Daiwa's View

US yields made steady by stabilization of inflation expectations

- If inflation expectations remain stable, dip-buying of 10Y Treasuries at 3% would be effective
- The trade-off for stable inflation expectations is a slowdown in growth rate

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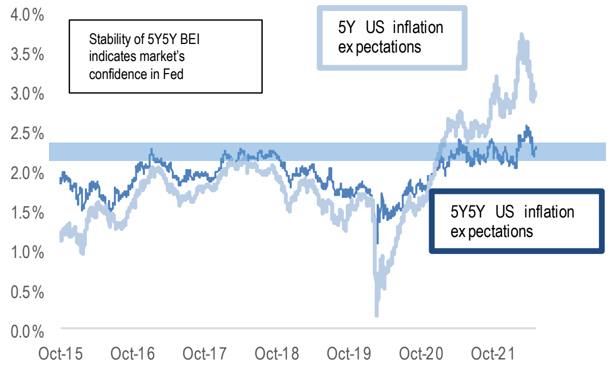
◆ Strikingly stable inflation expectations

Yesterday, the 10-year US Treasury yield remained flat at 2.91%. We can say that this is strikingly stable, given that the 10-year German yield faced a somewhat sharp rise of +0.05% (from 1.19% to 1.24%).

One distinctive aspect of the recent yield uptrend is that market-based inflation expectations (breakeven inflation rate: BEI) have been unexpectedly stable. Despite the release of the ISM Manufacturing Index and higher CPI readings in Europe at the beginning of the month, the 10-year US BEI remained largely flat at 2.68% yesterday. So far, the rise in inflation expectations has led to an uptrend in US yields. However, an important change in the current phase is that inflation expectations have been unexpectedly steady. It is particularly noteworthy that the Fed-focused 5-year forward 5-year BEI has remained stable at around 2.3%.

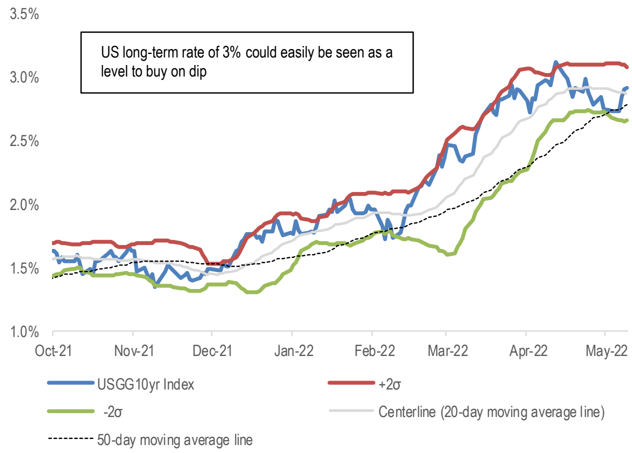
The BEI refers to the CPI, which is on average 0.3% higher than PCE inflation that is used by the Fed as a gauge for inflation. The fact that the BEI has remained stable at around 2.3% can be viewed as a sign of the market's confidence in the Fed, which has rapidly shifted to a hawkish stance. As long as inflation expectations remain stable (i.e., continued confidence in the Fed), the likelihood is low that the +2σ line in the Bollinger Bands, which has shifted to a flat trend, will rise again. Provided inflation expectations remain stable, 10-year Treasuries with a yield of around 3% could easily be seen as a level to buy on dip.

US Inflation Expectations (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Yield, Bollinger Bands

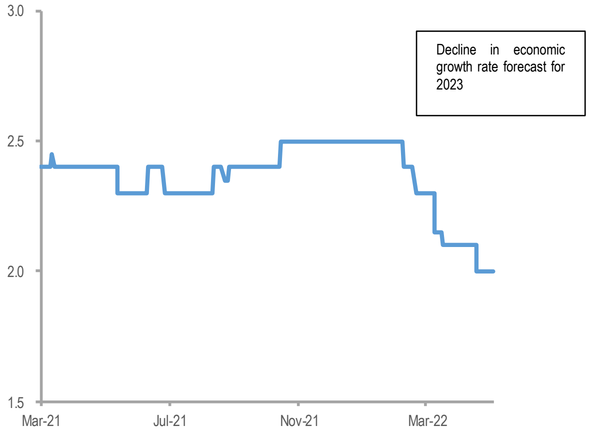


Source: Bloomberg; compiled by Daiwa Securities.

