Daiwa Securities

Daiwa's View

JGB yields have reached threshold levels

- Looking a little further into the future, estimated returns on investments based on current levels will very likely improve

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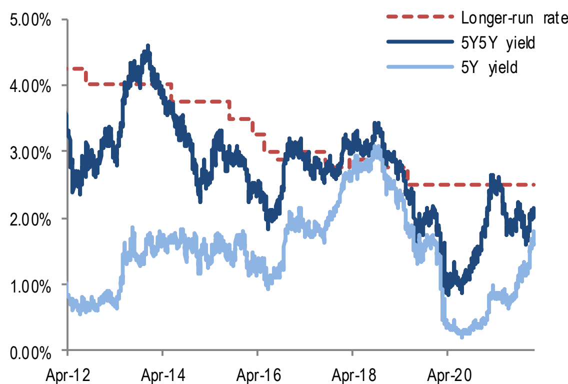
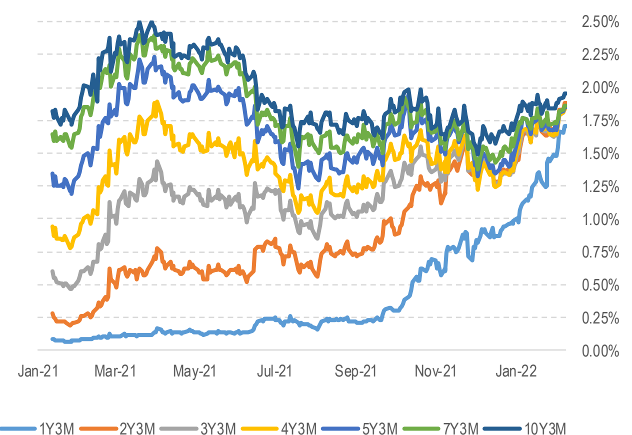
Yesterday, the 10-year US yield rose to 1.96%. As this is broken down into a 5-year yield of 1.81% and 5-year forward 5-year yield of 2.15%, the rise in short-term/intermediate yields is a main driver. That said, the 1-year forward 3-month OIS yield has now reached 1.7%, close to the levels of longer-term forward OIS yields (approximately equal to the terminal rate estimated by the market). Therefore, discussion regarding rate-hike pricing appears to be peaking, as we reported in yesterday's *Daiwa's View*.

US 5Y Yield, 5Y5Y Yield, Longer-run Rate



Source: Bloomberg; compiled by Daiwa Securities.

US Forward 3M OIS Yields



Source: Bloomberg; compiled by Daiwa Securities.

Of course, discussion about rate hikes may move in the direction of putting a strong brake on inflation via tightening at levels above the terminal rate. If so, concerns about an overkill would emerge due to further flattening of the yield curve (which has already flattened considerably). This would make the implications for long-term yields more complicated (the financial environment would become tight via the credit channel). The possibility of this happening shouldn't be ruled out, of course, but it is not something that should be regarded as a main scenario at this point.

Rate hikes will remain the focus of discussion in the month leading up the March FOMC meeting, during which a rate hike will probably be decided on. However, unless we see additional factors, such as a resurgence of discussion about the level of the terminal rate, it is highly likely that the rise in long-term yields, which is driven by anticipated rate hikes, will let up at around 2%. After the March FOMC meeting, debate is likely to grow once again regarding QT and the term premium.

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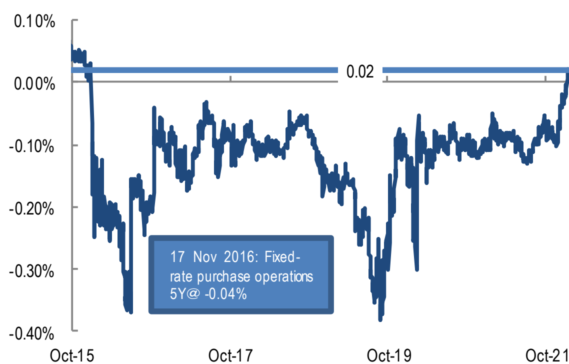
◆ JGB yields have reached threshold levels
JGB yields have reached threshold levels in various sectors, such as the 5-year, 10-year, and 30-year sectors. Of course, short-term price fluctuations are determined by changes in sentiment. However, looking at simple charts, we can confirm that JGBs have undergone corrections to levels that should be considered threshold levels on almost all parts of the yield curve.

