Daiwa Securities

Daiwa's View

Are we about to see a surge in real yields?

I. If real yields continue to rise, the rise will be led by the 5-year yield
II. The ball is in the credit market's court

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Daiwa Securities Co. Ltd.

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Are we about to see a surge in real yields?

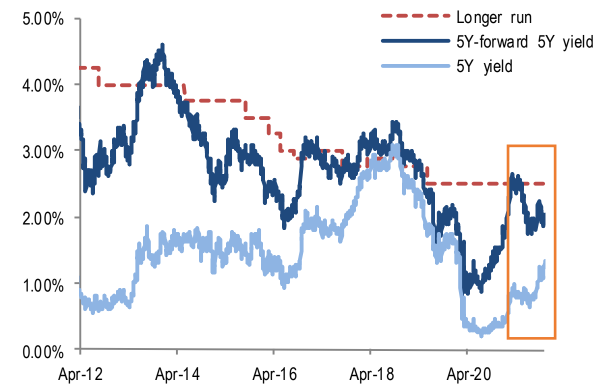
◆ Decision to reappoint Fed Chair Jerome Powell accelerated a rise in yields

US yields have risen substantially over the past two days. As we expected, the market phase appears to have changed. Due to 'double-speed tapering[1]' and 'expectations for earlier rate hikes,' the 5-year and 10-year yields rose to 1.34% and 1.67%, respectively. Reflecting the rise in the 5-year yield, the USD/JPY exchange rate recovered to Y115 at one point.

With Powell and Lael Brainard, who were appointed by President Joe Biden as Fed Chair and Vice Chair, respectively, showing a more cautious tone about inflation right away, the market seems to have been aware of the Fed's hawkish stance. Last week, Fed Governor Christopher Waller and Vice Chair Richard Clarida argued for faster tapering, which served as important preparation. As a matter of course, "a faster taper would certainly give us more optionality" in the words of Atlanta Fed President Raphael Bostic. Double-speed tapering will work on both a rise in the term premium and earlier rate hikes.

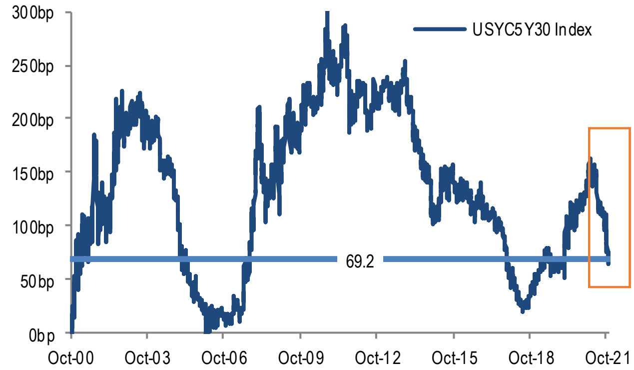
Meanwhile, the 5-year forward 5-year yield and the 30-year yield are continuing to maintain a cruising speed at 2.04% and 2.03%, respectively. From an overall perspective, a flattening market has been maintained due to the combination of a 'rising 5-year yield' and 'the lack of a rise in forward yields.' Yesterday's substantial bear steepening is probably a rebound from overly low levels of forward yields at the 1% level.

UST 5Y Yield, 5Y-forward 5Y Yield, Longer Run



Source: Bloomberg; compiled by Daiwa Securities.

UST 5Y/30Y Spread



Source: Bloomberg; compiled by Daiwa Securities.

1 Doubling the pace of monthly reductions starting next year from $15bn to $30bn, and ending QE in Mar or Apr 2022.

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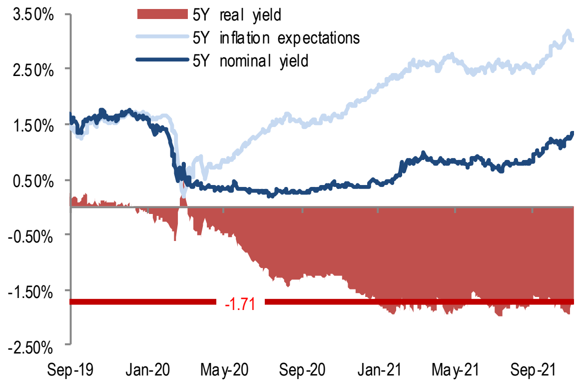
◆ <u>Are we about to see a surge in the 10-year US real yield?</u>

With the Fed chair and vice chair appointments now made, Chair Powell no longer needs to restrain his remarks. Overly low real yields may finally move towards normalization. As the 10-year US real yield is currently extremely low at around –1%, the ultra-accommodative financial environment is boosting a sharp rise in risk asset prices. With the exit strategy becoming an issue, it is a matter of time before a correction occurs with real yields.

