Daiwa Securities

Daiwa's View

'Kiss of the Devil' and reduction of balance sheet ahead of rate hikes

➢ Looks correct theoretically, but entails substantial downside risk

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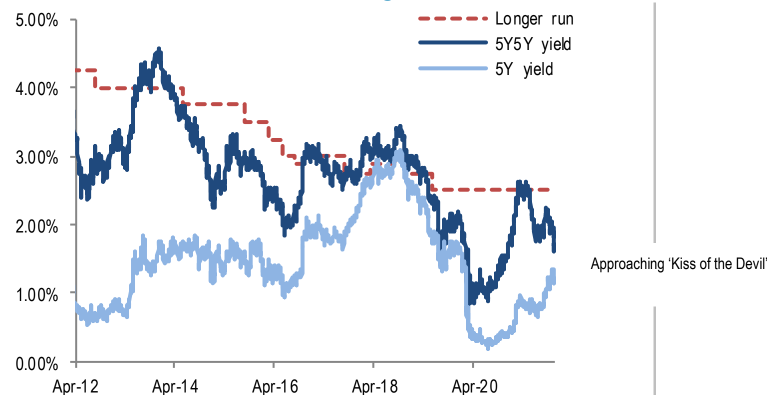
◆ Across-the-board buying as usual?

US stocks surged for the second business day in a row, and the long-term yield also rose to 1.47%. Apparently, rotational 'across-the-board buying' (higher stock prices due to lower yields) has returned.

That said, looking at the details, we notice that different changes are occurring. Due to two factors—increasing expectations of rate hikes amid rising inflation and constraints on forward yields—there is an increasing chance that the 5-year yield and the 5-year forward 5-year yield will cross, something I refer to as the 'Kiss of the Devil.' Even with the Omicron variant-induced risk-off sentiment waning, short-term/intermediate yields have risen due to growing expectations of rate hikes, resulting in their levels approaching each other even further. Since the 'Kiss of the Devil' means an inversion of the yield curve, we cannot remain optimistic if we ignore this phenomenon.

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



Source: Bloomberg; compiled by Daiwa Securities.

The optimistic interpretation of this phenomenon is that the 5-year forward 5-year yield is sagging at an excessively low level (vs. longer run) because the term premium is constrained by the Fed's QE. Certainly, past instances of the 'Kiss of the Devil' were observed as a result of the 5-year yield surfacing to around the longer run. With the current moves towards convergence at 1.5-1.75%, the level seems to be too low[1]. Based on this interpretation, the right move for the Fed's exit strategy after tapering would be reduction of the balance sheet (QT), rather than rate hikes. Ongoing stock rallies and declining forward yields have the potential to add impetus to thinking in favor of implementing QT ahead of rate hikes.

[1] Former New York Fed President Bill Dudley also takes a dim view of the current market perception that the Fed's rate hike ceiling is 1.5-1.75%.

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◆ Is implementing QT first correct?

To date, the Fed's official/semi-official communications regarding implementing QT ahead of rate hikes have been the following: Kansas City Fed's Economic Bulletin entitled "When Normalizing Monetary Policy, the Order of Operations Matters" (dated 14 Oct), the comment by Fed Governor Christopher Waller in his speech on 21 October that the "Fed can shrink b/sheet quickly via run-off if needed," and Fed Chair Jerome Powell's comment in his press conference on 3 November that the Fed would start to consider future options for the balance sheet within the next several months.

Certainly, as the Kansas City Fed's paper pointed out, if the reduction of the Fed's balance sheet leads to normalization of the term premium and a rise in the forward yield toward 2.5%, leeway for raising the future policy rate would become large. This would buy time until recession. We think the option of implementing QT first is appropriate in theory, and we agree with this approach.

Meanwhile, seeing 30% to 40% chances for a recession over the next 24 months, former Treasury Secretary Larry Summers stated at yesterday's council held by the Wall Street Journal that "engineering a soft landing is a very difficult thing to do in a rapidly growing, inflation economy." Although this may appear to be an extreme opinion, it was none other than Mr. Summers and former IMF chief economist Olivier Blanchard who advocated at the beginning of this year that (1) an excessively large fiscal plan (ARP) by President Joe Biden would cause an overheated economy and elevated inflation and (2) the Fed would be forced to raise interest rates at an early stage. Since the outbreak of the pandemic, Mr. Summers has been announcing spot-on predictions compared to Jerome Powell and Janet Yellen, so his opinion should not be taken lightly.

If the optimistic interpretation mentioned above is wrong, and warnings of a recession by the bond market, which is moving towards an inverted yield curve, are correct, subsequent failures in the Fed's policy responses would force the central bank to take the risk of conducting policy responses without any traditional policy tools. Subsequent failure would mean that the Fed would fall into the same situation as the BOJ/ECB, which would lead to a resurgence of discussions about the effective lower bound and negative interest rates in order to secure policy leeway (i.e., Japanization).

To put it mildly, the cost of a policy mistake would be large. Given the potential costs versus benefits, we are unable to assert with 100% certainty that implementing QT ahead of rate hikes would be the better option. Realistically speaking, it would be practical to follow the previous process of implementing slight rate hikes (1-1.5% or so) first, and proceeding with QT after securing minimal policy leeway via traditional policy tools. This approach would be appropriate.

That said, in such a situation, we would continue to see a rise in short-term/intermediate yields due to rate hikes as well as constraints on forward yields owing to concerns about a rate hike-induced recession. Therefore, the yield curve is likely to move towards the 'Kiss of the Devil' and inversion. In any case, the road ahead is a thorny one, and we can't shake the feeling that the Fed is already in checkmate.

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