

# Daiwa's View

## The 10Y US yield in 2% range is different from that in Feb

- Market is becoming more concerned about economic slowdown

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### Market is becoming more concerned about economic slowdown

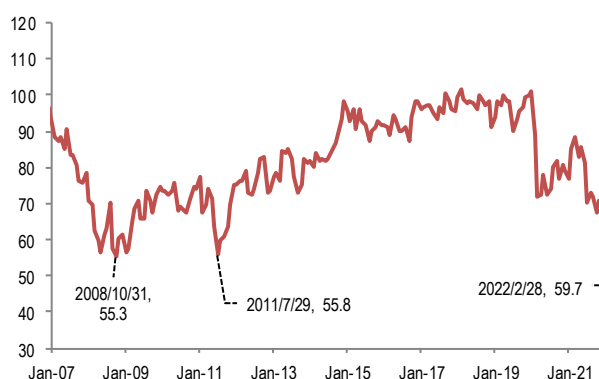
### The 10Y US yield in 2% range is different from that in Feb

In *Daiwa's View* reports, we see the University of Michigan Consumer Sentiment Index as an important barometer regarding concerns about stagflation. At the end of last week, the latest data in this index was announced, and showed that the Sentiment Index came in at 59.7, which is below the market estimate of 61.0. This figure should be examined carefully, considering that this is the first time the index has dropped to the 50s since the Global Financial Crisis (55.3) and the European debt crisis (55.8). Expectations for inflation one-year from now rose to 5.4% (5.1% at the time of GFC), which is the highest level since 1981. It is clear that consumer sentiment has been pushed down by the Russian invasion of Ukraine and concerns about rising inflation.

However, one of the few pieces of good news is that 5- to 10-year inflation expectations were unchanged from the previous month at 3.0%, and stayed within the range of past index findings. This data verified the Fed's understanding that the anchoring of medium/long-term inflation expectations has not broken down.

That said, there is room for doubt regarding whether this survey is fully reflecting the surge in crude oil prices since the deterioration of the situation in Ukraine. In any case, we think that it would be difficult for the central bank to shift to a dovish stance, given that (1) the drop in consumer sentiment is mainly caused by rising inflation and (2) the worsening situation in Ukraine is raising the upside risk of inflation. In that sense, the latest data from the University of Michigan Consumer Sentiment Index has further increased concerns about stagflation.

### University of Michigan Consumer Sentiment Index

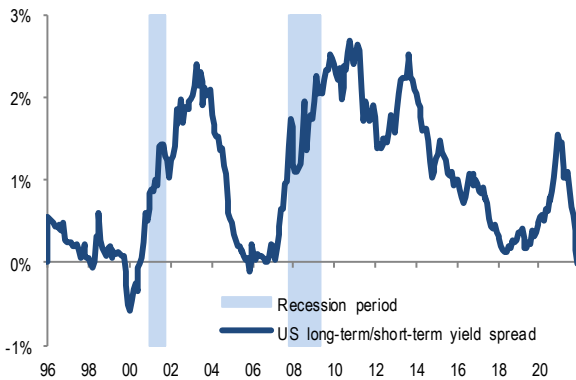


Source: Bloomberg; compiled by Daiwa Securities.

◆ Flattening yield curve

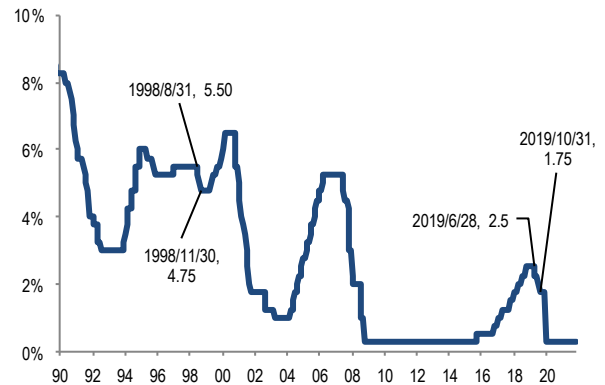
Economic concerns are manifesting as flattening of the yield curve in the sovereign bond market. The 5-year/10-year US Treasury yield spread finally declined to 4.2bp, a level not seen since June 2007. At that time, the 2-year/10-year spread fell into negative territory, and a recession started six months later (Dec 2007). In the current situation as well, the 6-month forward 2-year/10-year spread (long-term/short-term yield spread) has already fallen into negative territory, suggesting that we will inevitably see an inversion of the yield curve in the near future. Unlike in 1998 and 2019, when the Fed was successful in avoiding (delaying) recessions via preventive rate cuts, it would be difficult for the Fed to shift to a dovish stance now amid 30-year high inflation. The risk of recession is high, and even if recession is avoided, a substantial economic slowdown will likely be unavoidable.

6M-forward 2Y/10Y Spread



Source: Bloomberg; compiled by Daiwa Securities.

