Daiwa's View

First half ends in shift of US yields toward neutral rate reversion

- Trend breakout has not yet occurred
- Substantial bear steepening in JGB yields, but sustainability is dubious

Fixed Income Research Section
FICC Research Dept.

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

Daiwa Securities Co. Ltd.

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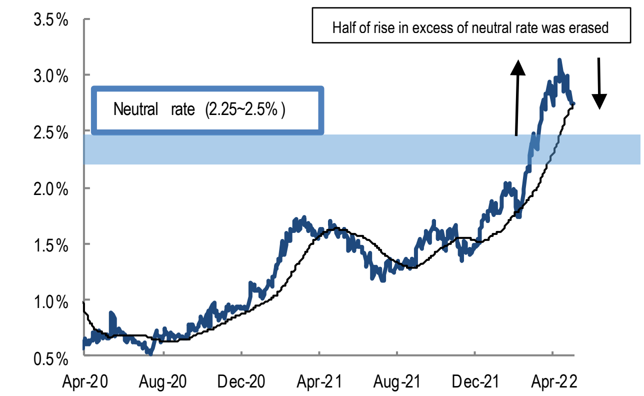
◆ First half ends in shift of US yields toward neutral rate reversion

Yesterday, the 10Y US yield declined to 2.70%, testing a downside breakout of the 50-day moving average line before returning to 2.75%. At end-May, the need to rebalance portfolios following lower stock prices and higher bond prices within the month should have made it easier for short-term pressure to buy stocks and sell bonds to intensify. However, the bond market is easily dealing with such selling pressure and testing a trend breakout, which is striking. From the viewpoint of a divergence from the neutral interest rate (2.25-2.5%) and its correction (return to the mean), the 50bp decline from 3.2% on 9 May to 2.7% last night means that mathematically, the first half of the reversion toward the neutral rate has been completed.

The developments up to this point have been very fast. Probably, this is because of the aspect that buying bonds is becoming easier owing to a sharp decline in both 5Y and 5Y5Y inflation expectations (right-hand chart below) amid a drop in the MOVE (bond volatility index) from 135 on 22 April to 102.5.

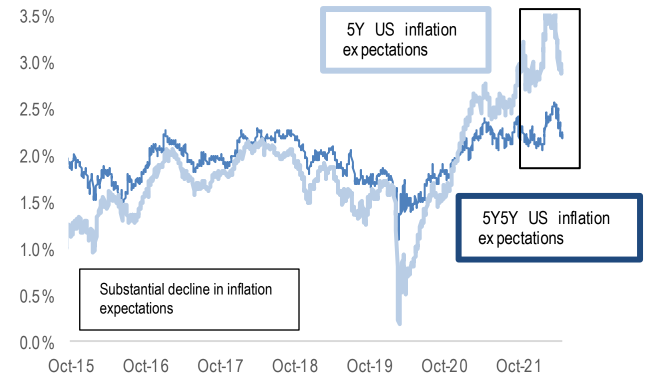
That said, even if inflation expectations decline, as long as actual inflation remains uncomfortably elevated, the Fed is unlikely to continue to allow easing of financial conditions with the risk-on rally driven by lower yields. Accordingly, it is too early to assume that there will now be a downside breakout of the trend, with the second half of the mean reversion toward the neutral interest rate going ahead in earnest. Instead, we expect the latter half of reversion to the neutral rate to start around the time when the Fed's hawkish stance is lessened due to calming inflation or when recession concerns resurge owing to an end to the relief rally.

10Y US Yield



Source: Bloomberg; compiled by Daiwa Securities.

5Y and 5Y5Y US Inflation Expectations



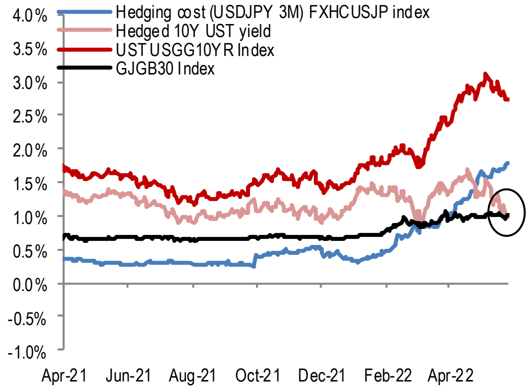
Source: Bloomberg; compiled by Daiwa Securities.

◆ Substantial bear steepening in JGB yields, but sustainability is dubious

Meanwhile, JGB yields bear steepened yesterday. Strong selling sent the 20Y JGB yield and 30Y JGB yield to 0.75% and 1% respectively. Similar to US yields, selling to rebalance portfolios at the end of the month was within expectations. However, JGBs might have faced stronger selling pressure than this.

Some data in my dashboard imply that this kind of sharp rise is unlikely to be sustained. First is the comparison between the hedged 10Y US yield and JGB yield. Yesterday, the 10Y US yield stood at 2.75%, while hedging cost rose to 1.77%. As a result, the hedged 10Y US yield declined to 0.98%, which has finally became lower than the 30Y JGB yield. Of course, a hedged 10Y US yield does not necessarily serve as a strict ceiling for JGB yields, but this seems to serve as one yardstick suggesting that JGBs have become more attractive than USTs.