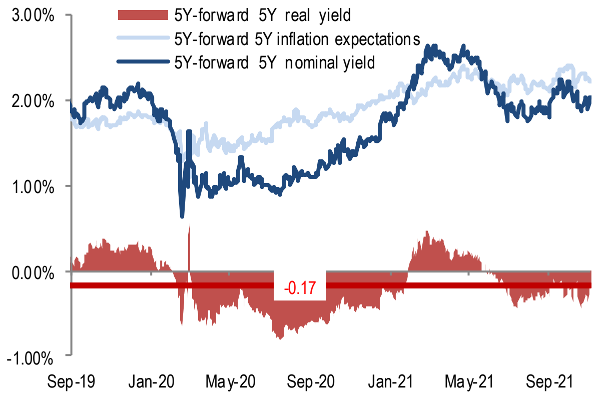
That said, a breakdown of the 10-year US real yield into 'the 5-year yield' and 'the 5-year forward 5-year yield' shows that the current situation is not that simple. While the 5-year yield is deeply negative at –1.71% (inflation expectations of 3.03%, nominal yield of 1.34%), the 5-year forward 5-year yield is still in shallowly negative territory at –0.17% (inflation expectations of 2.21%, nominal yield of 2.04%). The main reason behind the 10-year real yield sagging into deeply negative territory is a low '5-year real yield.' Therefore, if there is a correction with the 10-year real yield starting now, this will very likely happen through a surge in the 5-year real yield. (With the 5-year forward 5-year real yield in shallowly negative territory, it is unlikely to rise substantially.)

UST 5Y Nominal Yield, Real Yield, Inflation Expectations



Source: Bloomberg; compiled by Daiwa Securities.

UST 5Y-forward 5Y Nominal Yield, Real Yield, Inflation Expectations



Source: Bloomberg; compiled by Daiwa Securities.

◆ <u>A rise in real yields occurs in one of two patterns</u>

The issue is how a surge in the 5-year real yield will occur. A rise in real yields occurs in one of two patterns—the rise occurs either via a decline in inflation expectations or via a rise in nominal yields.

In this respect, the Fed repeatedly states that it is important to see if inflation subsides over the next several months. If inflation subsides over the next several months, the 5-year real yield will rise led by a drop in inflation expectations. On the other hand, if inflation does not subside in several months, the 5-year real yield will rise probably due to a surge in the 5-year nominal yield reflecting expectations for earlier rate hikes. If we assume that the 5-year real yield rises, for example, from the current –1.71% to –1%, it is calculated that the 5-year yield will exceed 2%.

However, the 30-year US yield is approximately at the 2% level, and the 5-year/30-year spread has now flattened to the 60bp level. If a surge in the 5-year yield occurs as mentioned above, the 5-year/30-year spread will tighten further and approach an inversion of the yield curve. If that were to happen, turmoil with risk asset prices would be unavoidable.

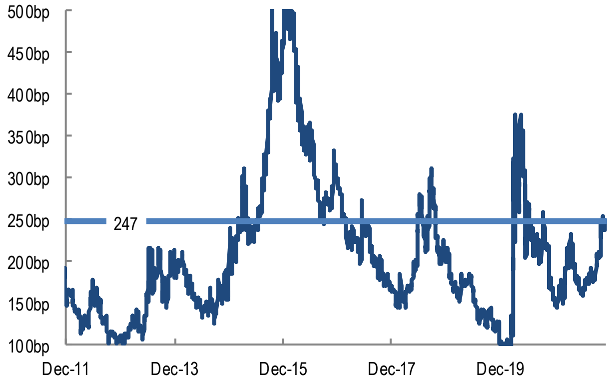
◆ <u>Is the ball in the credit market's court?</u>

Probably anticipating these developments, yesterday's VIX Index recovered to the 20 level and the Markit CDX Emerging Markets Index widened to 199bp, close to its lowest level over the past year (202bp on 8 Mar). The 5-year CDS spread on Brazilian sovereign bonds widened to 247bp, which is nearly the widest level excluding the crisis period. If the Fed becomes more hawkish due to inflation not subsiding after several months, these risk assets may enter 'crisis' mode.

EM CDS Index (5Y, CDX EM)

Source: Bloomberg; compiled by Daiwa Securities.

5Y CDS Spread on Brazilian Sovereign Bonds



Source: Bloomberg; compiled by Daiwa Securities.

As the Fed had been dovish up until now, credit spreads did not worsen in terms of the macro economy. However, with the Fed now serious about coping with inflation, as mentioned above, a surge in the 5-year yield has become a main scenario. In particular, since 5-years is the main maturity in the credit market, the impact of a rise in the 5-year yield on the credit market would be significant. (The two CDS indices mentioned above also have 5-year maturities.)

Of course, as was the case with the rate hike in December 2015 by former Fed Chair Janet Yellen, if serious risk-off situations happen due to tightening by the Fed, the road to rate hikes will be temporarily obstructed. In that sense, one could describe the current situation by saying that the ball is in the credit market's court. With the CDS spread on Brazilian sovereign bonds widening similarly to how it did in 2015, there is a good chance it will follow the same pattern (right-hand chart above).

Although the Fed has started tapering, it is still buying assets worth $105.0bn/month (about 1.5 times the scale of the 'Kuroda Bazooka') in the November reserve maintenance period. With large-scale asset purchases of this degree, risk asset prices are unlikely to decline substantially. That said, with the possibility increasing that the pace of tapering will double from next year, market waves will become correspondingly high.

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