Daiwa Securities

Daiwa's View

The 'cushion' is gone

➢ With the new structure going forward, risk asset prices will likely be directly hit by negative factors

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Yesterday, the 10-year US Treasury yield closed at around 1.25%. Since the beginning of this week, yields have changed little despite a decline in stock prices, which has made us aware of a change in trends.

The Fed has consistently offered a 'cushion' since the outbreak of the pandemic, but this appears to be diminishing. Up until now, the theory was that positive factors led to higher stock prices in a straightforward way, and negative factors also led to higher stock prices in anticipation of prolonged easing. However, amid persistent and stronger-than-expected (albeit transitory) inflation pressure, this structure seems to have started to change.

Yesterday's news that Toyota Motor will cut global output by 40% in September has confronted us with the reality that supply constraints since the pandemic are unlikely to be resolved soon. If so, the demand side, instead of the supply side, needs to be constrained in order to ease inflation pressure, which has been cooling consumer sentiment significantly. In other words, what is needed now is exactly what is prescribed during stagflation.

Basically, the policies of both fiscal spending and monetary easing are having the effect of tightening the supply/demand gap. This is extremely effective during deflation (demand < supply), but this will very likely worsen the situation during inflation (demand > supply), like now. Since the extension of easing worsens the situation, we cannot expect the kind of cushion we have had in the past, despite increasing concerns about economic downturns.

In the end, comments by Fed Vice Chair Richard Clarida in early August and the University of Michigan's Consumer Sentiment Index released at the end of last week were probably game changers. The minutes of the July FOMC meeting are simply confirming this trend after the fact. With this new structure, it is highly possible that risk asset prices will be directly hit by negative factors from now on. While this is in the essential nature of the market, people need to be rehabilitated from a state in which they have become accustomed to the market since the pandemic.

Fed Vice Chair Richard Clarida (4 Aug 2021)

・I have been surprised certainly by the magnitude of the decline in bond yields. …The necessary conditions for raising the target range for the federal funds rate will have been met by year-end 2022. …My projection of an interest rate liftoff in 2023 is consistent with the 2% average inflation targeting regime that the Fed adopted last year and incorporates the reality of an expansionary fiscal policy that has resulted more than $2 trillion in excess household savings.

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