30Y JGB Yield, Hedged 10Y US Yield

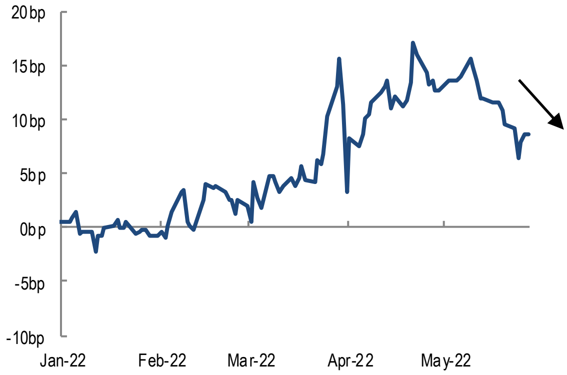


Source: Bloomberg; compiled by Daiwa Securities.

Second is the peaking out of the JGB-SWAP spread and the LCH-JSCC spread. Thus far, the 10Y swap spread has continually faced widening pressure as a result of the BOJ's fixed-rate purchase operations containing a rise in JGB yields amid the US yield uptrend. During the same period, the LCH-JSCC spread has widened, and payers (short) of these swaps were probably overseas investors.

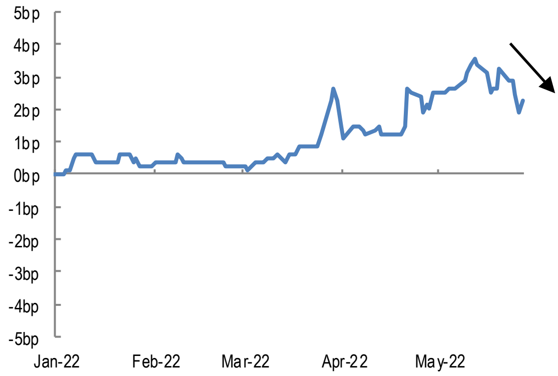
However, the JGB-SWAP spread, which had temporarily exceeded 15bp, has now declined to a single-digit level. In line with this movement, the LCH-JSCC spread has also peaked out. This implies that short pressure on JGB yields by overseas investors is diminishing.

10Y Swap Spread (Swap rate – JGB yield)



Source: Bloomberg; compiled by Daiwa Securities.

LCH-JSCC Spread (10Y)

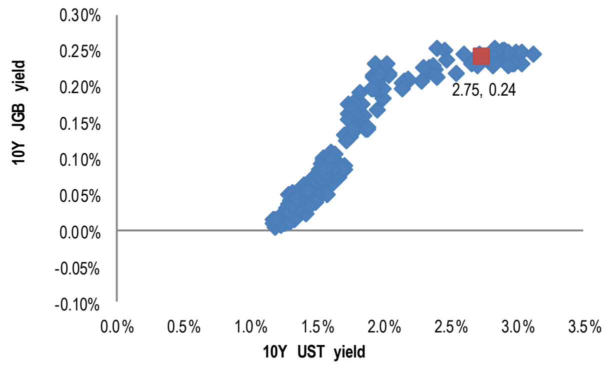


Source: Bloomberg; compiled by Daiwa Securities.

Of course, we are unable to deny the possibility that short pressure will strengthen again going forward. However, we think it difficult to assume stronger short pressure than the previous case under the current environment where overseas yields are peaking out.

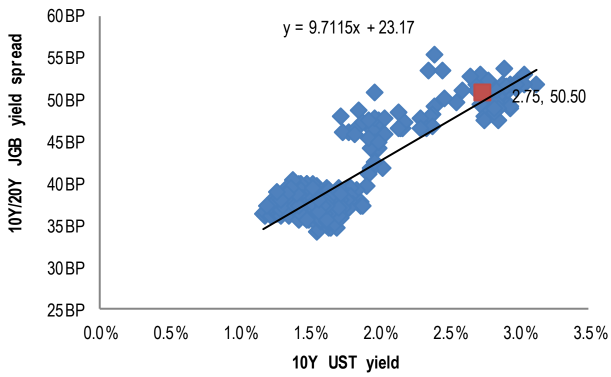
Third and final is the balance between JGB and US yields. Thus far, JGB yields have been clearly correlated with US yields. Currently, the 10Y/20Y JGB spread stands at around 52bp (10Y yield of 0.23% and 20Y yield of 0.75%). Based on the balance in the past, a rise in the spread beyond 55bp necessitates the 10Y US yield exceeding 3% once again (right-hand chart below). My conclusion is that, under the current condition where US yields appear to have peaked out, unless expectations for BOJ's policy revisions increase substantially, there is a slim chance that we will continue to see a sharp rise (bear steepening), like the case seen yesterday.

10Y JGB Yield, 10Y US Yield



Source: Bloomberg; compiled by Daiwa Securities.
Note: From Apr 2021 to date.

10Y/20Y JGB Yield Spread, 10Y US Yield



Source: Bloomberg; compiled by Daiwa Securities.
Note: From Apr 2021 to date.

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