Daiwa Securities

Daiwa's View

Factors behind violent flattening

- Violent flattening: Product of "stagflation-like" situation
- Recommendation: Long positions of superlong government bonds + Flexible delta hedging by using bond futures

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.

Factors behind violent flattening

Product of "stagflation-like" situation

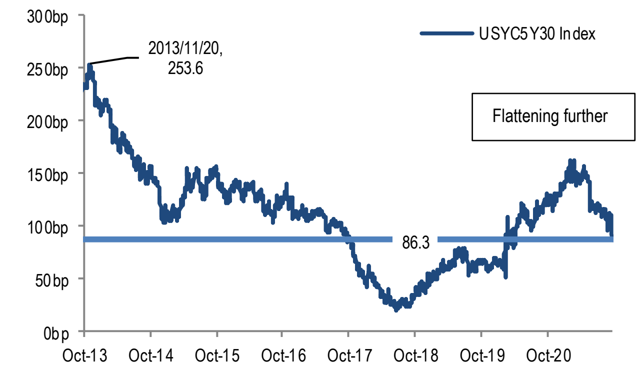
◆ 5-year/30-year US Treasury yield spread declined to 86.3bp

Yesterday, we reported the fact that last weekend's 5-year/30-year US Treasury yield spread substantially flattened to 91.5bp for the first time since May 2020. Last night, the spread flattened further, falling below 90bp at a stroke to 86.3bp. We are continuing to see a structure in which the combination of "the lack of a rise in long-term forward yields" and "rising short-term/intermediate yields" prompts twist-flattening. This makes us feel like describing this flattening as "violent."

Such flattening has been widely observed; it is not a US-specific phenomenon. For example, the 5-year German government bond yield rose 5.8bp yesterday, while the 30-year yield declined 4.4bp. As a result, the 5-year/30-year spread tightened by 10.2bp d/d. Given the fact that the flattening of the 5-year/30-year spread is occurring around the world (including Switzerland, Canada, Mexico, and Australia), we presume that one of current market topics is a "decline in the global equilibrium interest rate."

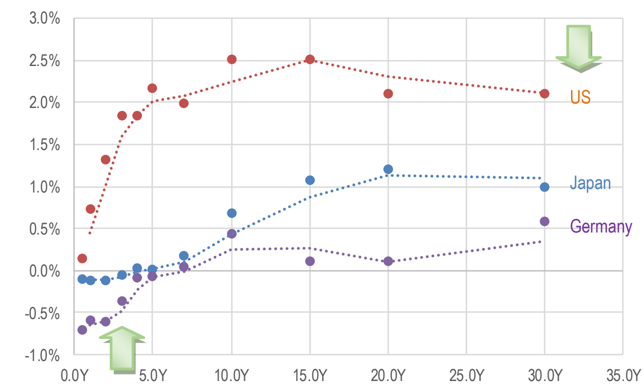
Following the approach outlined in an excellent speech on 17 May by Fed Vice Chair Richard Clarida, interest rates can be thought of in terms of an "equilibrium rate" explained by the macro economy, and a "policy rate spread," a spread between the equilibrium rate and the actual federal funds rate that is lowered by the central bank by making full use of easing tools. Based on the big-picture framework that the yield curve is formed by these two elements (which is used regularly in *Daiwa's View* reports), we can say that the recent flattening is reflecting the two elements of "weakening motivation to continue easing" at the central bank and "the decline in the equilibrium rate" in a "stagflation-like" situation.

5Y/30Y UST Spread



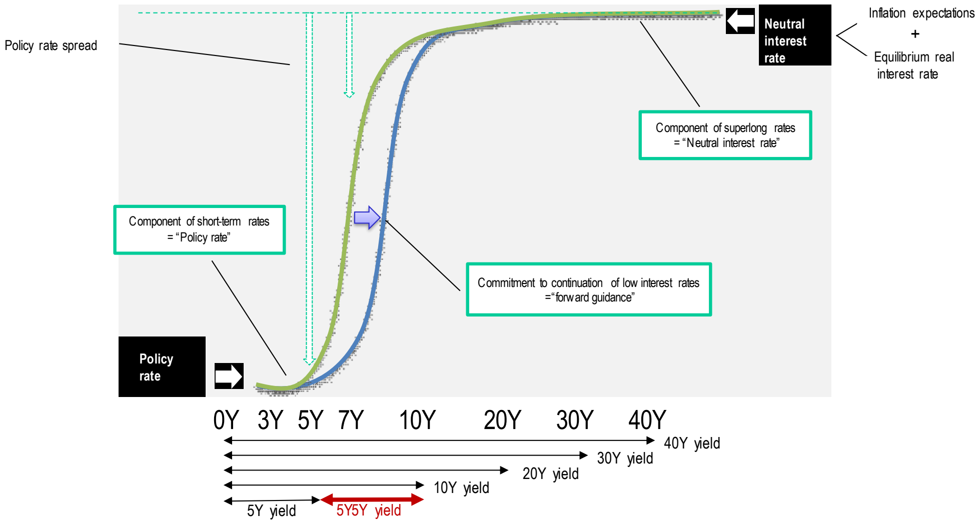
Source: Bloomberg; compiled by Daiwa Securities.

Instantaneous Forward Rates in Japan, US, Germany



Source: Bloomberg; compiled by Daiwa Securities.

Instantaneous Forward Rate, Policy Rate Spread (diagram)



Source: Compiled by Daiwa Securities.

◆ Tightening of policy rate spread and decline in equilibrium rate, products of the stagflation-like situation

There is one important issue to be confirmed when basing our assertions on this framework. That is whether the policy rate works on the equilibrium rate. The answer is "partially yes." Although the equilibrium rate is mostly accounted for by the macro economy, a high-pressure economy path due to the continued low interest rates raises (slightly) the level of the equilibrium rate. As the opposite is true, premature rate hikes result in (slight) decline in the level of the equilibrium rate. This would be obvious from the fact that the yield curve steepened the most in around March 2021 when the Fed's stance was judged as dovish, followed by full-scale flattening of the curve since the Fed turned to a hawkish stance at the June FOMC meeting. For reference, this policy effect from the high-pressure economy path was one of theoretical pillars of the flexible average inflation target (FAIT), which was adopted when last year's Jackson Hole speech was made.

However, "extended-transitory" inflation since the pandemic and the recent surge in energy prices stimulated the hawkish stance at the central bank and made it difficult to implement the FAIT and to continue on the high-pressure economy path. If this situation brings about a double punch of policy rate spread tightening and equilibrium rate decline, yield curve flattening would be self-evident. In short, the final impact from the current stagflation-like situation on the yield curve is flattening, and the main causes are the decline in the equilibrium rate and the tightening of policy rate spread. If we think of this from the standpoint of bond investment positions, we now recommend long positions of superlong government bonds and flexible delta hedging by using bond futures.

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** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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