Daiwa Securities

Daiwa's View

US yields are not rising as much as expected

- A rise to the 1.6% level appears possible in the near term, but..

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US yields are not rising as much as expected

A rise to the 1.6% level appears possible in the near term, but..

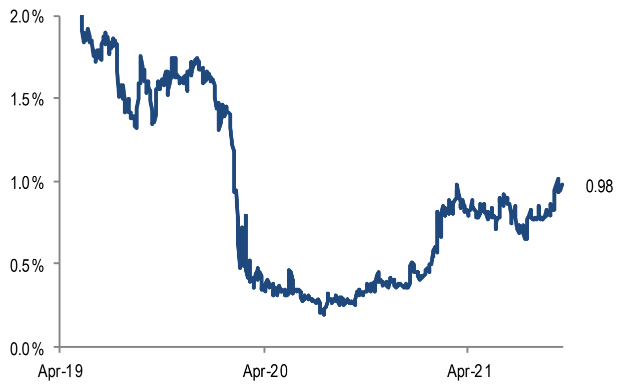
The media have been reporting about a 'surge in US yields,' but my honest impression is that yields are not rising as much as one would expect considering existing factors that have the potential to contribute to a rise. In this report, we observe developments by breaking down the 10-year US Treasury yield (10Y UST) into the 5-year yield (5Y UST) and 5Y-forward 5Y yield (5Y5Y UST).

The median of the estimated 5Y UST (first half of 10Y UST) at end-2021 is approximately 1%. However, the 5Y UST is currently at 0.98%, and its highest level over the past two weeks was 1.04%, both of which are very reasonable movements within the estimated range.

The 5Y5Y UST, on the other hand, is currently reflecting three factors: (1) a rebound from an excessively low level (nearly equal to the 1.7% level), (2) widening of the term premium due to a surge in energy prices (real term premium and inflation risk premium), and (3) a rise in short-term bond yields due to debt ceiling issues.

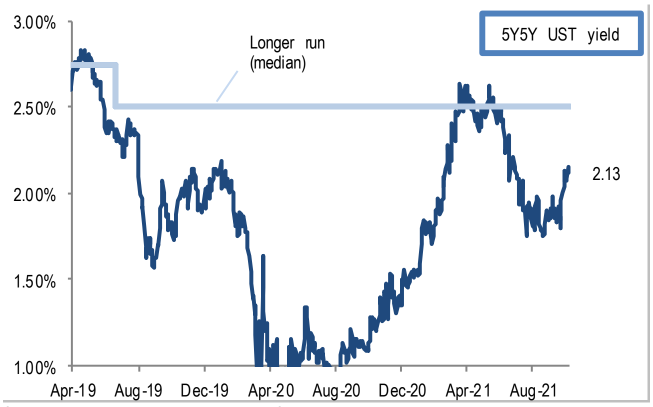
Accordingly, the 5Y5Y UST is expected to rise beyond its estimated value (median: 2%). On an intuitive level, I am not uncomfortable with a rise in the 5Y5Y UST to around the projections of primary dealers (2.25%), which corresponds to a 10Y UST of 1.60-1.65%. However, even the highest levels of the 5Y5Y UST and the 10Y UST were actually limited to the 2.1% level and the mid-1.5% level, respectively. This gave me the impression that yields are not rising as much as one would expect considering existing factors that have the potential to contribute to a rise. We could point out here aspects creating stronger demand for flight due to (1) a stronger dollar, (2) lower stock prices, and (3) a more bearish high-yield corporate bond market, in addition to contributions to bond supply/demand conditions from the ongoing QE proceeding at full speed at the Fed.

5Y UST Yield



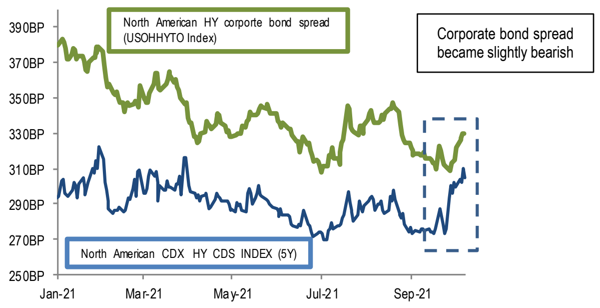
Source: Bloomberg; compiled by Daiwa Securities.

5Y5Y UST Yield, Longer Run



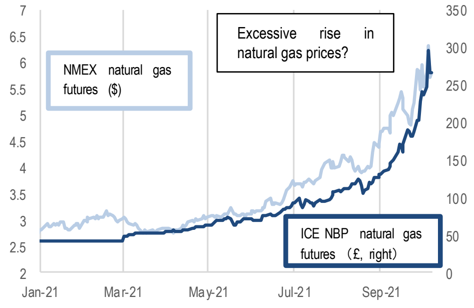
Source: Bloomberg; compiled by Daiwa Securities.

