Daiwa's View

There may have been a major relief rally, but …

- Market stress is also strong as yield curves remain inverted amid widening of Libor/OIS spread

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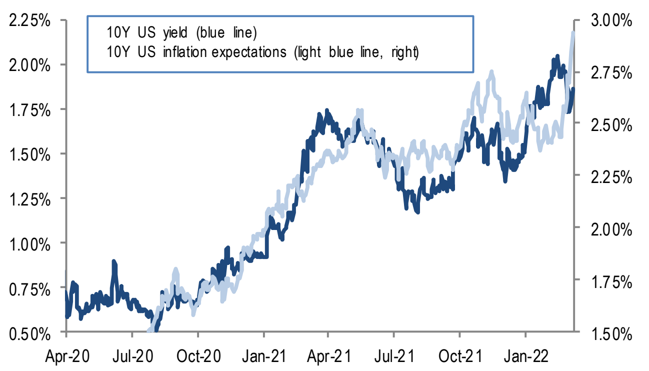
Yesterday, the market staged a relief rally that saw a partial reversal of excessive concerns about the situation in Ukraine. The EURO STOXX 50 Index jumped 7.44%, while crude oil price futures plunged by more than 12% at one point. The US Treasury yields rose by nearly 10bp across the entire curve.

Although the price of crude oil tumbled by 12% from its highest level ever, the level of WTI futures remains high at around $110. Accordingly, inflation expectations remain at a high level and the decline in real yields has reached a limit. (It would be difficult for them to decline below –1%.) Therefore, nominal yields are prone to face upward pressure in the current situation.

Meanwhile, inversions continue to be observed on the forward yield curves with both the 1-year forward OIS yields and US Treasury yields. Looking at OIS yields, the 1-year forward 1-year yield and the 1-year forward 5-year yield stood at 2.07% and 1.81%, respectively, leading to a -26bp spread. With respect to US Treasuries as well, the 1-year forward 2-year yield and the 1-year forward 10-year yield stood at 2.16% and 2.10%, respectively, leading to a 2-year/10-year spread of as much as -6bp.

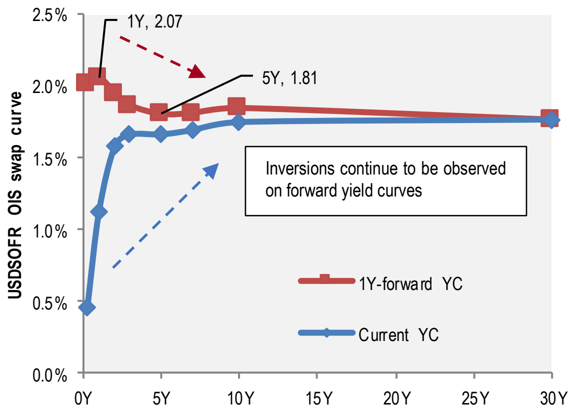
Normally, the price of crude oil and long/superlong-term yields are strongly correlated. However, in the current situation in which the Fed is falling behind the curve, high crude oil prices tend to lead directly to expectations of rate hikes. Therefore, the forward yield curves are unlikely to be able to revert back to normal easily. Although we saw a major relief rally yesterday, it would be premature to judge that there has been a full-scale reversal with regard to concerns about recession (stagflation).

10Y US Treasury Yield



Source: Bloomberg; compiled by Daiwa Securities.

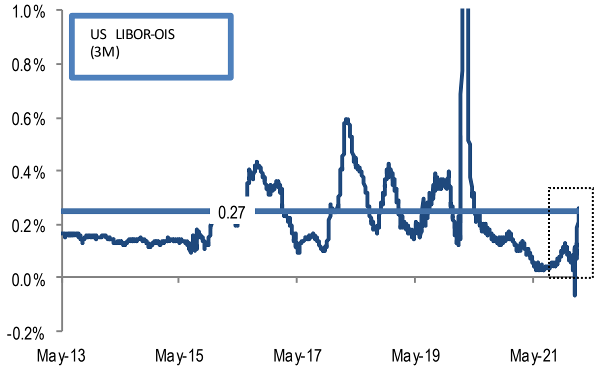
US OIS Yield Cuve



Source: Bloomberg; compiled by Daiwa Securities.

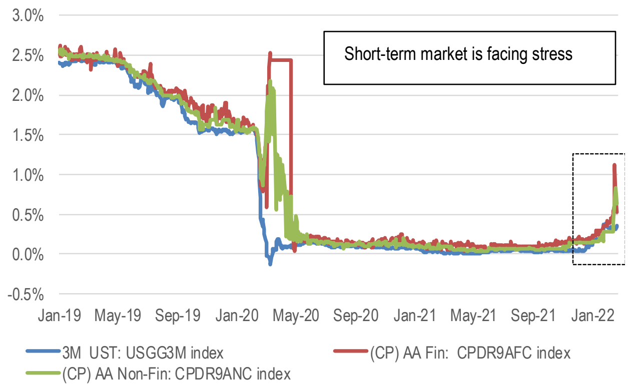
According to the latest data released yesterday, the 3-month Libor/OIS spread also rose to 27bp. The interest rate of 3-month US commercial paper (CP), which surged from the end of last week to the beginning of this week, declined slightly from the most stressed level it was at recently (0.53% for AA-rated financial institutions and 0.63% for AA-rated non-financial institutions). However, a wider spread is still required compared to the past average. In terms of deterioration in short-term liquidity, the situation is somewhat similar to that at the beginning of the COVID-19 pandemic, although not to the same extent, of course.

LIBOR/OIS Spread (3M)



Source: Bloomberg; compiled by Daiwa Securities.

US Treasury and Commercial Paper Yields (3M)



Source: Bloomberg; compiled by Daiwa Securities.

AA-rated companies are facing stress when procuring 3-month CP, which is an unusual situation. Needless to say, short-term interest rates are the foundation of the market. A decline in liquidity in the short-term market easily spreads to the entire market. The Fed is expected to decide on a rate hike next week, and discussions may continue regarding recognition of the default of Russian government bonds[1]. Unlike situations in the past, it may be difficult to expect support from central banks now, despite the stressful circumstances. Therefore, we need to carefully monitor whether unexpected factors ratchet up stress levels.

[1] Yesterday, the EMEA Credit Derivatives Determinations Committees (which have the authority to determine the default of CDSs) were convened. Discussions have started regarding recognition of Russian government bonds including Alternative Payment Currency provisions that include Russian roubles as one of the Alternative Payment Currencies. (Discussions are also scheduled for today.)

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