Daiwa's View

Does the corporate bond market suggest additional hawkish surprises?

- Fed is unlikely to switch to dovish stance with the current overheated corporate bond market

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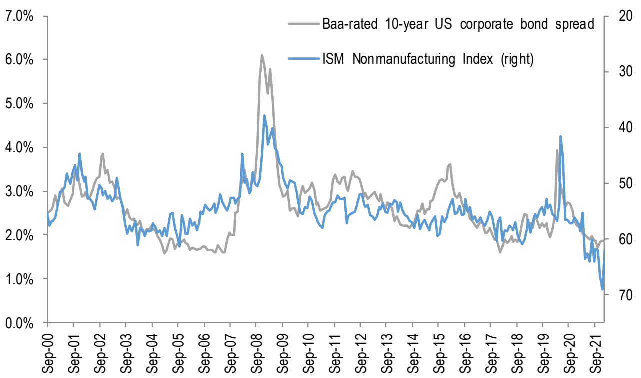
The market has been choppy ahead of the FOMC meeting. Some market participants appear to be increasing expectations of a helping hand from the Fed ('Fed put'), but that is unlikely. In a word, this is because the economy is overly strong.

We are focusing on the corporate bond market as one of the triggers for Fed put. Currently, the Baa-rated 10-year corporate bond spread is sustaining a very tight level at around 180bp. Why has this spread remained stable amid the high volatility of stock prices and yields? In fact, we can say that the current level of the corporate bond spread is appropriate, given the economic strength at this point. Thus far, the spread has declined (low and stable), with the ISM index logging a level of 55-60.

That said, what is hard to determine now is whether inflation can be contained in a situation in which the economy is overheated to this degree. The answer is probably "No." In this case, the economy and inflation are closely correlated, so a brake needs to be put on the economy (demand) in order to suppress inflation. If a brake is put on the economy, the ISM Index may decline to the lower half of the 50 level, and if the brake is too strong, the index may fall to the 40 level. In the past, the Baa-rated corporate bond spread was generally at the 200bp level when the ISM Index was in the lower half of the 50 level, and mostly widened to more than 300bp when the ISM Index was at the 40 level.

If the corporate bond spread were to worsen beyond the range of slight corrections and widened to a level entailing the risk of corporate fundraising, Fed put would be implemented. However, the current level of the corporate bond spread is signaling a need for faster tightening, rather than Fed put. Under the current circumstances, the Fed is unlikely to switch to a dovish stance. If anything, we now need to keep a lookout for additional hawkish surprises.

Baa-rated 10-year US Corporate Bond Spread, ISM Nonmanufacturing Index



Source: Bloomberg; compiled by Daiwa Securities.

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