Daiwa's View

The market phase has changed

- ➢ Country-specific factors becoming more pronounced
- ➢ Risks appear to lie with emerging nations, rather than US

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The market phase has changed

Country-specific factors becoming more pronounced

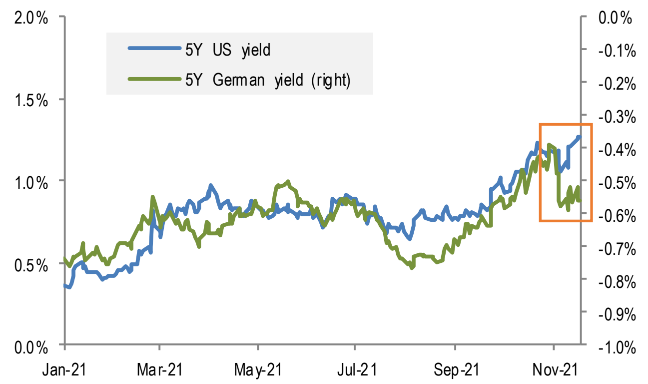
◆ Expectations for rate hikes growing in US, but weakening in Europe

Thus far, the US and European markets had been dominated by similar issues, such as concerns about rate hikes (rate-hike frenzy) and a stagflation-like situation, and price movements tended to go in the same direction. However, price movements appear to have finally changed, and started to reflect circumstances specific to each nation/region. And, on 16 November, US yields rose, while European yields declined led by the short-term/intermediate zone.

The resurgence in COVID-19 infections can be pointed out as one factor behind the drop in European short-term/intermediate yields. However, concerns about a situation resembling wage hike-induced inflation, something the US is beginning to meet the initial conditions for, are not particularly strong in Europe or Japan. Therefore, it is natural to be seeing a divergence in the rate-hike stance at central banks (approximately equal to the direction of short-term/intermediate yields).

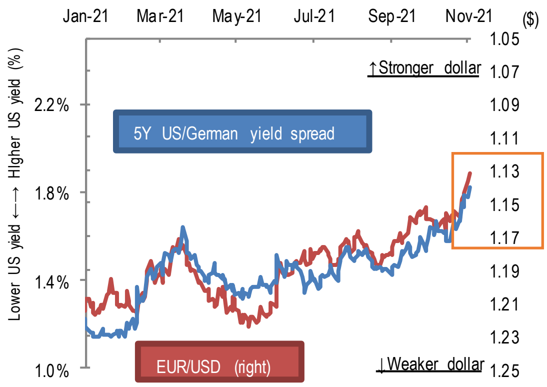
That said, with the divergence in the direction of short-term/intermediate yields becoming this pronounced, the impact on foreign exchange rates appears to be increasing. While the interest rate differential is, of course, not the only determining factor for exchange rates, the EUR/USD rate declined from 1.22 around May to around 1.13 on 16 November. The decline appears to mostly reflect the relative difference in short-term/intermediate yields (right-hand chart below). If we assume that short-term/intermediate yields have started to factor in specific factors in each nation more than before, it is possible the market has finally entered a stage of broad US dollar strength. In that sense, the market phase might have changed, and, therefore, there is a growing need to carefully watch the impact of the strong dollar.

5Y US and German Gov't Bond Yields



Source: Bloomberg; compiled by Daiwa Securities.

5Y US/German Yield Spread, EUR/USD



Source: Bloomberg; compiled by Daiwa Securities.

