Daiwa Securities

Daiwa's View

True implications of Jan FOMC meeting becoming apparent

- Rapid tightening will cool down (inflation and) macro economy

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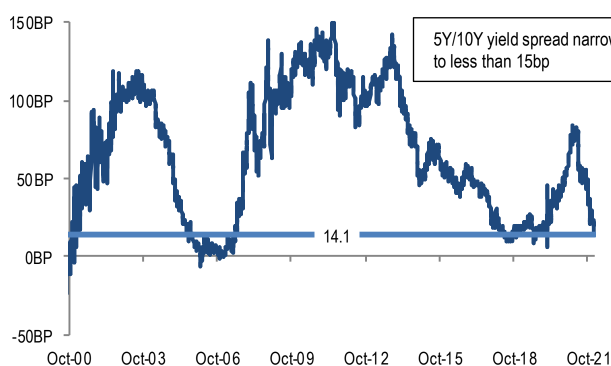
There is a market saying that jobs data should be interpreted on the next day, and this probably applies to FOMC meetings. This is because both jobs data and FOMC meetings are noteworthy events that have the power to change US economic trends (personal consumption), making it difficult to determine the long-term implications for the macro economy right away. Reactions immediately after the release of this information tend to be dominated by adjustments to positions that were established beforehand, with the true implications tending to be reflected from the following day onwards.

The initial reaction after the January FOMC meeting that delivered a hawkish surprise (more specifically, after the press conference by the Chair) was for US yields to surge almost in parallel across the entire curve. However, last night, while the 2-year yield continued to rise, long-term/superlong yields started declining. This led to substantial flattening of the yield curve with the 5-year/10-year and 5-year/30-year spreads tightening to 14.1bp and 43bp, respectively. Given developments with the yield curve, which has flattened to almost the same level as in 2018-2109, we can glean the true implications of the January FOMC meeting—i.e., that rapid tightening will cool down (inflation and) the macro economy.

5Y/10Y UST Spread



Source: Bloomberg; compiled by Daiwa Securities.

5Y/30Y UST Spread

Source: Bloomberg; compiled by Daiwa Securities.

That said, the Fed is unlikely to heed warnings from the yield curve in this case. After the Fed crashed the market in late 2018 due to excessive rate hikes, it implemented 'preventive rate cuts' the following year. However, unlike in 2018-2019, the Fed has no leeway to implement preventive actions because it now has an urgent need to put a sudden brake on inflation, which has overheated to the 5-7% level. The yield curve has now flattened to a level similar to what it was in 2018-2019, which indicates that it is now difficult to contain inflation (wages) without cooling down the economy. In other words, the warning from the expert—former Treasury Secretary Lawrence Summers' comment that "That's why my fear is that we are already reaching a point where it will be challenging to reduce inflation without

giving rise to recession"—is becoming a reality. It is natural that unrest has been created in the stock market. It probably won't be long before unrest spreads to the corporate bond market.

Given the difference between the rate of inflation now and that during the previous cycle, we forecast that (1) the upcoming rate-hike process will continue until a recession (slowdown in inflation) is actually confirmed and (2) the Fed will turn to rate cuts thereafter. Furthermore, rate hikes 'earlier and faster' than previously projected means that the time frame with which this series of processes will be completed has been moved forward. Long-term yields are likely to rise temporarily accompanied by flattening, after which they are expected to decline accompanied by recession and steepening.

◆ JGBs factoring in rate hikes

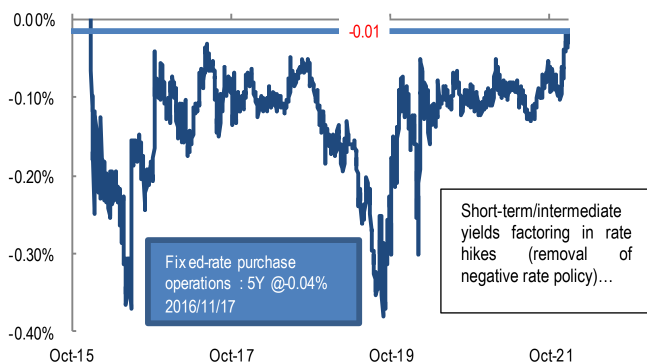
Yesterday, the 2-year and 5-year JGB yields closed at –0.055% and –0.015%, respectively. The 10-year JGB yield closed at 0.155%, the highest level since 2018. Of course, this was partly influenced by previously anticipated rate-hike actions by the Fed, which were confirmed at the January FOMC meeting. Of note is that the market has factored in rate hikes by the BOJ in the near future, despite the fact that the central bank issued forward guidance stating that it expects "short- and long-term policy interest rates to remain at their present or lower levels," and the fact that Governor Haruhiko Kuroda refuted rate hikes so strongly after the monetary policy meeting. At the very least, it would appear that the JGB market has completely priced in revisions to the forward guidance for policy rates.

One factor that might have convinced the market about revisions to forward guidance could be a comment that was made in the Summary of Opinions at the Monetary Policy Meeting in January (see below). Immediately after commenting on COVID-19 infections, it states that it would be appropriate for the Bank to maintain its current approach with regard to the inflation-overshooting commitment and forward guidance for policy rates. Reading between the lines, this could be interpreted to mean that the BOJ is considering revisions to forward guidance for policy rates and the inflation-overshooting commitment after the pandemic comes under control, while maintaining the yield curve control. With (market speculation regarding) such a hawkish stance by the BOJ weakening devaluating pressure on the yen but accelerating 'across-the-board selling' of equities/bonds, continued caution is warranted. Here, too, the true implications of premature tightening actions on the yield curve are flattening.

Summary of Opinions at BOJ's Monetary Policy Meeting in Jan (disclosed on 26 Jan 2022)

・For the time being, the Bank should closely monitor the impact of COVID-19 and not hesitate to take additional easing measures if necessary. It is appropriate for the Bank to maintain the current inflation-overshooting commitment and forward guidance for the policy rates.

5Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

10Y JGB Yield

Source: Bloomberg; compiled by Daiwa Securities.

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