Daiwa's View

Bond market remains very volatile, but …

➢ It may now be time for bond market to begin to gradually find opportunities to lower volatility?

Fixed Income Research Section
FICC Research Dept.

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

Daiwa Securities Co. Ltd.

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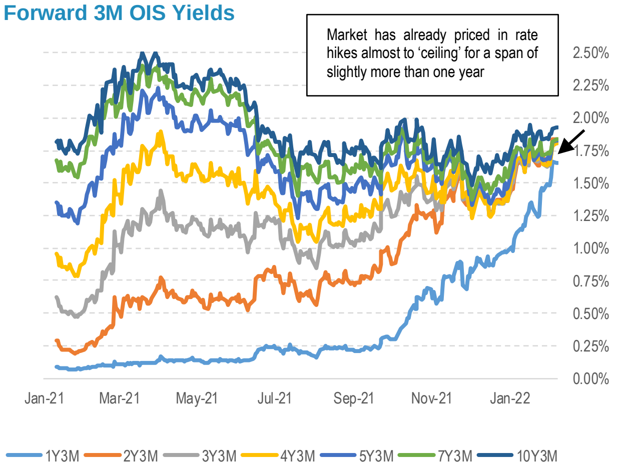
◆ Discussion about policy rate outlook peaking

In Europe, while they denied there would be a rate hike in July, ECB officials conveyed the message that they were maintaining a position that didn't rule out rate hikes in 2022. This has slightly pushed back the expected timing for a rate hike (0.25ppt) in the market. Therefore, short-term/intermediate yields were somewhat pared back from the gains seen at the end of last week.

In the US, the January jobs data has substantially changed the narrative regarding the labor market. On the following day, while the impact from the jobs data had not been fully canceled out, rate-hike pricing slightly weakened in the short-term/intermediate zone. That said, the probability of a 50bp rate hike in March is still more than 30% in the US federal funds rate futures market. And, a total of five or more rate hikes (5.6 times × 0.25ppt) are still factored in for 2022.

Needless to say, the pace of rate hikes from now on will depend on the data. However, we have begun to get the impression that discussion in the market regarding the path the policy rate will take in 2022 is peaking in both Europe and the US. For example, US forward 3-month yields show that the difference between the 1-year forward 3-month yield and the 5-year forward 3-month yield has rapidly approached 17bp. This means that the market has already priced in rate hikes almost to the 'ceiling' for a span of slightly more than one year (left-hand chart below). Of course, US CPI data to be released on the 10th is one factor that could disrupt the market. However, regardless of the results (whether they are higher or lower than estimates), assuming we have a clearer idea of market participants' rate-hike projections in either scenario, it may now be time for the bond market to begin to gradually find opportunities to lower volatility, which has remained very high for nearly one month after the FOMC meeting.

US Forward 3M OIS Yields



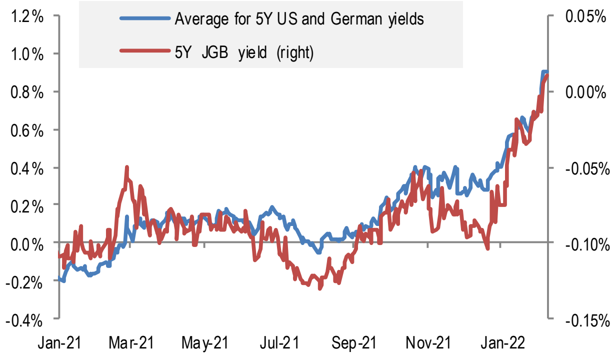
Source: Bloomberg; compiled by Daiwa Securities.

Bond Volatility Index (MOVE)

Source: Bloomberg; compiled by Daiwa Securities.

