Daiwa's View

Rate-hike pricing has reached 4%

➢ Ongoing pricing on the assumption there will be a hard landing

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Ongoing pricing on the assumption there will be a hard landing

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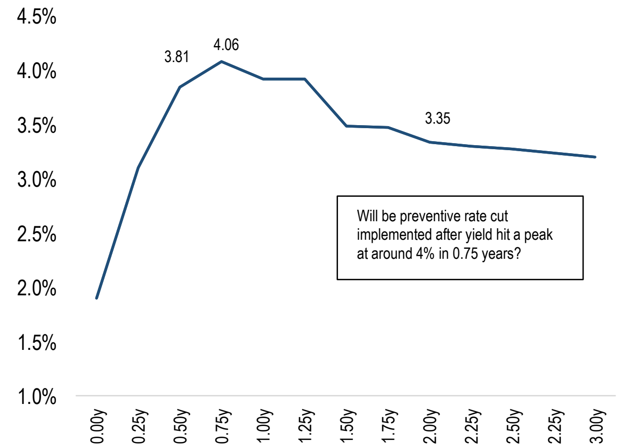
◆ The market's rate-hike projections have reached 4%

Yesterday, the 10-year US yield rose to around 3.5%. Although movements calmed down during Asian trading hours, a melt-up rise in yields resumed toward the close of European trading hours.

Confirming the rate-hike pricing situation based on the 3-month OIS forward yield shows that the market projects that the yield will rise to 3.81% in six months, hit a peak at 4.06% in 0.75 years, and decline to 3.35% in 2 years. Assuming inversion of the spot rate and the 1.5-year forward yield is a recession signal, the market has priced in a situation in which a recession signal will flash six months from now and a preventive rate cut (-0.71%) will be implemented two years from now.

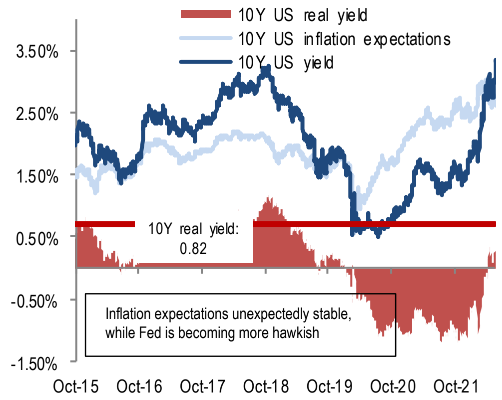
Furthermore, US inflation expectations (breakeven inflation rate: BEI) remained unexpectedly stable yesterday. The 10-year BEI and 5-year forward 5-year BEI declined again, to 2.66% and 2.3%, respectively. As such, inflation expectations are stable, while the credit spread is widening due to growing concerns about a hard landing, reflecting the more hawkish stance by the Fed. These figures also seem to reflect the Fed's resolution to prioritize stable inflation over concerns about the economy.

3M US OIS Yield



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Yield, Inflation Expectations, Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

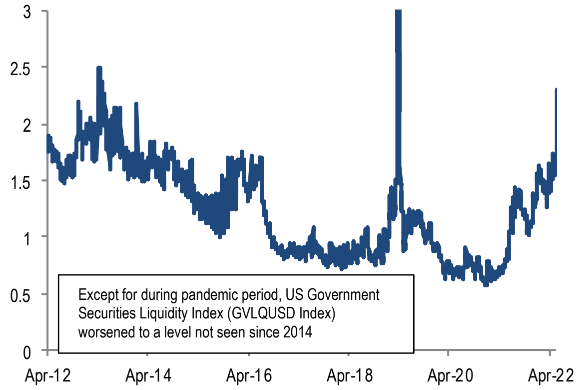
However, given the possibility of low market liquidity, we may have to take care not to buy too much into the belief that current market prices are reflecting fundamentals perfectly.

In the current market, prices appear to be choppy due to the synergistic effects of (1) the lower credibility of the Fed and (2) lower liquidity (Bloomberg US Government Securities Liquidity Index worsened to 2, a level not seen since 2014, except for during the pandemic period). While we have no intention of taking market pricing lightly, it should only be used as a reference for checking if fundamentals are being reflected accurately.

◆ Impact on corporate financing

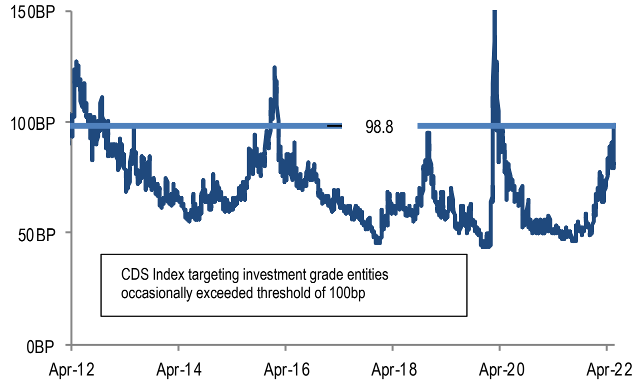
If the liquidity of the sovereign bond market continues to decline, this will have a significant impact on the corporate bond market. Yesterday, the Markit CDX North American Investment Grade Index rose to 100bp at one point, which suggests that an impact is finally spreading to the investment grade corporate bond market that cannot be ignored. We could just regard this as simply tightening of the financial conditions. However, if this situation, in which the decline in liquidity is having an impact on corporate financing, continues, actual adverse effects will emerge in the real economy, after a time lag.

