Daiwa Securities

Daiwa's View

Will flattening spread to JGBs?

- I. Flattening of US yields during rate hikes does not spread to JGBs
  II. From an economic cycle standpoint, now is the time to buy JGBs

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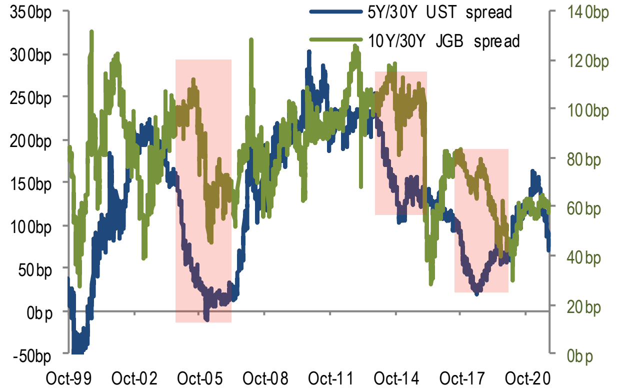
Reflecting the hot US CPI in October, the 5-year/30-year US Treasury (UST) spread flattened to below 70bp at one point. As previously reported, the combination of rising short-term/intermediate yields and the lack of a rise in forward yields is creating the third major flattening stage since the beginning of this century.

While US yields have flattened significantly in this way, the JGB yield curve has seen almost no flattening. How should we assess this divergence? To state our conclusion at the outset, it is expected that US yield flattening driven by the Fed's rate hikes will not spread to JGBs, at least in the initial stage of rate hikes. In addition, this kind of stage can be seen as a 'buying opportunity' from the standpoint of cycle-based investment timing.

5Y/30Y UST Spread, 10Y/30Y JGB Spread



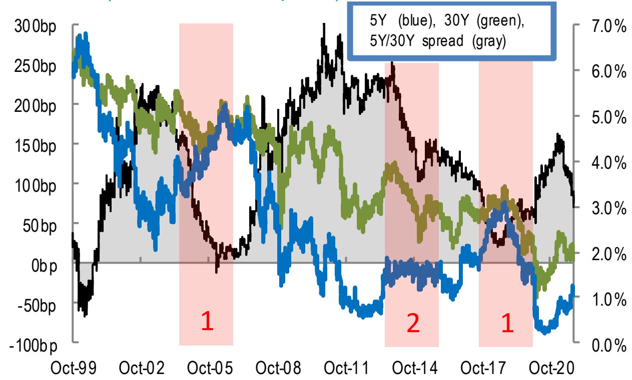
Source: Bloomberg; compiled by Daiwa Securities.

◆ <u>Two patterns of flattening</u>

A tighter spread between long-term and short-term yields is described as 'flattening.' Observing flattening of US yields since the beginning of this century, two patterns can be identified in their development (chart on next page). The first pattern of flattening is due to a rise in short-term/intermediate yields, while the other is led by a decline in long-term/superlong yields (forward yields). The implications for JGBs differ depending on the pattern of flattening of US yields.

- **Pattern 1:** <u>Flattening led by rise in short-term/intermediate yields</u>
  Observing the flattening of US yields since the beginning of this century, we see that flattening led by short-term/intermediate yields occurred during 2004-2006 when ex-Fed chair Alan Greenspan conducted rate hikes at a frequency of eight times per year, and during 2015-2018 when former Chair Janet Yellen and current Chair Jerome Powell implemented rate hikes at a frequency of four times a year (with a temporary pause), as indicated by "1" in the chart below.

UST Yields (5Y, 30Y, 5Y/30Y spread)



Source: Bloomberg; compiled by Daiwa Securities.

- <u>Pattern 2: Flattening led by forward yields</u>
  Meanwhile, the flattening of US yields during the taper tantrum during 2013-14 was led by a decline in long-term/superlong yields ("2" in chart above). The "global level factor" Fed Vice Chair Richard Clarida referred to in his speech in May 2021 was a contributing factor with this pattern. When the main cause of US yield flattening is a drop in the global equilibrium interest rate (r*), flattening tends to occur simultaneously around the globe.

