Daiwa Securities

Daiwa's View

Volatility is peaking

- We expect the 10yr Treasury yield to trade in a range of 2.8-3.05% between now and the June FOMC meeting
- This has major implications for JGBs

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

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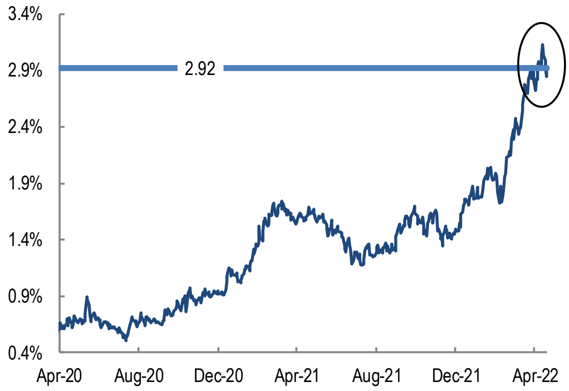
The 10yr Treasury yield traded between 2.8% and 3.2% last week, a wide range spanning 40bp. Particularly interesting were the pullbacks following the sharp moves up. A loss of confidence in the Fed sent the 10yr yield up to 3.20% on 9 May, and then a high core CPI reading caused a sell-off to 3.07% on 11 May, but with risk assets including equities and corporate credit also volatile on the deteriorating financial environment, on both days the 10yr yield wound up closing lower than the previous day's close (the candle leg had a large upper shadow).

Selling was not sustained by the important themes that had been driving strong upward moves in interest rates, and instead it was short covering that dominated. This quickly squashed the narrative that selling would push the 10yr yield well above 3%. Such changes in psychology also showed up in volatility, and MOVE, the US Treasury volatility index, dropped to 114.6, its lowest level since 17 March (lower right chart). Volatility is still high in absolute terms, but if it is peaking it would indicate a significant change to the bond market moving forward.

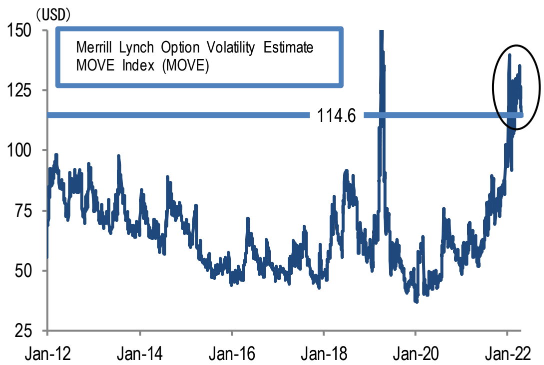
As a crosscheck to the current 10yr Treasury yield, we note that breakeven inflation is at 2.74% and the real rate at 0.18%, the term premium is at -0.1% and the risk-neutral yield at 3.02%, and the 5yr yield is at 2.87% and the 5yr forward 5yr yield is at 2.99%, all justifiable levels at this juncture. Although the new narrative about a recession bears close watching (see next page), we do not anticipate any recession catalysts materializing anytime soon, which in turn makes that narrative likely to lose luster near term. Given these factors, we expect the 10yr Treasury yield to stay within a core range of 2.8-3.05% until the June FOMC meeting.

10Y UST Yield



Source: Bloomberg; compiled by Daiwa Securities.

US Bond Volatility Index (MOVE)

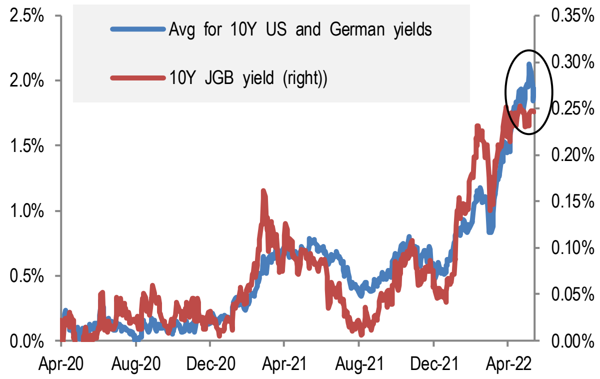


Source: Bloomberg; compiled by Daiwa Securities.

Major implications for JGBs

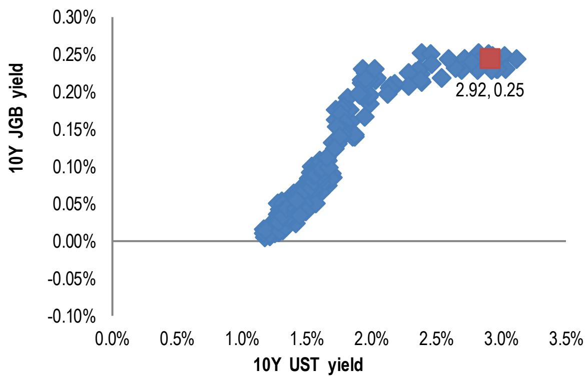
Treasury volatility is a key component of the external environment, and if it has peaked, it will probably have major implications for JGB investing. History indicates that a 10yr JGB yield of 0.25% has been generally consistent with a Treasury yield of around 2.9% and a German Bund yield of around 0.9%, and this combined with support from the BOJ's fixed-rate purchase operations makes it substantially easier to buy JGBs in the 10yr zone.

10Y JGB Yield, Average for 10Y US and European Yields



Source: Bloomberg; compiled by Daiwa Securities.

10Y JGB Yield, 10Y UST Yield (scatter diagram)



Source: Bloomberg; compiled by Daiwa Securities.

Also important to keep in mind is that BOJ Executive Director Shinichi Uchida, speaking in front of the upper house Committee on Financial Affairs, said "given the current monetary and economic environment, widening the allowable trading band for the long-term rate would be effectively the same as a rate hike, and that is not what the Japanese economy needs." It is widely understood that Mr. Uchida will be one of the key players in a post-Kuroda BOJ, and his statement suggests that there is effectively no chance that the BOJ will change its yield curve control policy before the upper house election in July this year at the earliest, and likely not before Mr. Kuroda's term ends in April 2023. It is unrealistic to take a short position now and hold it until after Mr. Kuroda steps down, and we think at some point nonresident investors will probably have to unwind their short positions on the intermediate and long-term sectors.

When the covering of these short positions begins, the unintentional increase in stock effects from fixed-rate purchase operations up to around Y3tn (including technical factors related to closing prices) from March 2022 will probably become impossible to ignore. Although shorts and buybacks by speculators are actually a zero-sum game, when some of the selling (about Y3tn) is absorbed by the BOJ as in the current case, it is not hard to envision buybacks ending up far from where they started. In other words, there is a possibility that the unintentional increase in stock effects will trigger a change, in the direction of slightly stronger JGBs, in the balance between JGBs and overseas government bonds as shown in the upper left chart.

JGB investments until now have primarily hinged around the question of whether JGBs made overvalued by fixed-rate purchase operations should be bought based on trust in those operations, but the changes noted above, namely the substantial easing (elimination) of richness and increased confidence that yield curve control will be maintained, has made such investments feel safer than previously. The Fed has yet to execute a full-fledged exit strategy and it is probably not yet time for JGBs to enter a full-fledged decline, but if there is some easing of upward pressures and volatility, we think that could spark an increase in minimal buying focused on the attractiveness of carry.

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