Daiwa Securities

Daiwa's View

Unexpected decline in inflation expectations

- Could be a reflection of the Fed's hawkish stance or faster tapering?

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Could be a reflection of the Fed's hawkish stance or faster tapering?

Making a final check of yield levels at the current time, immediately before the FOMC meeting, we noted that the UST 5-year yield, 5-year forward 5-year yield, and 10-year yield stood at 1.23%, 1.67%, and 1.44%, respectively, as of 4:00am. The 5-year yield is largely consistent with our scenario, but the 5-year forward 5-year yield has deviated downwards substantially from it. The reason for the 10-year yield level observed in the market being this low continues to be the substantial decline in forward yields. The focus will be on what kind of thinking the Fed indicates regarding the current level, which is hard to justify when compared with the longer run.

UST Yields (%)

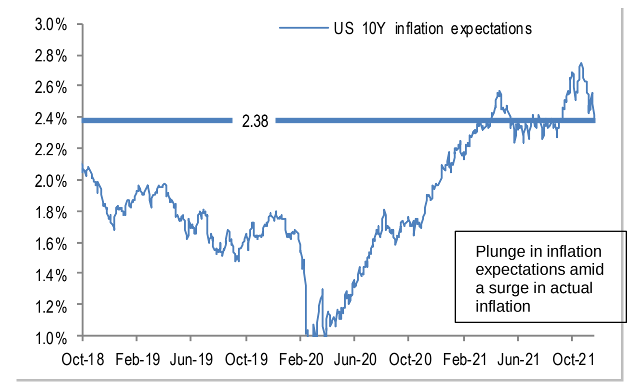
UST	5Y	5Y5Y	10Y
Current level	1.23	1.67	1.43
Main scenario at end-2021	1.20	2.00	1.60
Upward scenario	1.50	2.50	1.90
Downward scenario	0.80	1.75	1.25

UST	10Y	10Y10Y	20Y	20Y10Y	30Y
Current level	1.43	2.38	1.86	1.70	1.82
Main scenario at end-2021	1.60	2.50	2.00	2.20	2.05
Upward scenario	1.90	2.85	2.30	2.50	2.35
Downward scenario	1.25	2.20	1.75	2.00	1.80

Source: Bloomberg; compiled by Daiwa Securities.

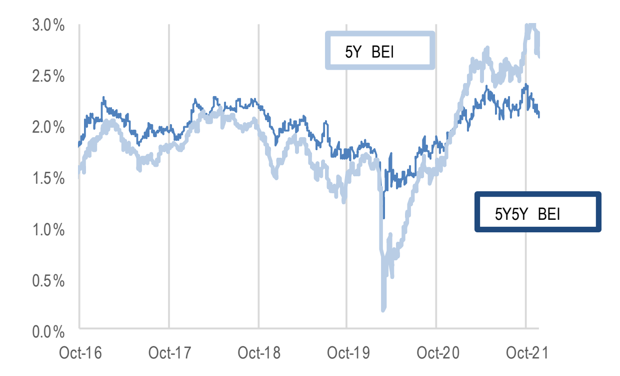
Observing this yield downtrend from different viewpoints, we found that, surprisingly, it is driven by a drop in the breakeven inflation rate (BEI). The 10-year BEI declined by as much as 37bp over the past month (2.75% on 15 Nov → 2.38% on 14 Dec). Both the 5-year BEI and the 5-year forward 5-year BEI plunged, with the latter in particular now at just 2.08%. This is converted to around 1.88% in PCE (when the CPI is converted to PCE, subtraction of 0.3% is assumed), which can be regarded as a constrained level. With the drop in the BEI starting around the time that the reappointment of Fed Chair Jerome Powell and promotion of Lael Brainard to Vice Chair were decided, it could be a reflection of the Fed's stance to rein in inflation under new leadership.

US 10Y BEI



Source: Bloomberg; compiled by Daiwa Securities.