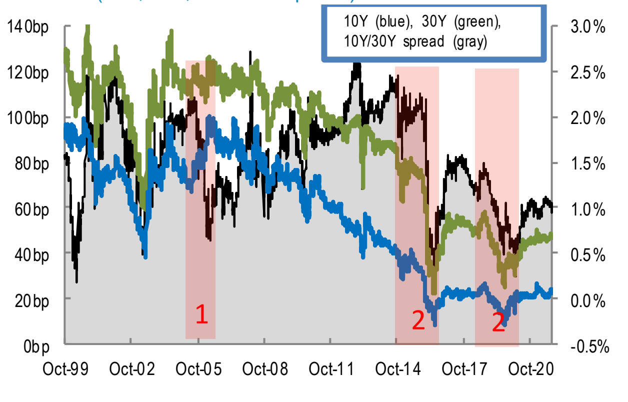
Global Level Factor, R*

Source: Extracted from speech by Fed Vice Chair Richard Clarida (17 May 2021).

- <u>Implications for JGBs</u>
  What are the implications of each pattern for the shape of the JGB curve?

  The implications of pattern 2 are obvious—reflecting the decline in the global equilibrium interest rate, JGB yields also decline led by superlong yields. In fact, JGB and UST yields flattened after the taper tantrum in 2013, having almost the same trajectory (chart below). This implies that it is highly likely that the drastic flattening of JGB yields since the Halloween easing in October 2014 was caused by both the BOJ's QE known as Kuroda Bazooka and the influence of the drop in the global equilibrium interest rate.

JGB Yields (10Y, 30Y, 10Y/30Y spread)



Source: Bloomberg; compiled by Daiwa Securities.

Meanwhile, the influence that is assumed to be behind pattern 1 (the current case) is somewhat more complicated than that behind pattern 2. To begin with, from an economic cycle standpoint, the US economy becomes overheated when the Fed engages in rate hikes. Such favorable economic conditions in the US have a certain degree of positive impact on (creating a tailwind for) Japan's economy, as well. Speculation about rate hikes by the Fed could also prompt appreciation of the dollar (weaker yen). There is a good chance this tailwind behind Japan's economy will exert (slight) upward pressure on JGB yields.

As a result of prolonged inflation at around 0%, Japan's inflation expectations are adaptively (or in a backward-looking manner) fixed at a low level. Accordingly, short-term/intermediate yields are unlikely to rise for the time being. When the Fed is engaging in rate hikes, the US yield curve is, therefore, expected to flatten due to a rise in short-term/intermediate yields. Meanwhile, JGB short-term/intermediate yields are likely to rise little, but superlong yields are expected to rise slightly. As a result of these two price movements, in the flattening stage of the US yield curve led by the Fed's rate hikes, the shape of the JGB yield curve is likely to change little, or steepen slightly, reflecting the rise in superlong yields.

In the final stage, when concerns about an inverted yield curve and a recession start to grow as short-term/intermediate yields exceed forward yields due to rate hikes by the Fed, the market grows aware of the Fed steering towards 'rate cuts.' In this kind of final stage, the US yield curve starts to steepen again due to rate cuts (decline in short-term/intermediate yields), but JGB short-term/intermediate yields do not decline, as there is no room for rate cuts. On the contrary, the JGB curve is likely to flatten due to a decline in long-term/superlong yields, reflecting the deterioration of business sentiment.

All in all, it is estimated that the movements led by long-term/superlong yields driven by a change in the global equilibrium interest rate (pattern 2) easily spread to global yields, while flattening (steepening) led by rate-hike expectations (pattern 1) does not easily spread to JGBs. Reconsidering the above from a slightly longer-term perspective, now is the 'time to buy,' as long-term/superlong yields are rising because the Fed's rate hikes are generating a tailwind for Japan's economy. Now is a good opportunity to buy JGBs (especially long-term/superlong JGBs) at the highest yields throughout the cycle.

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