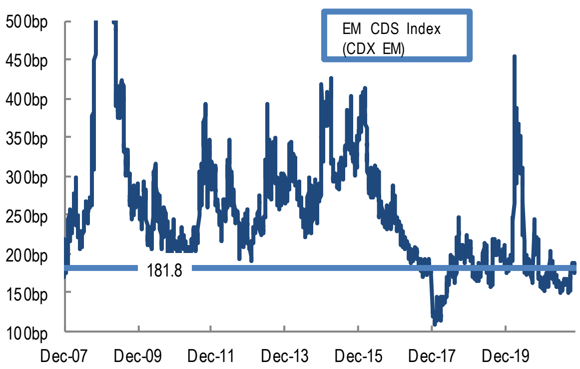
◆ Risks appear to lie with emerging nations, not the US
With the ongoing appreciation of the dollar based on the Fed's rate-hike outlook, it reflects US-specific factors of inflation and the strong US economy. Given its underlying economic strength, we do not expect the US economy to lose steam right away, even if it faces slight appreciation of the dollar.

However, as shown by citations given by Fed Vice Chair Richard Clarida in his speech in May, the impact of the Fed's actions on the entire financial market tend to differ depending on whether those actions are associated with "growth news" or "monetary news." In particular, it is known that Fed policy rate surprises attributed to US inflationary pressures trigger substantial spillovers to emerging market (EM) financial conditions. (Note that the impact of rate hikes attributed to US economic growth is limited.)

Fed Vice Chair Richard Clarida (17 May 2021)
There is a vast literature (Claessens, Stracca, and Warnock, 2016, provide an overview) that documents the existence of spillovers from U.S. monetary policy, especially to emerging market (EM) financial conditions, although the recent paper by Hoek, Kamin, and Yoldas (2020) suggests that the degree of those spillovers depends importantly on the source of the shock that triggers changes in Federal Open Market Committee (FOMC) policy. In particular, as summarized in figure 5.1, they identified FOMC actions associated with "growth news" as those that were immediately followed by changes in the 10-year Treasury yield and the S&P 500 index in the same direction, whereas actions associated with "monetary news" elicited changes in yields and equity prices in opposite directions. Their key finding, illustrated in figure 5.2, was that FOMC policy rate surprises attributed to stronger U.S. growth generally have only moderate spillovers to EM financial conditions, whereas FOMC policy rate surprises attributed to U.S. inflationary pressures trigger more substantial spillovers to EM financial conditions. Regardless of the type of FOMC policy action, Hoek, Kamin, and Yoldas (2020) also found compelling evidence that the size of the spillover effects from the United States depends importantly on the degree of macroeconomic vulnerability of each emerging market economy (EME), with more vulnerable EMEs experiencing larger spillovers.

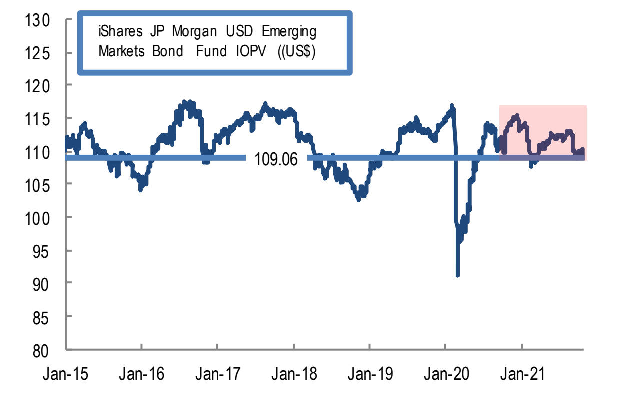
The consensus at the FOMC is that inflation trends over the next several months or until next spring are important, and that they need to watch whether inflation will decline by Apr-Jun or Jul-Sep 2022. Accordingly, the Fed is likely to keep an eye on inflation trends for now. However, if inflation remains high next spring, we may see a rate hike surprise triggered by inflationary pressures, which Hoek, Kamin, and Yoldas (2020) point out, lead to more substantial spillovers to EM financial conditions. It is likely that 'the canary in the coal mine' in this situation will be the EM bond spread, rather than the US high-yield corporate bond spread. Going forward, we need to pay more attention to trends in EM CDS indices and ETF prices.

EM CDS Index (5Y)



Source: Bloomberg; compiled by Daiwa Securities.

EM Corporate Bond Fund Price



Source: Bloomberg; compiled by Daiwa Securities.

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