Daiwa Securities

Daiwa's View

10-year US yield topped 3% again

➢ Higher inflation expectations driving rise in yields

Fixed Income Research Section
FICC Research Dept.

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

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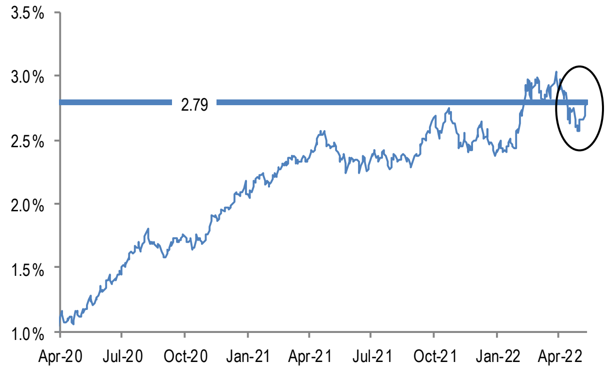
Higher inflation expectations driving rise in yields

Yesterday, the 10-year US yield rose to 3.04%. (The 5-year yield also rose to 3.04%.) This rise in yields is probably being driven by higher inflation expectations. Last Friday, we touched on "unexpectedly stable" inflation expectations. However, we have seen an abrupt end to this, with inflation expectations rising once more, reflecting the sweet-spot employment data released at the end of last week, speculation about the easing of lockdowns in China, and a rebound in resource prices (WTI rising to around $120/bbl). From the day before the jobs data announcement to yesterday, the 10-year US breakeven inflation rate rose by 11bp (and the 10-year US yield rose 13bp).

Rising crude oil prices will obviously lead to a rise in inflation expectations. However, compared to before, there is less chance of a resumption of the continuous uptrend in inflation expectations we saw after the outbreak of the pandemic. The biggest difference in the market between before and after Japan's Golden Week holidays (in early May) is the emergence of concerns about a recession as the Fed shifted to a position tolerant of "some pain" in order to rein in inflation. In that sense, the more bullish economic sentiment that has been observed recently in the market, the asset price rally, and the resurgence of inflation concerns are seen as sufficient to make the Fed's stance more hawkish once again.

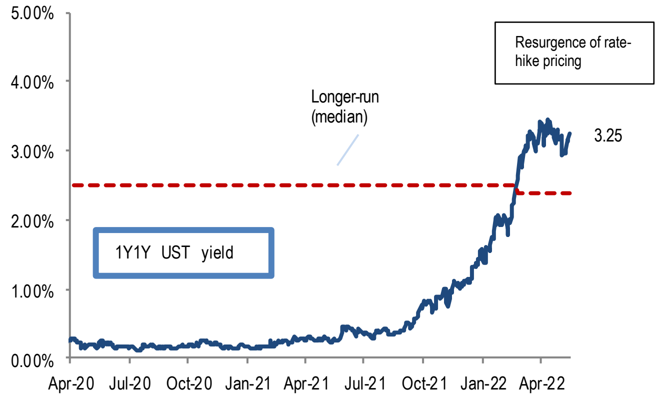
In other words, this rise in inflation expectations will make the Fed more hawkish again, and subsequently lead to a resurgence of concerns about flattening (inversion of the yield curve) and a recession. While the 1-year forward 1-year yield rose to 3.25% yesterday, the US long-term yield stopped at the +2σ line in the Bolinger Bands, with credit spreads reacting by widening slightly (High-yield CDS Index widened from 462bp on the day before the release of the jobs data to 477bp yesterday). The market will probably lean towards a risk-off mood again in the not-too-distant future, which is likely to calm inflation expectations (a seesaw pattern).

10Y US Inflation Expectations



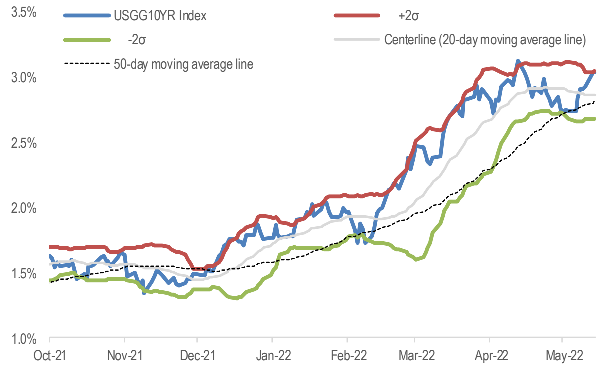
Source: Bloomberg; compiled by Daiwa Securities.