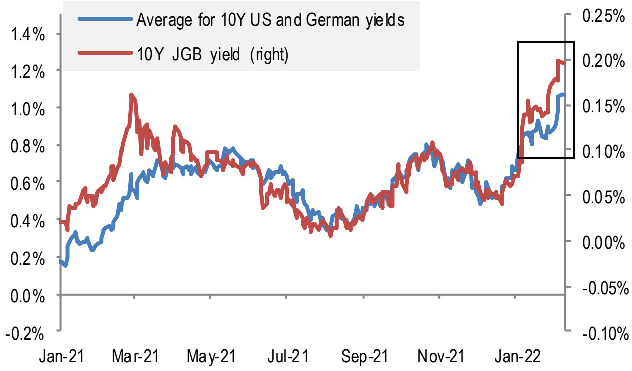
◆ <u>JGB yields continue to steepen</u>
Yesterday, the 20-year and 30-year JGB yields rose to 0.165% and 0.825%, respectively (bear steepening). Confirming JGB yields since last year by comparing them with the average for US and European yields, the 5-year yield has been moving in parallel with the average for US and European yields. Meanwhile, the 10-year yield now underperforms the average by around 4bp. In addition, the weakness of JGBs in the superlong zone is conspicuous. While the average for the 5-year/30-year spread of US and European yields tends to flatten, the rapid steepening of JGBs over the past several days appears to be truly remarkable (chart below).

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



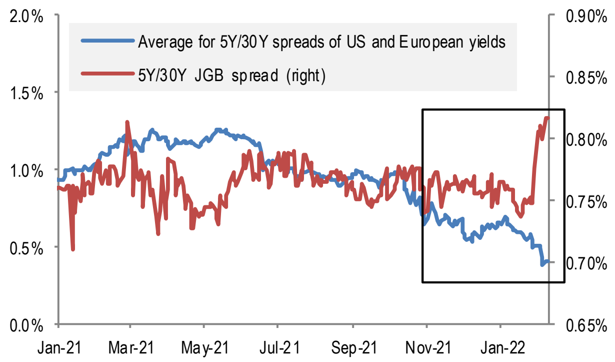
Source: Bloomberg; compiled by Daiwa Securities.

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



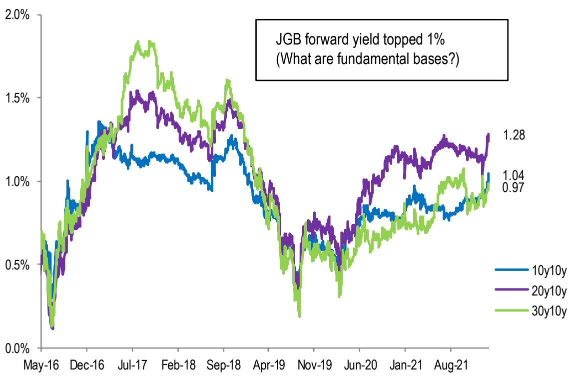
Source: Bloomberg; compiled by Daiwa Securities.

5Y/30Y JGB Spread, Average for 5Y/30Y Spreads of US and European Yields



Source: Bloomberg; compiled by Daiwa Securities.

JGB Forward 10Y Yields



Source: Bloomberg; compiled by Daiwa Securities.

Of course, assuming that the Japanese potential growth rate or inflation expectations have risen sharply compared to European/US figures, a rise in Japanese forward yields in contrast to European/US yields would be justified. In that case, it would be natural to expect Japanese stocks to outperform European/US stocks. However, with price movements in current stock markets being almost the complete opposite of this, the circumstantial evidence for this scenario is lacking. Rather than fundamentals, this rapid steepening and these rising forward yields appear to be caused by supply/demand factors—in other words, the impact of an increase in speculative investment as Japanese players tend to refrain from investment ahead of the end of the fiscal year amid lingering doubts and concerns regarding the BOJ's policy stance.

Yesterday, the 10-year forward 10-year JGB yield rose to 1.04%, exceeding the threshold of 1%. Given that the US forward yield is generally around 2-2.25%, that the gap in the potential growth rate between the two nations is about –1.5%, and that the gap in inflation expectations is estimated to be more than –1%, we think that a mere 1% difference between Japanese and US forward yields is not necessarily bad in terms of JGB yields because the JGB forward yield is exceeding 1%.

We could discuss fundamentals now, but the market may refrain from investment in JGBs due to concerns about fluctuations in market value led by speculative investors. However, in light of fundamentals, such as potential growth rate, current levels of JGB forward yields appear highly attractive.

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