US 5Y BEI, 5Y-forward 5Y BEI



Source: Bloomberg; compiled by Daiwa Securities.

◆ Is faster tapering being factored in?

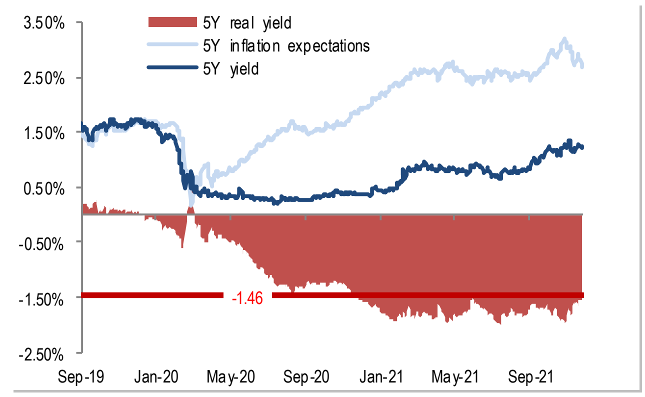
However, inflation pressure is increasing further, and gathering broader momentum. The Fed appears to be taking the stance of constraining inflation, but I wonder if this is the only reason behind the 5-year forward 5-year BEI falling to as low as 2.08%.

Another possible reason, besides the Fed's stance of constraining inflation under new leadership, is probably 'resolution of distorted supply/demand conditions.' As is well known, some, such as the BIS, have repeatedly pointed out that the BEI has been technically distorted by the difference in the supply/demand impacts on coupon-bearing Treasury bonds and TIPS due to the Fed's QE operations[1].

Accordingly, if the Fed were to accelerate tapering and exit QE earlier, the supply/demand relationship between coupon-bearing Treasury bonds and TIPS, which appears to have served as the reason for the BEI staying at a high level, would be normalized earlier. Also, the idea of implementing QT ahead of rate hikes itself has not yet become a main scenario in the market. However, if Fed Chair Powell and other officials provide hints of this idea at the press conference after the FOMC meeting, the market will sense a 'reversal' from the distorted supply/demand that has been caused by QE thus far.

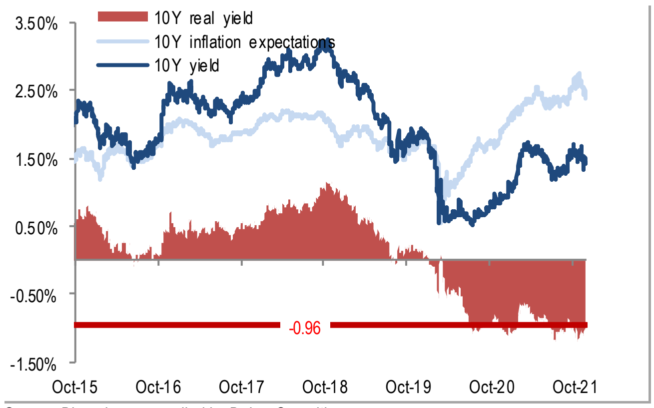
Regardless of the route by which the decline in BEIs is occurring, its impact on UST yields (nominal yields) could be (1) a decline in nominal yields or (2) a rise in real yields, or a combination of the two. In any case, current circumstances have decreased the possibility of the realization of the scenario anticipated by part of the market in which there is a rise in nominal yields led by real yields given BEIs. We probably need to revise our understanding of the situation.

US 5Y Yield, Real Yield, Inflation Expectations



Source: Bloomberg; compiled by Daiwa Securities.

US 10Y Yield, Real Yield, Inflation Expectations



Source: Bloomberg; compiled by Daiwa Securities.

[1] Because the Fed has been buying more TIPS than coupon-bearing Treasuries in terms of the ratio of the issuance amount to the outstanding amount, it has been pointed out that the breakeven inflation rate, calculated as the coupon-bearing Treasury yield minus the TIPS yield, may be overvalued.

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