Daiwa Securities

Daiwa's View

10-year US yield temporarily topped 2.5%

➢ We need to pay increasing attention to impact of rising yields of safe assets on peripherals

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Risky assets outperform – coming from valuations where they were excessively penalized for their riskiness – until they're priced more like safe assets. Then they underperform until they once again offer adequate risk premiums.

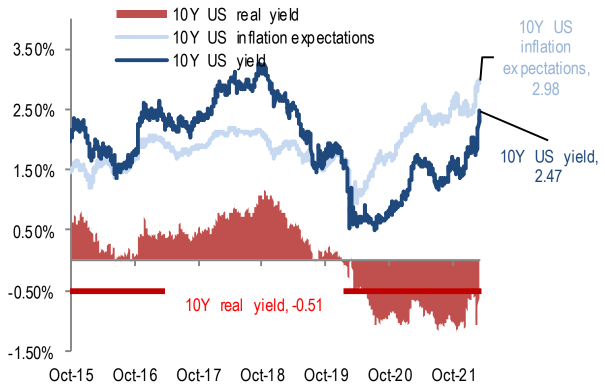
Source: Excerpted from Mastering the Market Cycle *by Howard Marks.*

10-year US yield temporarily topped 2.5%

We need to pay increasing attention to impact of rising yields of safe assets on peripherals

At the end of last week, the 10-year US Treasury yield temporarily topped 2.5% and closed at 2.47%. (The 5-year yield rose to 2.55%.) Therefore, the 5-year/10-year yield spread deepened to -8bp. The 5-year/30-year spread also narrowed to only 3.8bp, and is about to fall into negative territory.

10Y UST Yield, Inflation Expectations, Real Yield



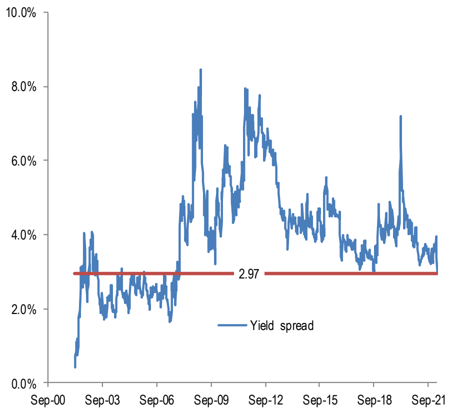
Source: Bloomberg; compiled by Daiwa Securities.

US 5Y/30Y Spread

Source: Bloomberg; compiled by Daiwa Securities.

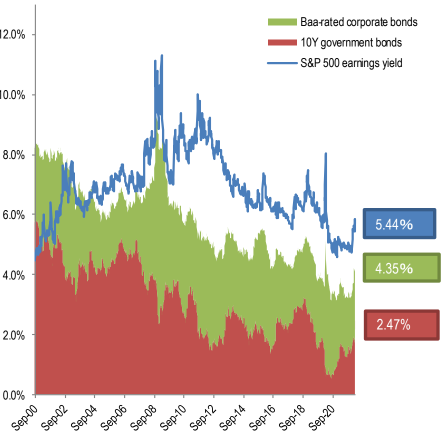
When thinking about the market in FY22, we get the impression that the impact of the rise in the yields of safe assets like this on the price of other assets cannot be ignored. Under normal circumstances, asset yields would be ranked in the following way: government bond yields < corporate bond yields < equity earnings yield. The yield spread between long-term government bonds and corporate bonds is referred to as the corporate bond spread, while that between long-term government bonds and stocks is referred to as the yield spread. Due to rising yields and a substantial rebound in stock prices since the March FOMC meeting, the S&P 500 yield spread fell below 3% at the end of last week for the first time since September 2021. With 3% being the lower limit for the range since the Global Financial Crisis, we think the yield spread has reduced leeway for providing a cushion for price declines in the future. The following warn of the possibility that the market is approaching a turning point as the Fed intensifies its hawkish stance: (1) risk premiums that are losing room for downside (too high vs. the Fed's 2% target), (2) the 10-year nominal yield rising above the longer-run rate, catching up to the level of inflation expectations, and (3) the inversion of the US Treasury yield curve.

S&P 500 Yield Spread



Source: Bloomberg; compiled by Daiwa Securities.

Yields of Government Bonds, Corporate Bonds, and Stocks,



Source: Bloomberg; compiled by Daiwa Securities.

That said, we are not assuming that the market will reach a turning point immediately. The balance of the reverse repo facility (which has been described by the Fed as excess liquidity) is currently as much as around $1.7tn (about Y200tn). A special note should be made of the unusual situation in which we are seeing concentrated demand to this extent for placing bids for the reverse repo facility, with which only a 0.3% yield is gained, despite the rise in the 2-year US Treasury yield to 2.27% on rising expectations of rate hikes. In other words, collection of excess liquidity—i.e., progress with QT—is seen as holding the key to optimizing risk premiums.

In this respect, after disclosing QT parameters in the minutes of the March meeting (to be disclosed on 6 Apr), and using that as an opportunity to send a message to the market, the Fed is apparently considering deciding to start QT all at once at the May FOMC meeting. Once the Fed starts QT, excess liquidity will decrease, so, the tone of the market may start to change. That said, it is estimated that (1) one to two years will be needed to eliminate excess liquidity and (2) about three years will be needed to reach the final targets for balance sheet reductions. Therefore, it is true that an enormous amount of excess liquidity will linger in the financial system for the time being, despite the start of collection. It is not easy to accurately forecast the timing of changes in valuations.

In *Daiwa's View* reports, we have revised our US yield outlook and set the upper limit for rate-hike projections in the upside scenario at 5%. The appropriateness of this 5% upper limit level is also backed up by discussions about risk premiums. According to the chart above showing yields of government bonds, corporate bonds, and stocks, we can see that it would be difficult for the equity earnings yield to be maintained at 5% if the policy interest rate level rose to 5%. In other words, a policy interest rate of 5% can be seen as a level at which inflation would be brought under control by forcibly collapsing prices of risk assets and cooling the economy/demand for goods and services via reverse wealth effects should we see neither inflation being brought under control nor valuation corrections even after the start of QT.

In any case, as we deal with the unsettling circumstances of FY22, the impact of the Fed's rate hikes and collection of excess liquidity will likely leave us unable to put our minds at rest. We need to formulate our investment plans with regard to JGBs as well after having sufficiently anticipated such drastic changes in the market environment.

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