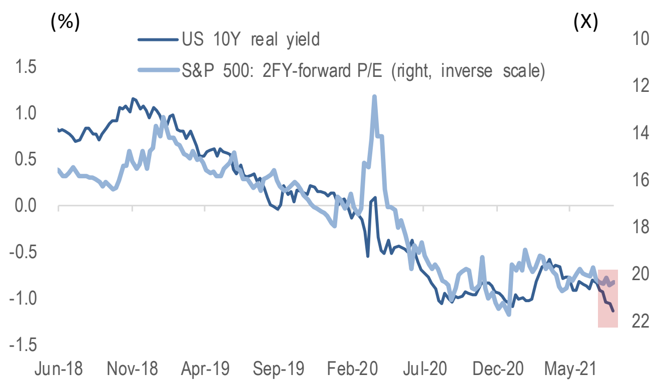
That said, I get the impression that the recent decline in real yields is beyond the range of what can be explained based on these considerations. One reason for them declining to the point that is somewhat counterintuitive may be a technical factor—specifically, real yields (inflation expectations) being distorted by an unbalanced allocation of coupon-bearing bonds and inflation-linked bonds via the Fed's QE. Currently, the correlation between the USD/JPY rate and the relative difference of real yields has weakened substantially. This fact points to the possibility that US real yields are reflecting technical factors, instead of actual conditions. Given the balance in the past, we estimate that the USD/JPY rate will drop further by around several yen and US stocks will rise by another 10% or so.

USD/JPY Rate, Relative Difference of US and Japanese Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

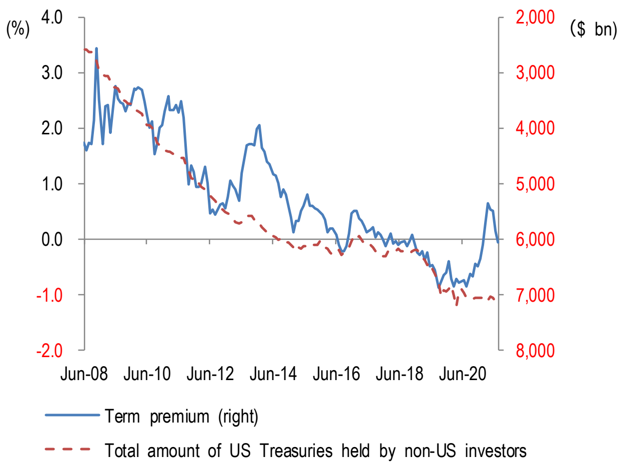
US 10Y Real Yield, Stock P/E (S&P 500)



Source: Bloomberg; compiled by Daiwa Securities.

Japanese investors appear to be taking the approach of selling on rally amid falling US yields. However, there appears to be a resurgence in investment in US Treasuries globally (with the exception of Japan). Looking at the amount of US Treasuries held by non-US investors (disclosed on 17 Jul), the balance of Japanese investors has declined slightly despite the amount held by non-US investors having increased from $7.07tn to $7.135tn. Given the long-term correlation between the term premium and the amount of US Treasuries held by non-US investors (chart below), we surmise that the amount held by non-US investors has been increasing (at an accelerated pace) since May, which should be confirmed by upcoming data.

Term Premium, Amount of US Treasuries Held by Non-US Investors



Source: Bloomberg; compiled by Daiwa Securities.

◆ JGB: Prime Minister Suga calling for formulation of additional economic package

Yesterday, the media (Jiji Press) reported that Prime Minister Yoshihide Suga intended to call for the formulation of an additional economic package. The article said that the LDP is planning to formulate a proposal in the first half of September in order to appeal to the electorate during the lower house election, and then pass a supplementary budget that includes an additional package in the Diet after the election. As this Jiji Press article is in line with our view in terms of the timing of the Cabinet approval of the extra budget, this seems reasonable. (At this point, we forecast that (1) the Cabinet will approve an extra budget with a real stimulus of Y30tn in November and (2) the JGB issuance plan will be slightly increased. For details, please ask our senior fiscal policy and credit analyst Kouji Hamada.)

Although the supplementary budget is a topic that has been factored in to some extent, we are seeing new developments due to the accelerating surge in the number of COVID-19 infections, the extension to the length of the state of emergency, and a further drop in the Cabinet's approval ratings. If the size of the real stimulus balloons in order to make a stronger appeal to the electorate, this may become a factor for steepening.

However, if we assume that the timing of the actual issuance of additional JGBs is far off, we cannot factor this in with conviction at this point. Therefore, we should continue to carefully monitor developments with infections and approval ratings.

Hypothesized Specifics of Supplementary Budget

Cabinet decision: Nov
Size of real stimulus: Y30tn
JGB issuance plan: Likely to be slightly increased

Source: Compiled by Daiwa Securities.

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