Daiwa's View

Inversion of hedged 10Y US yield and superlong JGB yields is expected within three months

➢ JGBs are likely to start outperforming hedged USTs

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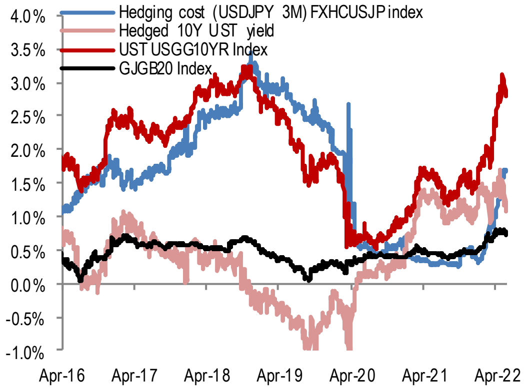
Yesterday, the 10Y US yield rose to 2.85% (up 0.07% d/d). While major stock indices rebounded by around 1.5-2% after a long interval, the North American High Yield CDS Index declined from 530bp to 509bp. This seems to have been a partial unwinding of concerns about a recession. Although recession concerns themselves will linger going forward, this is a matter that is still a little ways off for the moment. Therefore, there are certain limits to how far yields will decline at this stage. For the time being, the market is expected to form a range with the lower limit of the 10Y US yield at around 2.8%

◆ Bullish trend with superlong JGBs

Meanwhile, we must pay some attention to the fact that a bullish trend has recently begun with JGB yields, particularly superlong yields. Of course, one factor behind this is a feeling that the rise in the US long-term yield has peaked. However, one must not overlook another factor—that we now anticipate an inversion of the hedged 10Y US yield and superlong JGB yields within three months.

Looking back on the past, when US yields have been in the process of surging in line with the start of tightening by the Fed, superlong JGB yields have tended to rise temporarily in line with US yields. However, we have observed a tendency for superlong JGB yields to face downward pressure once the hedged 10Y US yield has started to become lower than superlong JGB yields mainly due to increased hedging costs in line with actual rate hikes by the Fed.

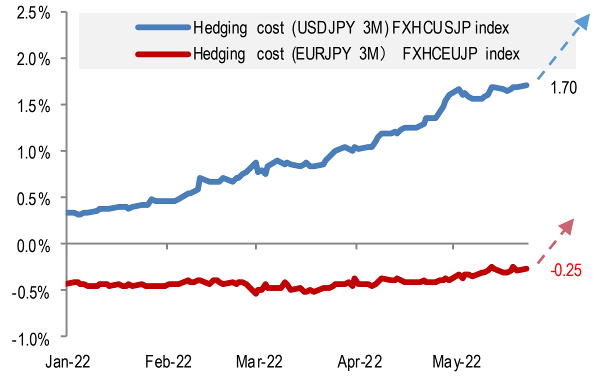
20Y JGB Yield, Unhedged/Hedged 10Y US Yields



Source: Bloomberg; compiled by Daiwa Securities.

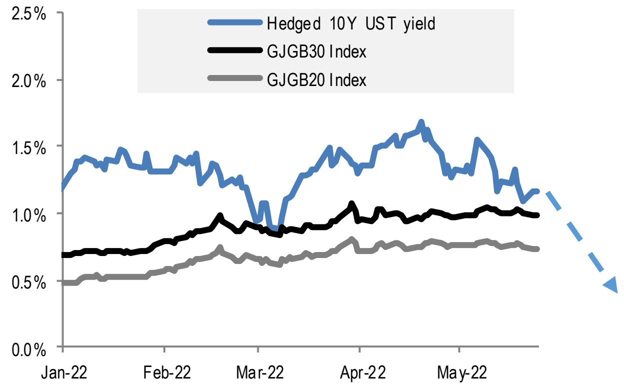
◆ Currency hedging costs are expected to deteriorate
Currently, the USD/JPY hedging cost (3M) is 1.7%, while the hedged 10Y US yield stands at 1.16%. Although, after considering hedging costs, the 10Y US yield is still slightly higher than the long-term JGB yield, a clear downtrend has started to be observed (right-hand chart below). The Fed will likely implement a 50bp rate hike at least in both June and July, totaling at least 1%. This means that a further deterioration in dollar hedging costs is almost certain. Currently, the 3M US yield stands at 0.98% and the 3M-forward 3M yield is 2.02%. If we add these expected rate hikes to current hedging costs under the assumption that other conditions remain constant, in three months hedging costs and the hedged 10Y US yield are calculated to be around 2.7% and at the 0.1% level, respectively. In other words, an inversion of the hedged 10Y US yield and superlong JGB yields is expected within three months.

Currency Hedging Costs (3M)



Source: Bloomberg; compiled by Daiwa Securities.

Hedged 10Y US Yield, Superlong JGB Yields



Source: Bloomberg; compiled by Daiwa Securities.

◆ Surge in net buying of superlong JGBs by overseas investors
Looking at past patterns, this kind of change in the balance with hedged yields has led Japanese investors to return to yen bonds and overseas investors to purchase JGBs. In this respect, the Trading Volume of Over-the-Counter (OTC) Bonds for April showed that net buying of superlong JGBs by foreigners reached a surprising Y1,062.6bn. On a single monthly basis, this is more than double that by life/non-life insurers. Furthermore, year-to-date net buying of superlong JGBs by foreigners is almost equal to that by life/non-life insurers. This investment behavior by foreigners stands in contrast to a reduction in the pace of "leveling" purchases by Japanese life/non-life insurers to the Y400bn level and net selling of superlong JGBs by major banks to the tune of more than Y1tn.

Trading Volume of Over-the-Counter (OTC) Bonds (Y bn, superlong JGBs on net basis)

	Major banks	Life & non-life insurers	Foreigners
Jan-22	-146.5	898.8	225.4
Feb-22	-178.7	853.0	596.1
Mar-22	-412.2	462.4	455.0
Apr-22	-293.5	425.7	1,062.6
YTD	-1,030.9	2,639.9	2,339.1

Source: Japan Securities Dealers Association; compiled by Daiwa Securities.

Assuming that anticipation of an approaching inversion in the near term of the hedged 10Y US yield and superlong JGB yields is an influencing factor in the recent bullish trend with superlong JGB yields, it is possible that a reversal of Japanese investors' cautious stance towards JGBs is also drawing near. This, no doubt, will have a certain degree of impact on superlong JGBs, to put it lightly.

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