Daiwa Securities

Daiwa's View

Market shaken by geopolitical tensions

- Mar ECB Governing Council is an important factor for JGBs, as well

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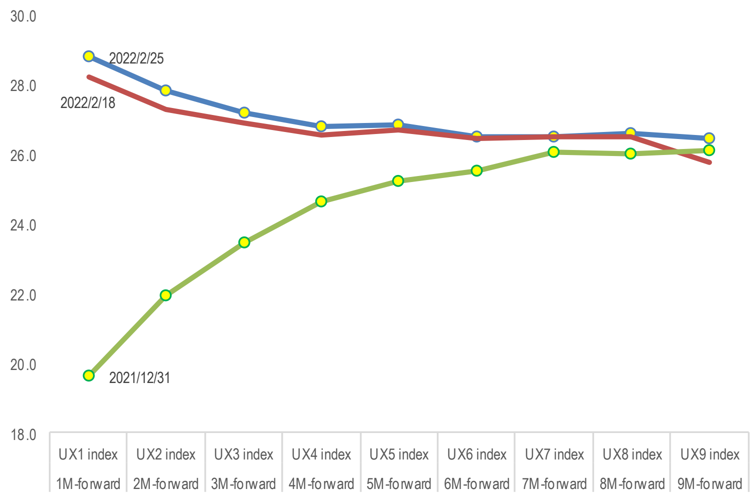
The international financial market has been shaken by geopolitical tensions due to the Russian military invasion of Ukraine. The VIX Index Futures term structure is a relatively accurate barometer of near-term uncertainty. Judging from its shape, the value in the nearest contract is 1-1.5 higher than that in the forward contract. As the 1-month forward index (Mar 22) is higher than the 9-month forward index (Nov 22) when the midterm elections will be held, we can say that caution about near-term uncertainty is strong (at an unsustainable level). Of course, the situation may deteriorate in the short term, with cautious positions accumulating further. However, if the situation calms down (or stops deteriorating), we need to be aware of the possibility that a considerable amount of unwinding could occur due to investors abandoning these cautious positions. For the time being, it will be difficult to distinguish between short-term fluctuations due to such factors and price movements based on fundamentals.

VIX Index Futures (USD)



Source: Bloomberg; compiled by Daiwa Securities.

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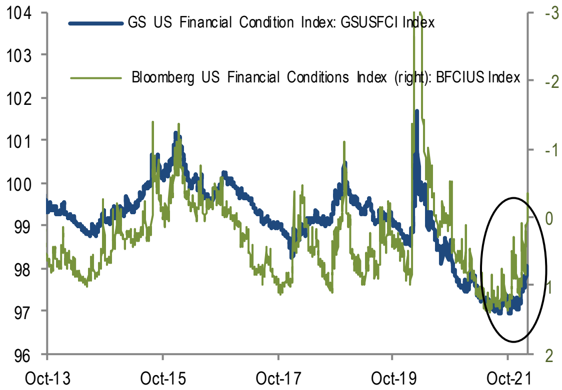
Turning to financial conditions, the Bloomberg United States Financial Conditions Index stood at –0.396, falling into negative territory for the first time since November 2020. The GS US Financial Conditions Index also worsened to the 98 level for the first time since November 2020. Although financial conditions have not yet reached levels that could be described as tight, historically speaking, it is true that (1) they have clearly diverged from the extremely accommodative levels seen in 2H 2021, and (2) the pace of recent corrections has been somewhat fast. A Fed official also mentioned that the Fed would continue to monitor the global financial conditions (Governor Michelle Bowman). The Fed is also no doubt paying a certain degree of attention to the situation.

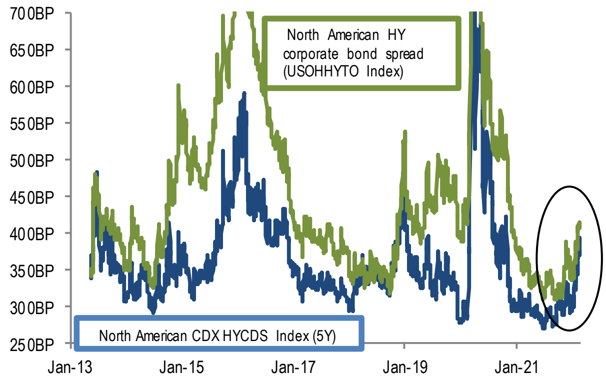
US Financial Conditions Indices



Source: Bloomberg; compiled by Daiwa Securities.

