Daiwa Securities

Daiwa's View

Flattening is led by term premium

➢ Constraints on forward yields may persist into next year

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

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◆ Flattening caused by 'rising shot-term yields' and 'declining long-term forward yields'

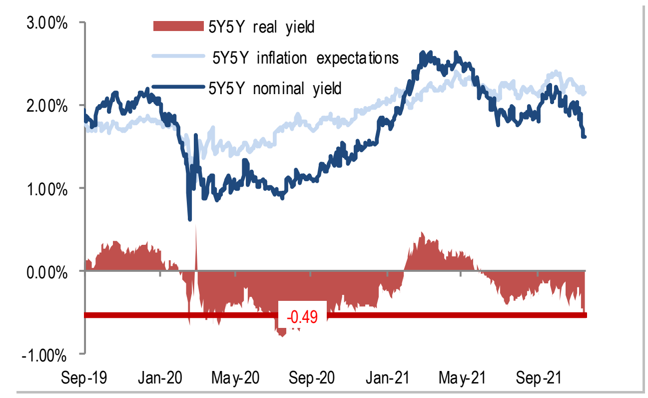
The US long-term yield rose to 1.43%, reducing declines that occurred after the release of the November jobs report. And, the 5-year yield recovered fully (1.21→1.13→1.21%), but the 5-year forward 5-year yield remained at a low level after the jobs report (1.71→1.61→1.63%).

Is the constraint on the 5-year forward 5-year yield reflecting a decline in the longer run? We can certainly see how some of the results of the jobs report imply a decline in the longer run. Thus far, we have pointed out the possibility of a decline in the longer run. However, it feels like a bit of a leap to conclude that the longer run suddenly fell substantially due to last Friday's jobs report alone. It would be premature to conclude that the entire decline in forward yields since the jobs report has been caused by the longer run (fundamentals). We should suspect the existence of supply/demand factors.

◆ The decline in long-term forward yields is led by term premium

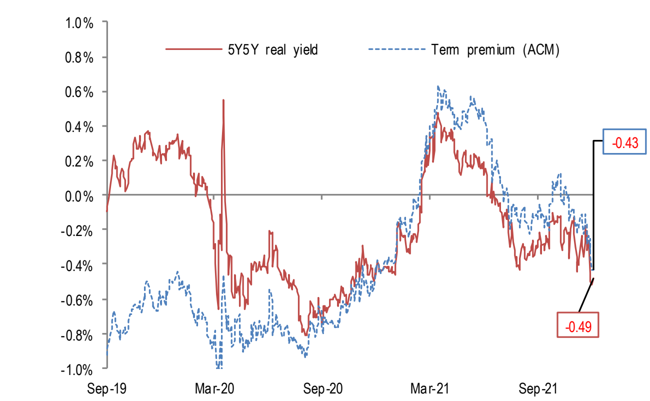
The 5-year forward 5-year real UST yield tends to correlate closely with the 10-year term premium (right-hand chart below). Breaking down the current 5-year forward 5-year nominal yield into the real yield and inflation expectations, we see that the real yield dropped sharply to around –0.50% after the release of the jobs report. The decline in the real yield started to accelerate after last month's congressional testimony by Fed Chair Jerome Powell. On 29 November, prior to the testimony, the 5-year forward 5-year real yield had stood at –0.26% (meaning it plunged as much as 23bp in just one week). Given this situation, we strongly suspect that the term premium (which reflects supply/demand factors) contributed about 20-30bp to the plunge in the 5-year forward 5-year nominal yield to 1.63%.

5Y forward 5Y UST Yields



Source: Bloomberg; compiled by Daiwa Securities.

5Y forward 5Y Real Yield, 10Y US Term Premium



Source: Bloomberg; compiled by Daiwa Securities.

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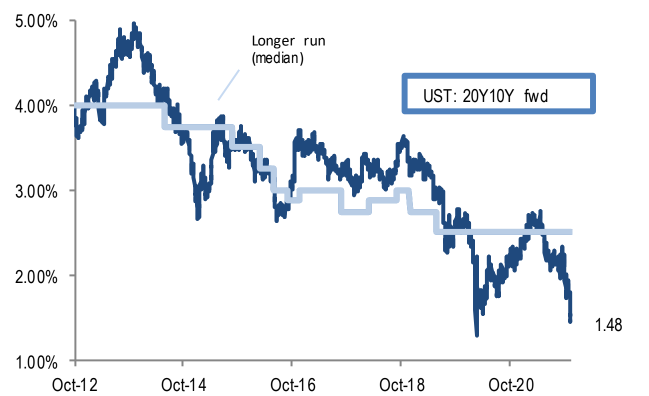
Looking at developments over the past two years, the 5-year forward 5-year real yield bottomed out at around –0.5%. While we should avoid jumping to premature conclusions, it probably isn't very likely that there will be a sharp drop in forward yields from current levels led by real yields. Rather, forward yields are expected to rise from current levels when we see an easing of temporary supply/demand factors that are currently causing the decline in the term premium.

◆ Supply/demand factors are unlikely to ease until next year
However, it appears unlikely that these temporary supply/demand factors will ease soon. The most important point is that the Fed's QE money, including in the November reserve maintenance period, is continuing to flow into the market at a pace of $105.0bn/month (with an inflow of $90bn in the Dec reserve maintenance period). Moreover, private-sector investors, who are cautious about the Fed's hawkish stance, appear to be pumping money into US Treasuries, which are safe assets, at an accelerated pace, while hesitating to chase higher priced equities/corporate bonds[1].

During this time, it can be difficult to handle the short-term/intermediate UST sector, which is more susceptible to the Fed's aggressive rate-hike stance. Due to a lack of alternatives, the long-term/superlong UST sector tends to become the choice of safe-haven funds. It is probably precisely this that is behind the temporary supply/demand factors causing the decline in forward real yields and the term premium mentioned above. If so, we cannot expect a change in this structure until at least next year, when double-speed tapering is likely to be implemented. Long-term forward yields are likely to remain low compared to fundamentals going into the beginning of next year.

20Y forward 10Y UST Yield



Source: Bloomberg; compiled by Daiwa Securities.

[1] Bloomberg News on 5 Dec: Credit Funds Signal More Pain as Record Cash Swamps Treasury ETF.

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