North American HY CDS Index, Corporate Bond Spread



Source: Bloomberg; compiled by Daiwa Securities.

Natural Gas Futures Price



Source: Bloomberg; compiled by Daiwa Securities.

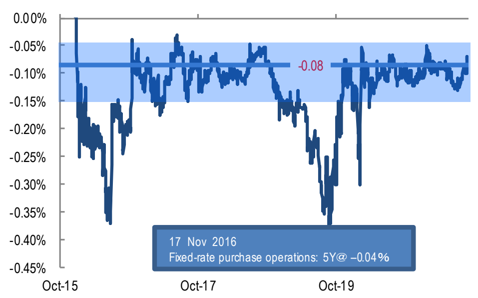
As the 30Y UST yield is strongly correlated with the WTI crude oil futures price (refer to our report dated 1 Oct), the yield is influenced more by energy price trends than yields in other maturities. In this regard, it is important to recognize that energy price trends involve a strong element of politics, as well as demand. In fact, the price of ICE NBP natural gas futures plunged from 407 pounds to 273 pounds yesterday after Russian President Vladimir Putin indicated his intention to increase the supply of natural gas to Europe.

As is well known, it is not Russia but the US and some of the EU nations concerned that are against Russia's gas supply via the Nord Stream 2 pipeline. We understand that energy dependence on Russia is a security threat. However, a surge in natural gas prices to critical levels will make it easier to produce a political compromise. The exponential rise in natural gas prices since last month appears to be excessive. If so, we need to carefully gauge how long the rise in yields, which reflects the sharp rise in energy prices, will continue. Yesterday's comments by Russian President Putin and the plunge in natural gas prices may have increased awareness of the issue.

◆JGBs

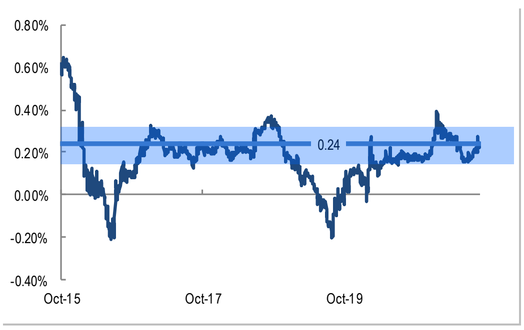
Yesterday, the 10-year JGB yield and 20-year JGB yield rose to around 0.085% and 0.45%, respectively. These levels are close to the upper limits of our estimated core ranges for 2H FY21. Observing developments by breaking down the 10-year JGB yield (10Y JGB) into the 5-year JGB yield (5Y JGB) and 5Y-forward 5Y yield (5Y5Y JGB), we found that both are within the estimated ranges, but they are close to the upper limits.

5Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

5Y5Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Currently, the 5Y JGB is at –0.08%, 2bp higher than the policy interest rate level of –0.10%, and close to the upper limit of the range since the introduction of the yield curve control (YCC) policy. We presume that this level is reflecting (1) the impact from rising intermediate yields in Europe and the US, which have priced in rate hikes, (2) the BOJ's measures to allow negative interest rates to lose their effectiveness (lavishing IOER at 0% and +0.1%), and (3) the issuance of additional JGBs for a supplementary budget.

Furthermore, the 5Y5Y JGB is now at 0.24%. It has remained at the 0.2-0.25% level for a long time since the introduction of the YCC policy, and that level is our projected core range for 2H. In all three cases in which the 5Y5Y JGB topped 0.3% in the past, we simultaneously saw (1) a sudden rise in US yields and (2) a decline in confidence in the BOJ's YCC (or trading band).

Interpreting current levels given the above, US yields are expected to rise to some extent, but we do not have absolute proof whether or not the rise will become panicky (as currently trumpeted by the media) to the point of constituting the sudden rise in US yields mentioned in item 1 above. In addition, market participants want to ascertain the impact of newly introduced BOJ measures to allow negative interest rates to lose their effectiveness, which appears to be resulting in movements at the upper levels of the range.

I do not forecast that the surge in US yields will continue. Regarding the BOJ's measures to allow negative interest rates to lose their effectiveness, the upper limit of the IOER would be 0.1% (unless it is lifted). Therefore, we think there is a very strong need for the 10Y JGB to be at least 0.1%. Considering the risk of reinvestments to secure yields after COVID-19 special operations come to an end, as well, we think that a 10Y JGB of at least 0.07% is the level to activate buying on dips. Assuming the median of the 10Y/20Y spread were 38bp, we would come to the same conclusion regarding a 20Y JGB of at least 0.45%.

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