Daiwa's View

Perfect storm

➢ Recession concerns return, and so does flattening

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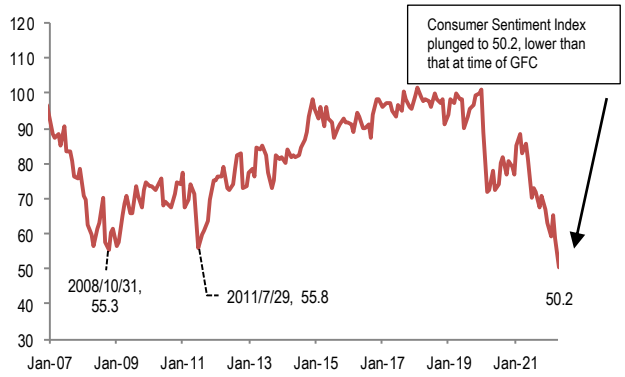
◆ Hot CPI brings back recession concerns

Last Friday the markets was buffeted by two data shocks, a US CPI hot enough to cast doubts over the market's peak inflation hypothesis and a sharp drop in the University of Michigan's Consumer Sentiment Index to 50.2, which is lower than it was during the global financial crisis (GFC). The University of Michigan's 5-10yr inflation expectation rose to 3.3%, its highest since the GFC, and that in conjunction with a hot CPI have rekindled recession concerns.

The 10yr Treasury yield rose +12bp to 3.16% on Friday. More interesting, however, were the deepening of yield curve inversion, to -10bp for the 5yr/10yr and to -7bp for the 5yr/30yr, and the widening of North American high-yield CDS premiums to 535bp, their widest since the pandemic began. Although this return of inflation concerns to end last week will undoubtedly push the Fed in a hawkish direction, the University of Michigan's consumer sentiment numbers suggest the possibility that the US economy lacks the resilience to weather any tightening. This perfect storm will bring back concerns over a recession.

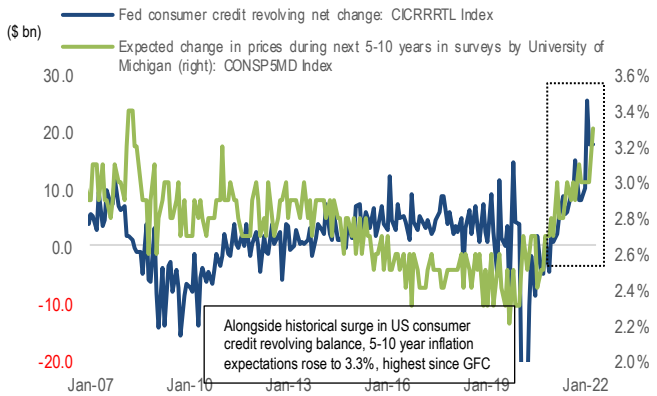
Numerous top-level executives have issued warnings, with Citigroup CEO Jane Fraser commenting that "it will not be easy to avoid" a recession, JPMorgan Chase CEO Jamie Dimon announcing an economic "hurricane" advisory, and Goldman Sachs President John Waldron warning of "tougher economic times ahead" (although many economists and strategists are optimistic). Recent changes in the data, including the sharp increase in US consumer credit outstanding (revolving loan payments) and the plunge in the University of Michigan's consumer sentiment index, give voice to the screams of consumers suffering from high inflation.

University of Michigan's Consumer Sentiment Index



Source: Bloomberg; compiled by Daiwa Securities.

US Consumer Credit Revolving, Expected Change in Prices During Next 5-10 Years in Surveys by University of Michigan



Source: Bloomberg; compiled by Daiwa Securities.