1Y1Y US Yield, Longer-run Rate



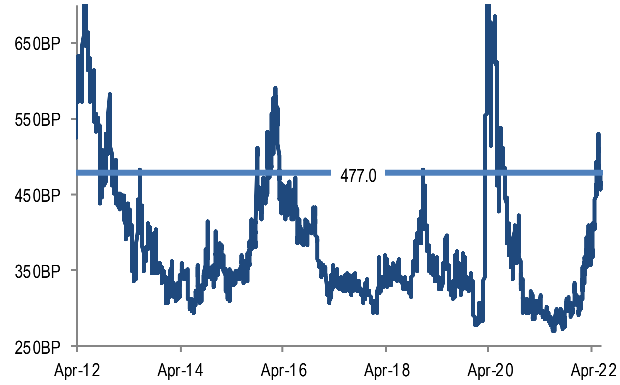
Source: Bloomberg; compiled by Daiwa Securities.

10Y US Yield, Bollinger Bands



Source: Bloomberg; compiled by Daiwa Securities.

North American High Yield CDS Index (5Y)



Source: Bloomberg; compiled by Daiwa Securities.

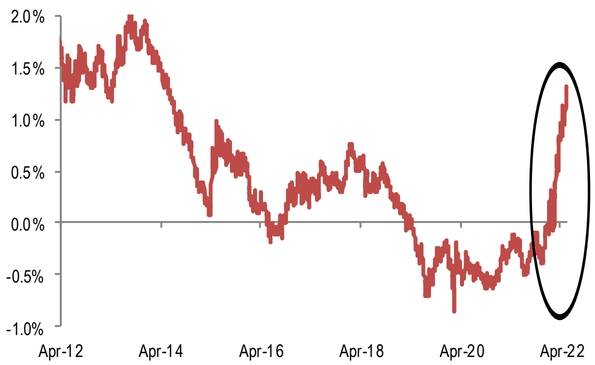
◆ Is ECB preparing to establish a new bond purchase program?

Yesterday, some British newspapers reported that the ECB would firm up plans to ward off bond market stress at this week's Governing Council meeting. In our *Daiwa's View* reports, as well, we have recently pointed out the possibility that decisions by the ECB Governing Council, which is becoming more hawkish, may increase the stress on peripheral nations in Southern Europe. As it turns out, there appears to have been a keen awareness of such concerns within the ECB, with the media reporting that "The bulk of the 25 governing council members are expected to support a proposal to create a new bond-buying programme if needed to counter borrowing costs for member states, such as Italy, spiralling out of control."

If this news is correct, the ECB will implement another de-facto QE program that targets nations (such as peripheral nations in Southern Europe) whose sovereign bonds have wide margins vs. German bonds (details are unknown) even if the ECB ends existing QE in 3Q 2022.

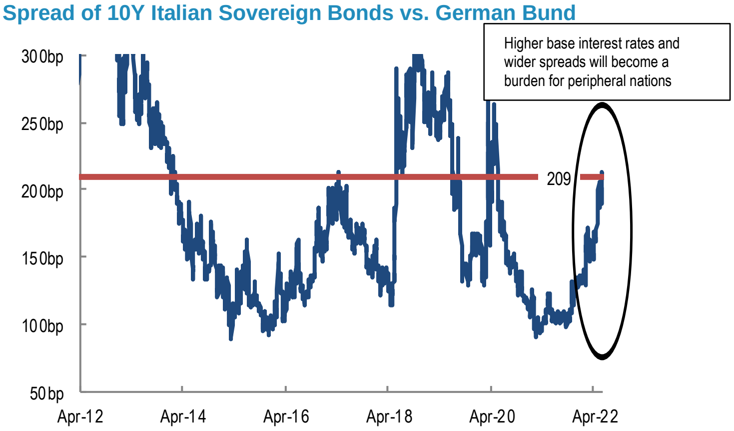
Looking at it from a different perspective, this can be seen as proof that the ECB itself is aware that a sovereign debt problem could emerge unless such countermeasures are prepared. Furthermore, if concerns about national-level debt ease due to the introduction of this new bond purchase program, an alternative scheme for LTROs also needs to be prepared in order to ease the impact on private-sector economic entities, which are players in the actual economy. That said, if the ECB introduces de-facto QE and de-facto LTROs, tightening measures will be undermined. This in turn could easily give rise to doubts about the effectiveness in reining in inflation. It doesn't look as if it will be easy to strike the right balance here either.

10Y German Bund Yield



Source: Bloomberg; compiled by Daiwa Securities.

Spread of 10Y Italian Sovereign Bonds vs. German Bund



Source: Bloomberg; compiled by Daiwa Securities.

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