Daiwa's View

Factors behind recent across-the-board selling

➢ Prelude to across-the-board buying reaction

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Prelude to across-the-board buying reaction

Factors behind recent across-the-board selling

◆ Pause in adjustments to flattening speed

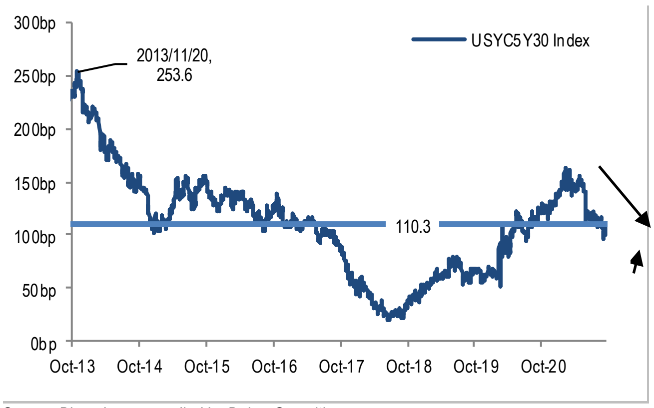
Yesterday, US Treasury yields rose substantially. Given market factors, we think that the 10-year yield will likely rise briefly to around 1.65%. That said, looking at the extent of the rise by maturity, the curve posted a parallel shift of around 5bp in the 5-year and longer zone. Thus, we note a change in the situation from the steepening seen over the past two weeks.

Examining the 5-year/30-year US Treasury spread in the past shows that it had steepened substantially from August 2020 toward May 2021 when reflation was a major topic. Since the spread hit a peak on 13 May at 156bp, the curve turned, flattening in the light of a hawkish shift by the Fed. On 22 September, the 5-year/30-year spread logged at 95bp, which was 61bp narrower than its recent peak.

Subsequently, the 5-year/30-year spread has rebounded slightly to 110bp. However, we do not think that this rebound means a full return of the steepening market. It appears to have been just a pause in adjustments to the speed of flattening.

Since the Fed turned to a hawkish stance at the June FOMC meeting, favorable economic conditions and rising inflation have served as factors in strengthening the prospect of rate hikes. Therefore, we have gradually seen flattening alongside higher probability of rate hikes, with superlong yields largely stabilizing, anchored by the longer run. This big picture is still unchanged. Regarding the slight rebound over the past two weeks, it can be interpreted as the extent of adjustments being slightly larger than anticipated due to the combination of adjustments to the flattening speed and a surge in resource prices.

5Y30Y UST Spread



Source: Bloomberg; compiled by Daiwa Securities.

◆ Factors behind across-the-board selling

Another characteristic movement seen over the past two weeks is that the markets were close to "across-the-board selling" of stocks, bonds, and credit. As such a situation had not been seen since the recovery from the pandemic, we need to examine the background factors. To state our conclusion at the outset, we think that this movement reflected the progress of the Fed's exit strategy.

In qualitative terms, asset prices are determined by the interplay of two factors: fundamentals and degree of monetary easing. Under normal circumstances, there is support from monetary easing in a phase of deteriorating fundamentals. In contrast, in a phase of recovering fundamentals, removal of monetary easing dampens upward momentum and constrains cyclical fluctuations. In other words, monetary easing plays a counter-cyclical role under normal circumstances.

The COVID-19 crisis brought the worst and shortest recession in the world's history. Consequently, when the cyclical recovery of fundamentals hit a peak, but monetary easing continued to provide the largest-ever support, this appears to have excessively amplified the cyclical uptrend. In other words, there is a possibility that a delay in removing monetary easing caused across-the-board buying in this case. (This is the reason I wrote "Is Fed almost in checkmate?")

Although a little late, the Fed's monetary easing will enter a new phase next month, heading towards the removal of easing. On 13 May 2021, our senior economist Kenji Yamamoto warned of the risk of the Fed's reluctant shift to the hawkish stance amid stagflation, which is becoming a reality. If so, the recent "mini" across-the-board selling may have been a prelude to the start of reactionary movements against the continued "across-the-board buying." The opposite of across-the-board buying is across-the-board selling. When the peaks are high, the valleys are deep. We probably need to brace for a bumpy market in 2022.

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