Bloomberg US Government Securities Liquidity Index



Source: Bloomberg; compiled by Daiwa Securities.

Markit CDX North American Investment Grade Index (5Y)



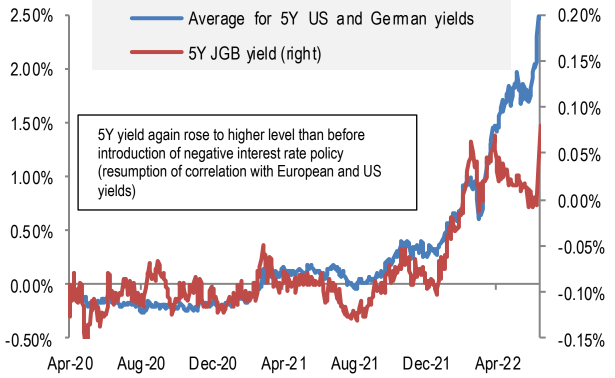
Source: Bloomberg; compiled by Daiwa Securities.

◆ Resurgence of battles with YCC

In the JGB market, as well, liquidity declined dramatically and prices were bumpy yesterday, leading to the implementation of the BOJ's unscheduled operations, in addition to fixed-rate purchase operations. These unscheduled operations were implemented for the first time since March. Before the operations, a rise in JGB yields caused a distortion of the curve, with a concave shape only in the 10-year sector. Because of this, in addition to operations in the 5- to 10-year zone announced on the previous day, unscheduled operations were implemented in other maturity zones in order to make the curve consistent with a 10-year yield of 0.25%.

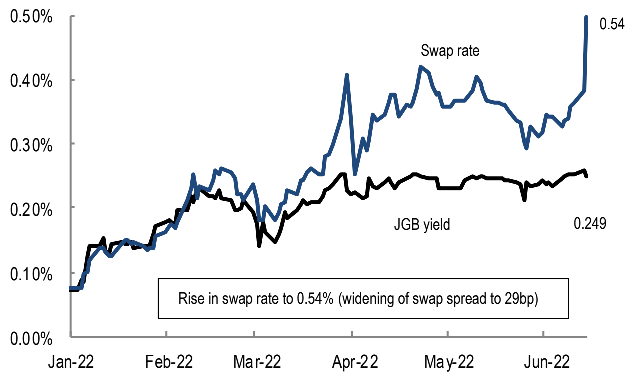
That said, the 5-year JGB yield, which is susceptible to the impact of policy revisions (rate hikes), rose to 0.075% on a closing basis yesterday, which is a higher level than before the introduction of the negative interest rate policy in January 2016 (resumption of correlation with European and US yields), and the 10-year swap rate rose to 0.54%, which is 25bp higher than the JGB yield (chart on next page). This suggests that speculation on policy revisions by the BOJ has resurged in the market. Swap rates rose yesterday, while the LCH-JSCC spread changed little, reminding us of the possibility that Japanese financial institutions hedged positions. By its very nature, securing credibility is important for the yield curve control (YCC). It seems unlikely that the BOJ will withdraw from the YCC without debate (as the Reserve Bank of Australia did). However, movements in yesterday's swap market may be a sign that we should now be concerned about a decline in the credibility of the YCC at Japanese financial institutions. (That said, similar to the situation with the US, it may be better to just use this as a reference for checking if fundamentals are being reflected accurately amid low liquidity.)

5Y JGB Yield, Average for 5Y US and German Yields



Source: Bloomberg; compiled by Daiwa Securities.

10Y JGB Yield, Swap Rate



Source: Bloomberg; compiled by Daiwa Securities.

Similar to the US, the adverse impact of choppy yields is spreading to the Japanese corporate bond market. Through issues such as the postponement of bond issuance, the impact on fundraising is becoming impossible to ignore. If this were observed in the US, where policymakers want to calm inflation (wage hikes) by tightening the financial conditions, it would have policy effects to a certain degree. However, Japan wants to maintain accommodative monetary conditions in order to achieve wage hikes at companies and narrow the output gap in the negative territory, so, in one respect, excessive tightening of the financial conditions via higher yields is unacceptable. Some hedge funds have professed in the media that they were 'battling' with the YCC. In light of the differences in economies, prices, and financial situations, it does not seem likely that such 'battles' will be successful, at least in the near term. However, with US yields gaining substantially yesterday, 'battles' with the YCC are likely to continue today.

◆ They may be short-term 'battles'?

If one sees the corporate bond market continuing to face an adverse impact on fundraising as long as 'battles' with the YCC continue, the battles may become short-term, rather than long-term battles. We may have to consider the possibility that the BOJ may once more implement overwhelming unscheduled operations similar to those at end-March.

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