Daiwa's View

Back to intense bull flattening

➢ Forward yields would probably remain low in the near term

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◆ Second day of congressional hearings by Fed Chair Jerome Powell: Hawkish stance reconfirmed

After the Tokyo market closed, the global stock market advanced significantly until the European markets opened, and US Treasury yields also posted strong bear flattening. However, the trends rapidly changed due to Fed Chair Jerome Powell's testimony at the lower house and confirmation of the first US case of the Omicron variant. At the end, US shares fell by more than 1%, erasing the entire intraday gains. The 10-year US Treasury yield showed intense bull flattening, declining to 1.4%.

In the congressional testimony, Powell pointed out that inflation has spread more broadly. He assured Congress that the Fed would take measures "to make sure this high inflation we're experiencing does not become entrenched," which reconfirmed that the Fed has leaned more toward a hawkish stance.

Testimony at House of Representatives by Fed Chair Jerome Powell: (1 Dec 2021)

・The inflation that we're seeing is still clearly related to pandemic-related factors. I would also add, though, that it has spread more broadly in the economy and I think that the risk of persistent higher inflation has clearly risen.…Price stability is one of our two goals, the other being maximum employment. We have to balance those two goals when they're in tension as they are right now. I assure you we will use our tools to make sure this high inflation we're experiencing does not become entrenched.

On Bloomberg, former New York Fed President Bill Dudley stated yesterday that the Fed would probably double the pace of tapering. This shows that his opinion has changed during the past several days because he had mentioned that it would be slightly difficult to accelerate the pace of tapering in his interview with *Nikkei* dated 30 November. This confirms the fact that even former Fed officials revised their recognition of the Fed's stance to more hawkish one during the past several days. Probably, the market is also in the same situation, and because of this, the market moved substantially for a second straight day after Powell's congressional testimony.

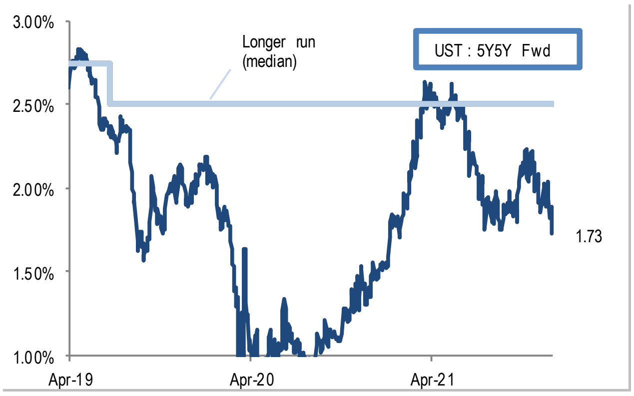
◆ Forward yields are likely to remain low in the near term

In European time, US Treasury yields staged a sharp bear flattening, but they turned to intense bull flattening at the end. What is noted is the possibility of safe-haven buying—"government bonds" may have started to work as a hedge tool[1]. As a matter of course, such a supply/demand factor lowers the term premium and implies that forward yields may be pushed down to lower levels than the fair values that are estimated by fundamentals (such as the longer run).

[1] Yesterday, BlackRock's Rupert Harrison stated that "We've seen duration and government bonds coming back into fashion as a hedge."

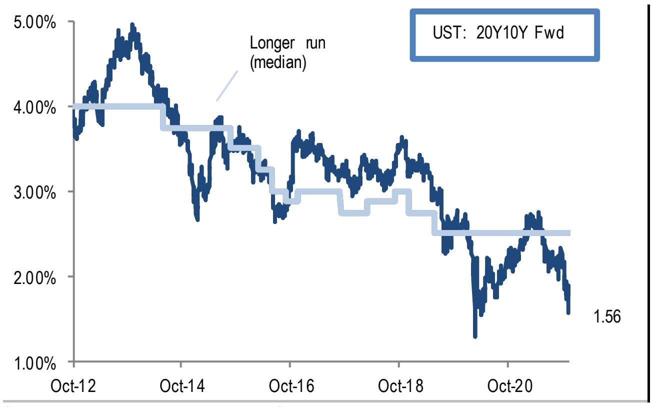
Currently, the 5-year forward 5-year UST yield and 20-year forward 10-year UST yield are sagging at 1.73% and 1.56%, respectively. They are in a somewhat overshoot area in light of current projections for the longer run (2.50% by the Fed, 2.25% by primary dealers, 2.00% by market participants). If we assume that the market has started to re-evaluate long-term government bonds as a hedge tool, it would be somewhat difficult to forecast that forward yields will return to the ordinary fundamental levels soon.

5Y forward 5Y UST Yield



Source: Bloomberg; compiled by Daiwa Securities.

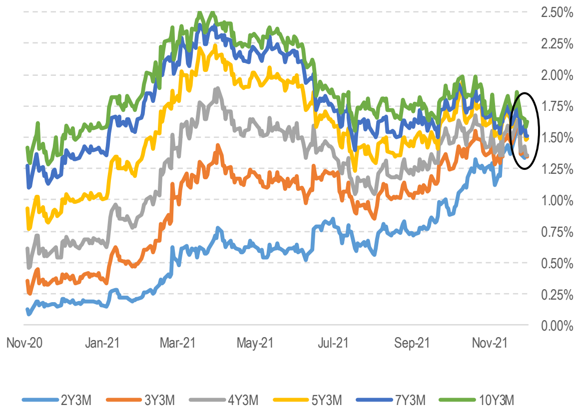
20Y forward 10Y UST Yield



Source: Bloomberg; compiled by Daiwa Securities.

As our senior economist Kenji Yamamoto pointed out yesterday, the length of the normalization path after the pandemic may cause a decline in both the terminal rate and forward yields via a drop in the potential growth rate and the real equilibrium interest rate (natural rate of interest). Therefore, the spotlight may return to a theme of whether the Fed and primary dealers/market participants will maintain current projections for the longer run. Currently, forward 3-month OIS yields appear to be converging at around 1.25% to 1.75% from the 2-year forward to the 10-year forward timeline. Of course, there is a possibility that projections for the rate hike ceiling is too low (= a rise in forward yields in the future). However, we could see reluctant buying by investors who held off on investment in anticipation of a rise in forward yields in the future.

Forward 3M OIS Yield



Source: Bloomberg; compiled by Daiwa Securities.

Yesterday, long-term JGB futures also surged by Y0.11 to Y151.99. If we assume that the price will remain at this level going forward, the range of the 10-year JGB yield would stabilize at around 0.05%. This would be a somewhat unacceptable level if we assume only Japanese investors. However, as the movements of the US Treasury market imply a near-term major change, we may see a correlation with a decline in the term premium. The overnight price movements provided a troubling aspect in the JGB market, where a 10-year JGB auction is to be held today.

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