US Federal Funds Rate

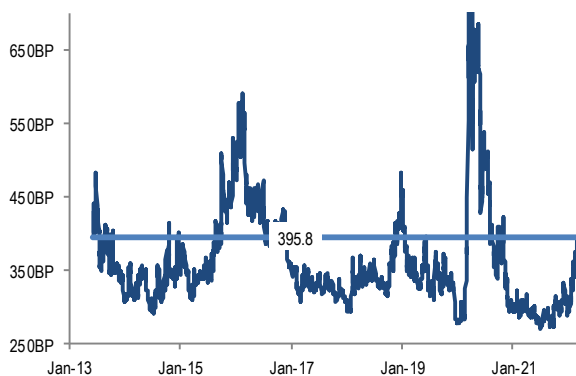


Source: Bloomberg; compiled by Daiwa Securities.

◆ Widening is becoming evident in the credit market

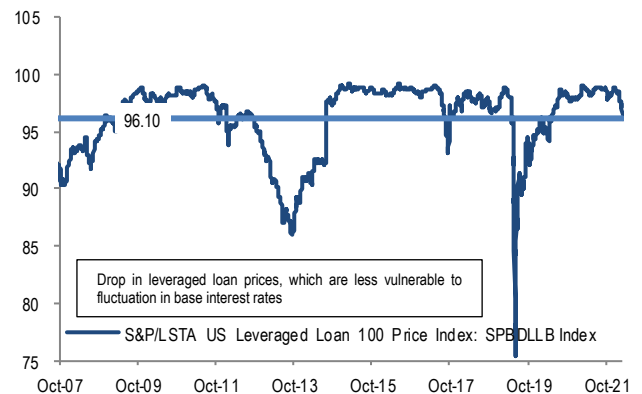
Increasing concerns about the economy are also becoming clear in the credit market. At the end of last week, the North American High Yield CDS Index widened again to 395bp. The price of leveraged loans, which tend to be preferred during rate hikes because they are mostly variable rate loans, have also clearly dropped, falling to 96.1. This indicates a situation in which the market's views on pure credit risk have started to change (right-hand chart below).

North American High-yield CDS Index (5Y)



Source: Bloomberg; compiled by Daiwa Securities.

S&P/LSTA US Leveraged Loan 100 Price Index:



Source: Bloomberg; compiled by Daiwa Securities.

Based on this broader perspective, the 10-year US yield appears to be approaching 2%, like it did in February. However, it is clear that the economic circumstances behind it this time are very different from what they were before the Russian invasion of Ukraine (naturally, the difference is reflected in stock price levels).

◆ JGBs are surprisingly solid

I get the impression that we have also started to see a change in market sentiment with JGBs in the current situation. Last Friday's price actions following the revision in forward guidance by the ECB the previous day was striking. Normally, JGB yields would have

reacted in an upward direction reflecting higher European/US yields and the more hawkish stance by the central bank. However, although JGBs were sold temporarily, they were largely flat d/d and bought back to a slightly lower level, without reacting to the depreciation of the yen, which progressed to a range between the upper half of the Y116 level and the Y117 level.

While there are some factors, including seasonal factors, that come to mind, the biggest factors are probably (1) the difference between last month and now regarding concerns about inflation and the economy and (2) the response of other central banks. If the Fed and ECB, both of which are more concerned with inflation than the economic situation, maintain their rate-hike stances, it is possible that investment in foreign bonds from the yen could face deterioration in hedging costs in the near future. Meanwhile, there are strong concerns regarding widening of the spread with credit investment, which tends to be preferred when hedging costs are deteriorating with a high carry return. Therefore, it is also difficult to invest in credit in the current circumstances. Investors may be aware of the increasing relative attractiveness of JGBs, which do not entail hedging costs, compared to foreign bonds. In particular, if the 10-year JGB yield rises to around 0.20%, which is close to the level at which the BOJ will likely conduct fixed-rate purchase operations, we can say that JGBs would be one of the few true risk-free products in the current market environment that is seeing an increase in investment risk.

Regarding the fact that JGBs did not react to the revision of forward guidance by the ECB, our interpretation is that JGBs had already factored in a revision to the BOJ's forward guidance on its policy interest rates when it changed its price outlook to "risks to prices are generally balanced" in the January *Outlook for Economic Activity and Prices* report. That said, pricing of rate hikes could have intensified only on Friday in order to digest this fact, but the desire to buy JGBs on dips appears to have outweighed the impact of the revision by the ECB. Therefore, this indicates the possibility that market sentiment for JGBs is strengthening somewhat.

A mild rise in resource prices serves as a factor in raising prices, while a surge serves as a factor in restricting the economy. If market awareness regarding the overseas economy worsens due to the Russian invasion of Ukraine, it is possible that the BOJ will make a downward revision with respect to the risk balance in the outlook for Japan's economy, which was described in the latest *Outlook Report* as "risks to economic activity are skewed to the downside for the time being, mainly due to the impact of COVID-19, but are generally balanced thereafter." With regard to the difference in inflation rates, it is not clear whether the BOJ will take the same stance as the Fed and ECB of being more concerned with inflation than the economic situation. We would like to pay close attention to the BOJ's thinking on this, which will be disclosed at the monetary policy meeting to be held this week.

#### **BOJ Outlook for Economic Activity and Prices (Jan 2022)**

• With regard to the risk balance, risks to economic activity are skewed to the downside for the time being, mainly due to the impact of COVID-19, but are generally balanced thereafter. Risks to prices are generally balanced.

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