Daiwa Securities

Daiwa's View

Hawkish shift by ECB brings abrupt changes in Japan and overseas

- Rise in hedging cost may accelerate return to investment in yen bonds

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◆ ECB also showed a hawkish pivot

In our report at the beginning of the year, we pointed out a hawkish pivot by the ECB as a risk factor. This rapidly became a reality at last night's ECB Governing Council meeting, which was the first meeting in 2022. At yesterday's press conference, ECB President Christine Lagarde shifted to a stance of not ruling out an interest rate hike in 2022. This came as a fresh hawkish surprise, leading to sharp pricing of this year's 50bp hikes (= withdrawal from negative rates) in the OIS market. Due to the rapid change in the outlook for the policy interest rate, German yields rose by around 5-12bp led by the short-term/intermediate zone, accompanying bear flattening. In addition, yesterday produced another hawkish surprise as four of nine BOE members supported a 50bp rate hike (Note: The BOE decided on a 25bp hike as expected and a start of QT via suspension of reinvestment by redeemed bonds).

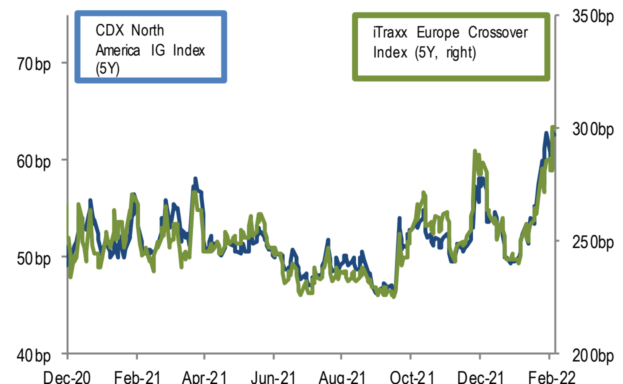
◆ Valuations in the credit market have also changed

As the ECB has been providing direct/indirect support to private-sector credit/sovereign bonds in the European peripheral nations via the LTRO, in addition to the PEPP/APP, the hawkish pivot also has a substantial impact on the credit market. In fact, yesterday's 10-year Italian government bond spread vs. German bonds widened to 150bp. The iTraxx Europe Crossover Index widened by 20bp, exceeding 300bp for the first time since November 2020. The CDX North America Investment Grade Index also rose to 63bp, the highest value since last year. As such, valuations in the credit market are changing. As worsening of spreads was added to the rise in base interest rates, it was natural to see resumption of stock price corrections, although stock prices had recovered about halfway from a plunge at the beginning of the year. Now the three major central banks—in Japan, the US, and Europe—have all shifted to the hawkish stance, and, therefore, a "fallacy of composition" risk scenario becomes more likely.

10Y Italian Government Bond Spread vs. German Bonds

Source: Bloomberg; compiled by Daiwa Securities.

CDS Indices in US and Europe



Source: Bloomberg; compiled by Daiwa Securities.

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- <u>Return to yen bonds caused by sudden change in hedging cost</u>
  If rapid rate hikes by the Fed and a removal of negative rate by the ECB are realized, investment return from hedged foreign bonds would change drastically. To foresee the impact of this change on markets at home and abroad, we need to look farther into the future, like thinking many moves ahead in chess. One consequence brought by these interest rate movements would probably be Japanese investors' return to yen bonds and flattening of the JGB yield curve.

  Investment return from hedged foreign bonds is mainly decided by two factors: (1) hedging cost and (2) the long-term/short-term yield spread. There is little scope for disputing that rapid rate hikes by the Fed raise hedging costs. In addition, if a removal of negative rate by the ECB is also realized, Japanese investors would lose the -50bp benefit for hedging cost. This is likely to lead to a drastic change in investment return from currency-hedged foreign bonds.

  Of course, if return on yen-based investment in foreign bonds after considering hedging cost remains attractive vs. overseas yields in terms of the long-term/short-term yield spread, such investments would remain attractive. However, this situation has started to change recently. For example, looking at the 5-year/30-year spreads, we see that the Japanese spread stands at 80bp, vs. 48bp in the US and 38bp in Europe. As such, the shape of the yield curve in Japan is markedly steep.

Yields in US, Europe, and Japan (%), Spread Between Maturity Segments

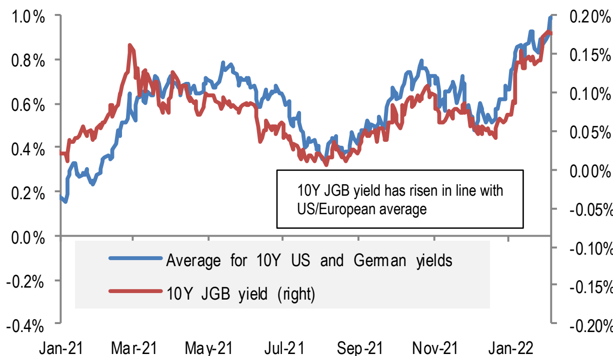
	US	Europe	Japan
5Y/30Y	48bp	38bp	80bp
10Y/30Y	32bp	19bp	61bp
5Y yield	1.67	-0.04	-0.01
10Y yield	1.84	0.14	0.18
30Y yield	2.16	0.33	0.79

Source: Bloomberg; compiled by Daiwa Securities.

This suggests that yen bonds may become relatively more attractive around the world after worsening of hedging cost. On top of yen-based investors returning to yen bonds, overseas investors may increase investment in yen bonds in line with improvement in hedging cost. (Note: Worsening of hedging cost for investment in foreign bonds by Japanese investors means improvement in hedging cost for investment in yen bonds by overseas investors.)

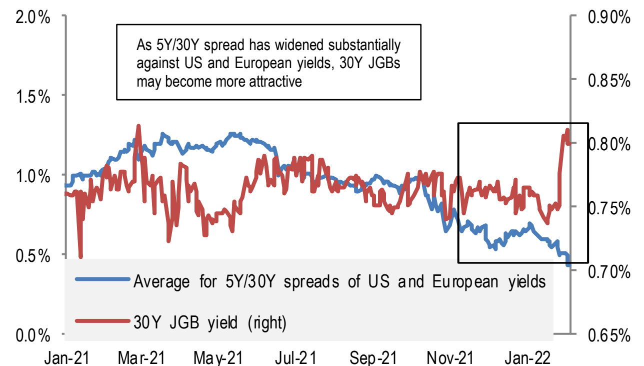
While JGB yields up to the 10-year zone have been moving in line with the 'average' for US and European yields, the superlong zone alone has been moving against the average, resulting in steepening (chart below). JGB superlong yields have now risen close to the threshold levels of 0.60% for the 20-year sector and 0.80% for the 30-year sector. If rate hikes by the Fed and ECB cause a drastic change in hedging cost, the steepness of the JGB yield curve would attract attention from domestic and foreign investors at some stage. We strongly recommend buying both 20-year and 30-year JGBs at current levels.

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



Source: Bloomberg; compiled by Daiwa Securities.

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



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