◆ <u>The trade-off for stable inflation expectations is a slowdown in growth rate (or an economic 'hurricane')</u>

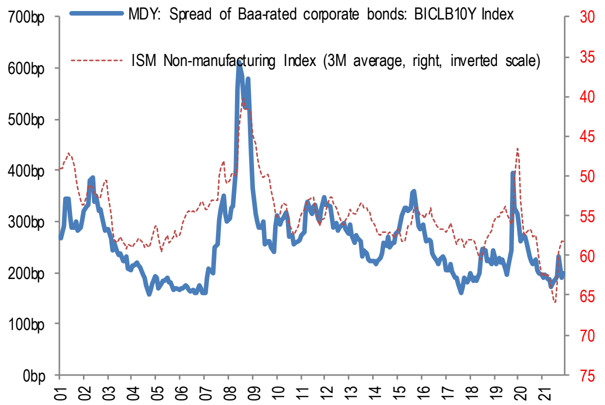
Of course, the trade-off for these stable inflation expectations is a decline in the economic growth rate. With the Atlanta Fed's *GDPNow* suggesting low growth at 1.3%, the Bloomberg consensus for US GDP growth forecast for 2023 has now declined to 2.0%. Some houses have lowered their growth rate forecasts for 2023 to around the 1.5% level, below the potential growth rate (1.8%). In that sense, the growth rate forecast for 2023 in the Summary of Economic Projections to be disclosed at the June FOMC meeting will be a point of interest at the June meeting, which is seen as being uneventful.

US Growth Rate Forecast for 2023 (Bloomberg consensus, %, ECGDUS 23 Index)



Source: Bloomberg; compiled by Daiwa Securities.

ISM Non-manufacturing Index, Spread of Baa-rated Corporate Bonds



Source: Bloomberg; compiled by Daiwa Securities.

Recently, JPMorgan Chase CEO Jamie Dimon warned investors to prepare for an economic 'hurricane.' Goldman Sachs Group President John Waldron also stated "We expect there's going to be tougher economic times ahead." So, we are hearing an increasing number of warning bells. This is somewhat of an unprecedented situation, in which strategists are recommending buying in anticipation of stock prices bottoming out while managers are giving investors warnings in the opposite direction. However, it goes without saying which view is a more accurate forecast of the long-term economic environment.

The views of JPMorgan Chase CEO Dimon in particular have an impact on credit standards at JPMorgan Chase, which is a money center bank. Therefore, they have a direct impact on the credit market. He stated that "JPMorgan is preparing for that turbulence by being conservative with its balance sheet." Regardless of the times, the credit market is known for lending you an umbrella when the sun is shining and taking it back when it rains. Suspension of QE by central banks (QT), a slowdown in the economic growth rate, and tighter credit standards at money center banks are enough for us to become cautious about the arrival of an economic 'hurricane.'

Amid the increasing alarm about this 'hurricane,' one could say that slightly dark clouds have formed around the question of whether the BOJ will actually implement policy revisions and rate hikes in April 2023 when Governor Kuroda's term comes to an end, as the market is expecting. It is certain that European and US economic growth rates will slow down next year, and it is possible that the hurricane Dimon is warning about will come. (Japan's economy would also be exposed to strong downward pressure.) If the hurricane were to come immediately after a rate hike by the BOJ and the central bank were forced to cut the rate, that would constitute the third such policy mistake by the organization, following its rate hike in 2001 immediately before the bursting of tech bubble and its rate hike in 2006 immediately before the bursting of the subprime bubble.

Of course, the BOJ's first two mistakes are no guarantee that it won't happen a third time. If the same mistake is repeated three times in a row, this would lead to problems in the future. It is said that "haste makes waste." If the BOJ wishes to successfully implement policy revisions, it must give full consideration to global economic trends, as well as the timing of personnel issues.

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