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Daiwa Securities

Daiwa's View

Japan has started to diverge from US

➢ Reversal in growth rate projections for 2023 in Japan and US could cause 'divergence from US

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Japan has started to diverge from US

◆ Typical seesaw pattern

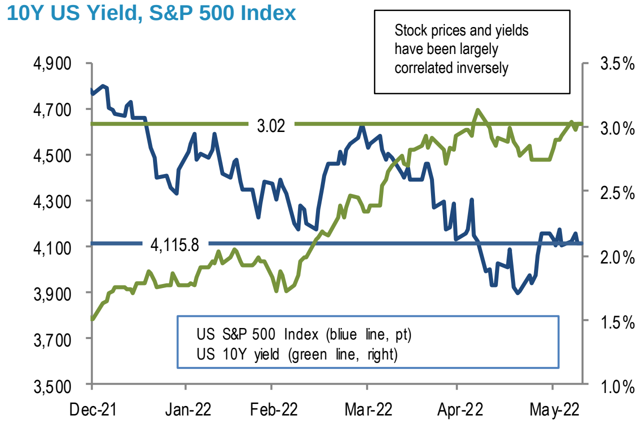
Yesterday, the 10-year US yield topped 3% again, while US stock prices declined. We are seeing a typical seesaw pattern with the US yield at around 3%. We tend to focus on whether the yield is 3%, but there is little difference between 2.98% and 3.02% in terms of the macro economy. What is more important is the emergence of an inverse correlation between yields and stock prices (effects of risk diversification) at this level. As long as this inverse correlation is maintained, a surge in yields will mean a plunge in risk asset prices, so there is less chance that yields will continue to rise (emergence of recession concerns).

◆ Revision to growth rate projections by OECD: US growth projection for 2023 lowered to 1.2%

With regard to topics related to recession concerns, yesterday the OECD released its global economic projections, which were lowered substantially. The US figures are striking—the US growth rate forecast for 2023 was lowered to a surprising 1.2% (right-hand chart below). Recently, one US bond house trimmed its growth rate projection to the upper 1% level, but the OECD's figure of 1.2% is very surprising. The Fed's growth rate projection for 2023 in its Summary of Economic Projections (SEP) as of March was 2.2%, with a potential growth rate of 1.8%. Obviously, the 1.2% projection does not mean a soft landing. Of course, the greatest focus of attention will be the SEP figures to be disclosed at the June FOMC meeting, but downward revisions to them will also be inevitable.

In any case, the series of downward revisions to growth rate projections, to which the OECD data is the latest addition, has reinforced doubts about a continuation of the US yield uptrend. While there could possibly be a slight rise in the range, from a broader perspective, it would be appropriate to see the rise in US yields as having peaked out.

10Y US Yield, S&P 500 Index



Source: Bloomberg; compiled by Daiwa Securities.

OECD Economic Growth Rate Forecasts (%, as of 8 Jun)

		2022	2023
World	Latest	3.0	2.8
	(Dec 2021)	4.5	3.2
US	Latest	2.5	1.2
	(Dec 2021)	3.7	2.4
Euro area	Latest	2.6	1.6
	(Dec 2021)	4.3	2.5
Japan	Latest	1.7	1.8
	(Dec 2021)	3.4	1.1

Source: OECD; compiled by Daiwa Securities.

◆ Japan's growth rate projection for 2023 exceeded figures in Europe and US

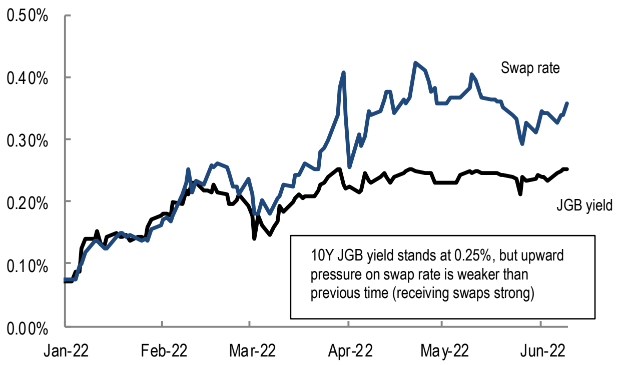
Another focus of attention in the OECD economic projections is Japan's growth rate forecast for 2023 exceeding the growth rate projections for the US and Europe, following substantial downward revisions to US and European forecasts and an upward revision to Japan's forecast to 1.8%. Of course, an important factor behind this reversal in growth rate projections is the difference in monetary policies. While Europe and the US are cooling economies via rapid tightening, the Bank of Japan is providing support for economic growth via monetary easing. This is a major point. (Due to the difference in inflation rates, Japan is the only major developed nation that can continue with monetary easing.)

◆ Japan has started to diverge from US: It is becoming easier to buy JGBs

If the difference in monetary policy stances is what is behind the reversal in growth rate projections, it may become easier to buy JGBs, from which investors had been refraining due to concerns about policy revisions by the BOJ. I will list some possible reasons.