Yesterday, the 5-year yield rose to 0.015% vs. the 0.05% logged before introduction of the negative interest rate policy. Assuming that the 5-year yield will return to this level after the BOJ removes the negative rate policy, the point of reference (limit) for an additional rise in the 5-year yield is 3.5bp. In forward guidance for the policy interest rate, the BOJ currently expects "short- and long-term policy interest rates to remain at their present or lower levels." However, the market has now factored in a very high probability of not only a revision to this forward guidance but also rate hikes after Governor Haruhiko Kuroda's term comes to an end. Assuming no rate hikes occur before the end of Governor Kuroda's term, we can say that the yield is approaching the upper limit.

The 10-year yield also rose to 0.215% yesterday. The situation here is simple. Given that the BOJ has already explicitly stated that the level for fixed-rate purchase operations for consecutive days was 0.25%, we can say that the limit for an additional rise in the 10-year yield is also 3.5bp (which happens to correspond to that for the 5-year yield).

5Y JGB Yield



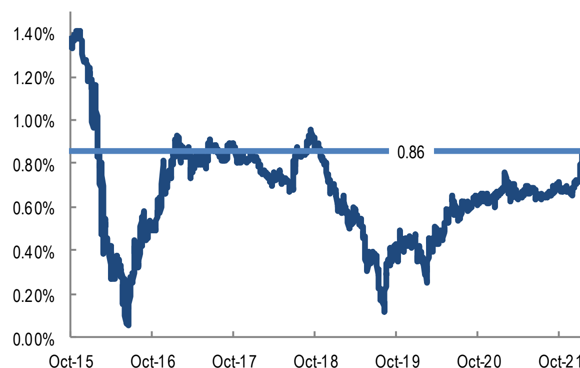
Source: Bloomberg; compiled by Daiwa Securities.

10Y JGB Yield

Source: Bloomberg; compiled by Daiwa Securities.

Yesterday, the 30-year yield rose to 0.855%. This level was seen in the initial stages after the introduction of the yield curve control (YCC) policy, and has effectively been the peak level since the introduction of the YCC policy. Moreover, given that the 20-year forward 10-year US yield has now declined to around 2% from the 3-3.5% of around 2016-18, we can say that a recovery of the 20-year forward 10-year JGB yield to 1.3%, the same level as that of around 2016-18, proves that yields have undergone corrections to around threshold levels.

30Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

20Y10Y JGB and UST Yields

Source: Bloomberg; compiled by Daiwa Securities.

Furthermore, the 10-year yield is now far from the zero percent target. Based on simple common sense, if JGBs stay at these levels until the end of March, the BOJ is likely to consider an increase in the purchase amounts in *Rinban* operations. There's still some time between now and end-March, so this is not a market topic at the moment. However, looking a little further into the future, this serves as an additional factor enabling us to think that estimated returns on investments based on current levels will very likely improve.

In closing, we present two quotes from Howard Marks' book *Mastering the Market Cycle.* They remind us of the fact that similar circumstances are continually repeated in the market. We can make use of them in the current situation.

The outlook for returns will be better when investors are depressed and fearful (and thus allow asset prices to fall) and worse when they're euphoric and greedy (and drive prices upward).

Just as risk tolerance is unlimited at the top, it is non-existent at the bottom. This negativity causes prices to fall to levels from which losses are highly unlikely and gains could be enormous. But the sting of the prior declines tends to increase risk aversion and send investors to the sidelines just as prices (and thus risk) are at their lowest.

Source: Excerpted from *Mastering the Market Cycle by* Howard Marks.

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