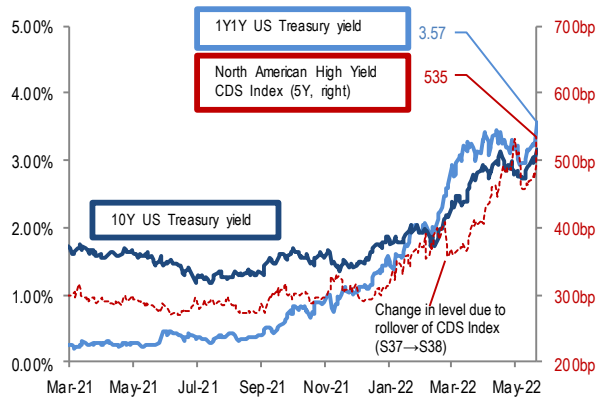
◆ Rising trend in interest rates has not returned, but curve flattening has

Although renewed inflation concerns have slightly raised the trading range for long-term rates, long-term rates do not appear to have resumed their rising trend. What has resumed is the flattening (and inversion) of the yield curve. This is because a consequence of the Fed becoming more hawkish in response to inflation worries is that it has become more likely there will be a hard landing that constrains longer-term inflation expectations. Last Friday, there was almost no increase in US 10yr breakeven inflation (BEI) and the 5yr forward 5yr BEI actually declined, from 2.4% to 2.36%.

This directionality is also evident from moves in the 10yr yield and 1yr forward 1yr yield. Looking at the data since September 2021, when the Fed signaled more readiness to hike rates, during the first stage of inflation rising toward target, the 1yr forward 1yr rate rose but the 10yr yield also rose as if a mirage, and no inversion occurred (they gradually converged instead). Around Jan-Feb this year, when the rate hikes that were priced in drew closer to the neutral interest rate, the 1yr forward 1yr yield and the 10yr yield wound up at roughly the same level. It was around this time that concerns over the economy's direction arose and credit spreads started widening (present-day Europe).

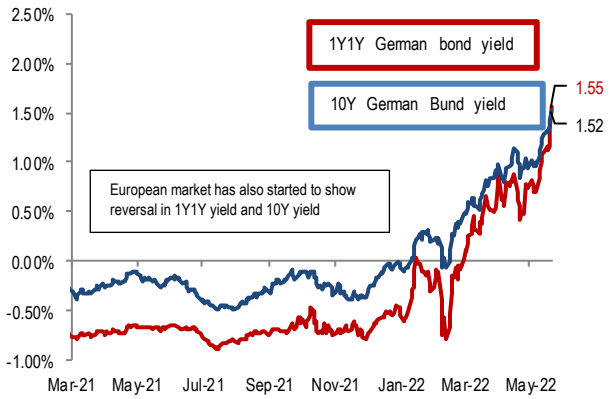
Despite this, inflation has persisted, and once the terminal rate hike exceeds the neutral rate, the 1yr forward 1yr and the 10yr will invert (an economic death cross). The US moved to this stage starting in late February to early March, when the situation in Ukraine deteriorated the most. Even during this stage, serious concerns over recession will not develop as long as the 10yr yield continues rising, but once it stops rising, concerns over yield inversion and a recession will arise.

10Y US Yield, 1Y1Y Yield, North American High Yield CDS Index



Source: Bloomberg; compiled by Daiwa Securities.

10Y German Yield, 1Y1Y Yield,



Source: Bloomberg; compiled by Daiwa Securities.

With the 1yr forward 1yr yield now at 3.57% and the 10yr yield at 3.16%, there is already an inversion of 41bp of that pair. Although this inversion suggests the possibility of future yield inversions, if the Fed becomes more hawkish and thereby increases the probability of inversion and a hard landing, longer-term inflation expectations would be unlikely to rise even if actual inflation does, and this would make an increase in long-term rates less likely. The likely result of this would be curve flattening.

More importantly, given the increased probability of a hard landing, what happens later will be of concern. Eventually, it will not just be near-term rises in interest rates but also Fed rate cuts and expectations of declining long-term rates following a hard landing that start attracting attention. Although the market consensus is not there yet, once the market comes around to that view, it could spark a sudden and significant inversion of the yield curve.

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