Daiwa's View

Is Fed Chair Jerome Powell facing a conundrum?

➢ Chair Powell referred to overseas supply/demand factors and the neutral interest rate when explaining reasons for decline in long-term yields

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Is Fed Chair Jerome Powell facing a conundrum?

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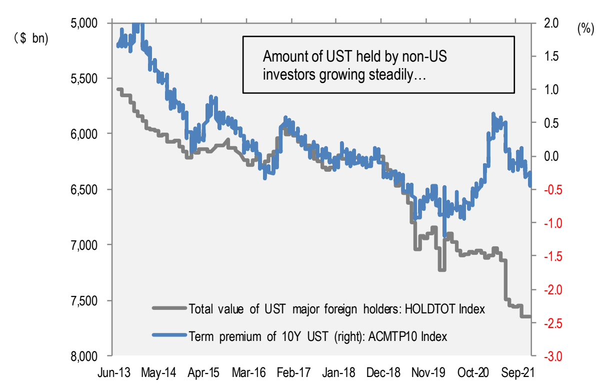
Conceivably, Fed Chair Powell may be facing a conundrum similar to the one ex-Chair Alan Greenspan faced. The post-FOMC press conference gave me that impression.

All major policy decisions at the December FOMC meeting were in line with projections by our senior economist Kenji Yamamoto. In terms of current UST yields, meanwhile, I have been struggling to interpret the forward yield level, which has been substantially lower than the longer run in the Fed's dot plot. Therefore, we paid attention to whether any interpretations would be provided for this. Fed Chair Jerome Powell gave a detailed explanation regarding the background behind the flattening of the yield curve, in which long-term yields are hovering at a low level, by pointing out two factors in the press conference (55 minutes 50 seconds - 59 minutes)[1].

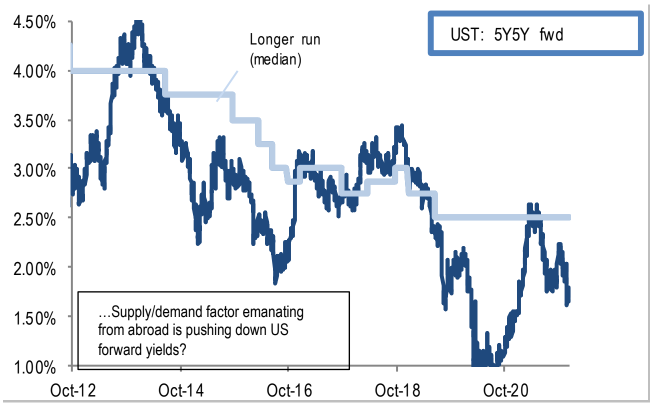
First, he pointed out low yields in other nations and relatively high US yields in the global sovereign bond market. After referring to JGBs and bunds several times, he said that US Treasuries (UST) currently provided high yields even after hedging currency risk and that this attracted global investment demand for risk-free bonds. He also mentioned that "In a way, it's not surprising that there's a lot of demand for US sovereigns in a world," given yield levels in other nations.

Amount of UST Held by Foreign Investors, Term Premium



Source: Bloomberg; compiled by Daiwa Securities.

UST 5Y5Y Yield, Longer Run



Source: Bloomberg; compiled by Daiwa Securities.

[1] He stated "So I think the short-end actions are easy to understand, which is, you know, they're basically very policy-sensitive rates at the short end and it makes sense that it's reacting to changes in expectations for policy."

Somewhat more detailed information was also provided regarding the neutral interest rate (terminal rate). He emphasized that estimating the neutral rate is "highly uncertain," touching on the experience of the previous rate-hike cycle, in which the Fed was forced to preemptively cut rates three times in 2019. He also indicated his view that the current US long-term yield level was not a problem in light of strong overseas demand (caused by the low yields of JGBs and bunds, etc.) and uncertainty regarding the estimated value of the US neutral rate.

◆ Are US forward yields not going to rise in the near term?

Of course, the aforementioned explanations by Chair Powell are probably correct. However, regarding the question of whether the yield levels of JGBs and bunds will rise soon, the answer is probably "No." If we assume that it is difficult to resolve the supply/demand factors caused by overseas investors, US forward yields will remain constrained over the long term.

Also, the Fed Chair's second explanation means that he indirectly admitted the possibility of the US neutral interest rate being lower than the longer run level (median: 2.5%, central tendency: 2.3-2.5%). If we assume that there is a reason to doubt the possibility of forward yields falling from the standpoint of fundamentals, as well, we should view it as highly unlikely that forward yields will rise for the time being.

Moreover, Chair Powell pointed out strong overseas demand as the reason behind the lack of a rise in US yields, which reminded us of "The *Seiho* (Japanese life insurers)" during Greenspan's term. Mr. Greenspan's conundrum has already been resolved—the core of the issue was the decline in the neutral interest rate caused by economic globalization, the aging society with fewer children, and labor saving through advanced technology. But the Fed was unable to fully see this at that time.

In the latest press conference, Chair Powell gave labored explanations about reasons for the decline in US long-term yields by using overseas supply/demand factors stemming from JGBs and other things. Given this, we are unable to deny the possibility that he may be falling into the same rut as Mr. Greenspan. Going forward, this problem will probably have lasting effects. These latest explanations were important for participants in the JGB market, as well as those in the UST market.

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