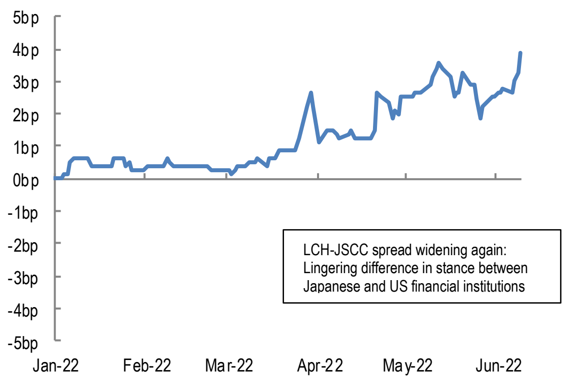
First is the decline in upward pressure on the JPY swap rate. In March-April 2022, when the US long-term yield approached 3%, like the current situation, and fixed-rate purchase operations expanded greatly, the 10-year swap rate exceeded 0.4% and the swap spread widened to 17bp at one point. However, the swap rate has recently remained at around 0.35% (with a swap spread of around 10bp), despite the US long-term yield topping 3% again and the 10-year JGB yield rising to around 0.25%. This is a situation in which the swap spread is changing as the LCH-JSCC spread is again widening to 3bp or more. In the power balance between overseas investors who are paying swaps in anticipation of policy revisions by the BOJ and Japanese investors who are receiving swaps under the assumption that there will be no revisions, we can point out the possibility that the latter is now advantageous.

JGB Yield, Swap Rate (10Y)



Source: Bloomberg; compiled by Daiwa Securities.

LCH-JSCC Spread (10Y)



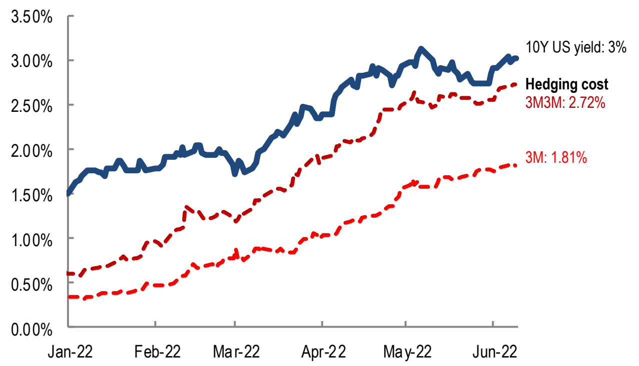
Source: Bloomberg; compiled by Daiwa Securities.

Second possible reason is a somewhat minor issue. We have recently seen some cases with transactions among trading companies (Japan Bond Trading) in which the board of bids for buying 10-year on-the-run JGBs at around 0.25% has been very thick (more than Y100bn, which is more than five times the figure in Mar-Apr). Given this point, as well, we can point out the possibility that concerns about the BOJ's policy revisions (incl. widening of the trading band) have now diminished, although there was a tendency to refrain from buying JGBs in March-April even at around 0.25% owing to such concerns. BOJ Executive Director Shinichi Uchida's remarks denying the widening of the trading band on 10 May and the speech by Governor Haruhiko Kuroda at the Kisaragi-kai Meeting on 6 June have probably had an effect. While public attention has fixated on the remark at the Kisaragi-kai Meeting that inflation has been accepted, considering from a broader perspective the overall tone of the speech and its title "The Bank's Thinking on Monetary Policy: Toward Achieving the Price Stability Target in a Sustainable and Stable Manner," we think it sends a strong signal for no revisions to near-term policies.

Finally, we can say that JGBs are becoming attractive in terms of hedged returns, although one could argue that the BOJ's policy revisions (rate hikes) are contributing little to this. Due to the Fed's intensifying rate-hike stance, the 3-month dollar hedging cost has already risen to 1.81%. The 6-month hedging cost (longer than 3 months) is 2.27%. Using back calculation, the 3-month hedging cost three months from now will stand at 2.72%. Assuming US yields remain flat at around 3%, we calculate that the hedged 10-year US yield will decline to around 0.3% in three months. This not only approaches the level of superlong JGB yields, it even comes close to the 10-year JGB yield level. As such, JGBs are becoming relatively attractive.

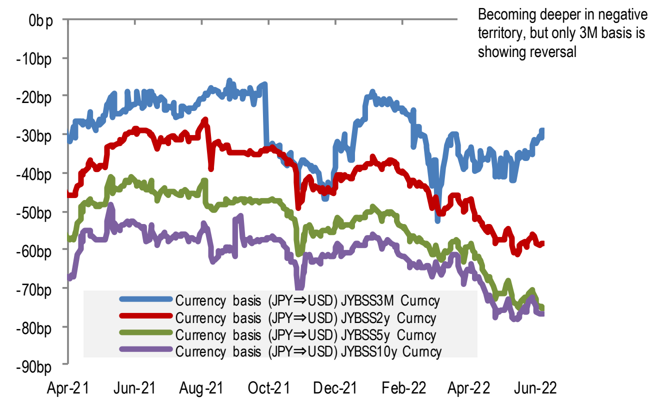
Looking at the recent USD/JPY currency basis, the levels remain deeply negative in the 5-year and longer zones. However, we can observe a tendency for the levels to be shallow in the 3-month tenor. We can think of various factors behind the changes in basis. However, based on one interpretation from the perspective of inward/outward bond investment, it could be a slowdown in investment in foreign bonds from the yen by Japanese investors or an increase in yen bonds by overseas investors.

10Y US Yield, Dollar Hedging Cost



Source: Bloomberg; compiled by Daiwa Securities.

USD/JPY Currency Basis



Source: Bloomberg; compiled by Daiwa Securities.

Thus far, JGB yields have risen, posting a very faithful correlation with the US yield uptrend. However, as we have started to see an outlook in which growth rates in Japan and the US become reversed due to the difference in policy stances at central banks, trends with stock prices and JGBs may diverge somewhat from those in the US. In 1Q, Japanese investors took a very cautious stance regarding JGBs due to caution about the Upper House election in July and personnel issues following the end of Kuroda's term at the BOJ, in addition to the rise in US yields. However, more active investment can be expected in 2Q, compared to 1Q at the very least.

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