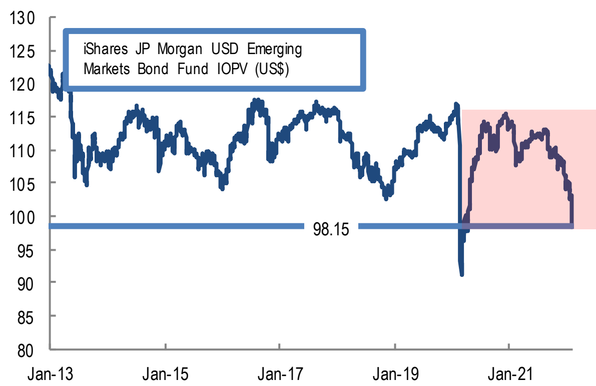
The credit market is attracting a lot of attention as a factor that could suddenly change financial conditions (beyond what the Fed intends). In this respect, the North American High Yield CDS Index widened to 377bp. In addition, the Russian sovereign 5-year CDS (dollar denominated) widened to 933bp (+485bp d/d, Bloomberg SOVR). The latter appeared to be regarded as an isolated case. However, looking back on the past, European crises, such as the Dubai shock and the Greek debt crisis, have gradually spread through the accumulation of multiple isolated cases. The plunge in prices in the dollar-denominated emerging markets bond fund is striking (chart below). Emerging market sovereigns normally have a tendency to attract attention during rate hikes by the Fed, so a certain degree of care needs to be taken over time to see if this spills over into a problematic situation.

US High-yield Corproate Bond Index, CDS Spread



Source: Bloomberg; compiled by Daiwa Securities.

Price of Emerging Market Bond Fund



Source: Bloomberg; compiled by Daiwa Securities.

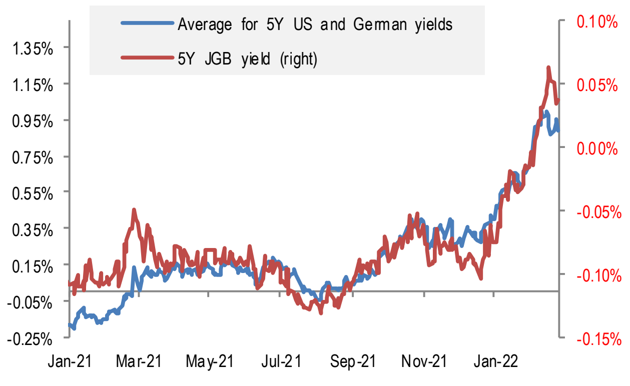
We explained the impact of the situation in Ukraine on the Fed's policy in our report yesterday. The situation has escalated further over the course of one night. That said, actions by the Fed are unlikely to change (at least in the near term). Current rising tensions in Ukraine are a factor increasing a sense of caution in the near term regarding the course that inflation might take. Given the current strength of the US economy and rising inflation, we feel there is no leeway for the Fed to put off deciding on a rate hike in March. However, the possibility of a 50bp hike in March appears to have nearly disappeared due to the rapid tightening of financial conditions. (But the chances of this happening had already nearly disappeared when New York Fed President John Williams made his remarks.)

However, judging this will be more complicated in Europe, which is more greatly influenced by changes in the situation in Ukraine. The region must weigh higher inflation (than in the US) due to soaring energy prices against a substantial decline in real disposable income caused by a sharp rise in energy prices. Also, it will face a greater economic impact than the US because it has a stronger economic relationship with Russia than the US due to its geographical proximity to Russia. We should also consider credit factors—i.e., sovereign bond spreads in peripheral nations, such as Italy. ECB governor Robert Holzmann touched on the possibility that the exit strategy from easing measures could be delayed due to the situation in Ukraine. In the OIS market, this led to a slight retreat in rate-hike pricing by the ECB in 2022. We would like to continue to monitor the situation carefully.

These developments with the ECB may serve as a factor when considering the relationship between the situation in Ukraine and JGBs. Since last year, JGB yields have been closely correlated with the average for US and European yields. The timing with which the rise in JGB yields gained speed since the start of 2022 occurred almost around the same time as the market became aware of the ECB's hawkish pivot. A factor behind this development is thought to possibly be strong speculation that, if rates are raised by the ECB, which has a similar economic environment to Japan, the BOJ may follow suit.

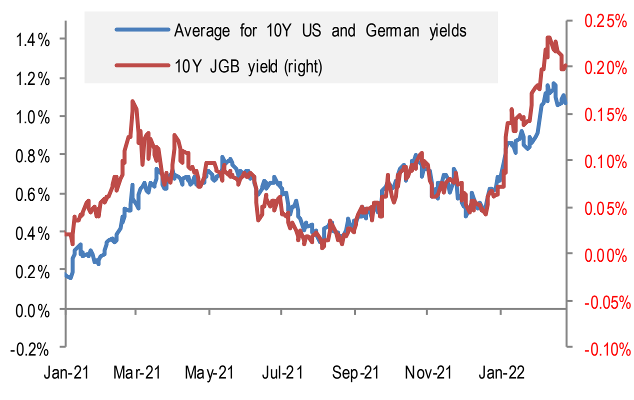
In that sense, if the ECB becomes cautious about the negative economic impact due to the situation in Ukraine, JGBs, which are now regaining stability, may become even more stable. Conversely, if the ECB strengthens its rate-hike stance reflecting headline inflation due to soaring energy prices, contrary to the market's pricing over the past several days, JGBs may become less stable. (In this case, concerns about stagflation over the long run are likely to increase.) It is safe to say that the ECB Governing Council slated for 10 March is garnering more attention than before.

5Y JGB Yield, Average for 5Y US and German Yields



Source: Bloomberg; compiled by Daiwa Securities.

10Y JGB Yield, Average for 10Y US and German Yields



Source: Bloomberg; compiled by Daiwa Securities.

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