Daiwa's View

Lingering impact from Clarida's comments

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Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

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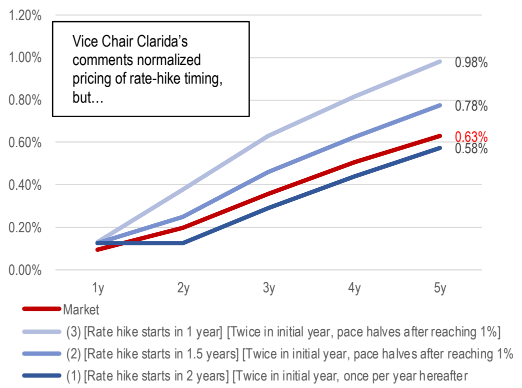
Yesterday, US Treasury yields rose led by intermediate yields, leading to flattening. Looking back, we get the strong impression that we are seeing the lingering impact of comments made by Fed Vice Chair Richard Clarida the night before last. Reviewing his comments, we found that it was clear that he intended to suppress an excessive drop in yields, as he made a direct reference to the extent to which yields had fallen, saying "I have been surprised certainly by the magnitude of the decline in bond yields," and, in effect, stated that his (vice chair) dot was included in those projecting rate hikes in 2023.

We also note that the 10-year real yield rose by 5bp, more than the nominal yield did. Amid the rise in real yields, the S&P 500 Index hit a record high. As higher yields did not have an impact on risk asset prices, the rise appears to be partly reflecting a decline in the impact of technical factors. As we have often pointed out in Daiwa's View reports, real yields have declined more than the true value due to technical factors. However, this phenomenon is likely to be eased by (1) an increased issuance of TIPS in quarterly regular auctions and (2) the Fed's early tapering path implied by Vice Chair Clarida.

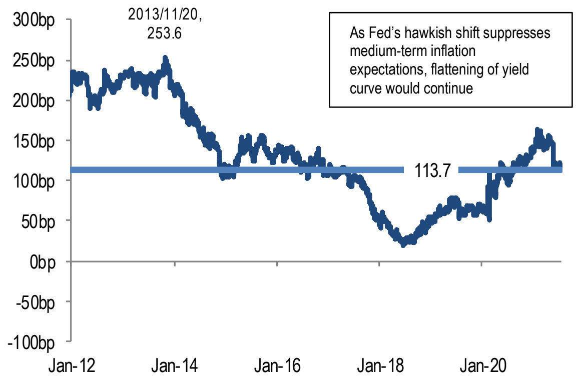
Moreover, the absence of these technical factors serves as a factor in lowering the BEI, which has been overvalued thus far. In fact, the 5-year forward 5-year BEI declined to 2.19% yesterday in contrast to the rise in stock prices and nominal yields. Although there are strong concerns about near-term inflation, it is highly possible that the yield curve will flatten if the Fed rushes to the exit strategy with medium/long-term inflation expectations staying at around 1.89% on a PCE basis (2.19% – 0.3%). A rebound from the overshooting range is expected, but it would be premature to think that long-term yields have returned to an uptrend due to expectations for reflation.

5Y OIS Yield, Simulation by Rate-hike Scenario



Source: Bloomberg; compiled by Daiwa Securities.

US Treasury 5Y/30Y Spread



Source: Bloomberg; compiled by Daiwa Securities.

- Expectations for higher yields diminishing
  The Delta variant is spreading more than anticipated in Japan under the circumstances, as witnessed by the fact that Minister of State for Economic and Fiscal Policy Yasutoshi Nishimura mentioned that the government was temporarily considering declaring a state of emergency nationwide as the number of daily infections in Tokyo has exceeded the 5,000 mark. It is becoming increasingly likely that the policy of firmly restricting the flow of people will continue, which would inevitably lower growth rate projections in the Jul-Sep quarter.

  According to today's *Nikkei* (morning edition), the size of summer bonuses at major firms as tabulated by the Japan Business Federation decreased by 8.27% compared to last summer, the sharpest drop since the global financial crisis. The size of bonuses in the non-manufacturing sector dropped 17%, which appears to have exceeded the decline at the time of the global financial crisis. Favorable earnings in some sectors, which are less susceptible to the pandemic, are impressive. However, as we are seeing a patchy recovery, regaining balance on a macro basis would appear to be getting harder than indicated by stock indices. If measures for restricting the flow of people are bolstered due to the Delta variant, the tendency towards a lopsided recovery may increase even further.

  This situation is likely to cast a dark cloud over economic recovery scenarios that assume withdrawals of "forced savings" estimated at Y20tn in the BOJ's April *Outlook for Economic Activity and Prices* report.

  First of all, using a unique method for making corrections to consumption propensity, our senior economist Toru Suehiro estimates that the amount of forced savings is around Y10tn, not the Y20tn estimated by the BOJ. (This means that the amount of forced savings estimated by the BOJ may be excessive.) Mr. Suehiro also pointed out that "forced savings" may shift to preliminary savings due to worries about the future, which is very convincing on an intuitive level. In addition to this estimate and opinion, if (1) a policy to firmly restrict the flow of people is bolstered due to another declaration of a state of emergency caused by the spread of the Delta variant and (2) incentives for preliminary savings increase due to the substantial cut in bonuses, that will also cast a dark cloud over scenarios that assume the following chain of events: vaccine distribution → withdrawals of forced savings → economic recovery → higher yields. Putting aside for the moment whether a 10-year JGB yield of 0% is correct, we get the impression that expectations are diminishing that a recovery in the PMI will result in higher JGB yields.

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