Daiwa's View

Economic concerns lead to lower commodity prices, which lead to declining inflation expectations

- Use of term "unconditional" constitutes declaration of war by the Fed

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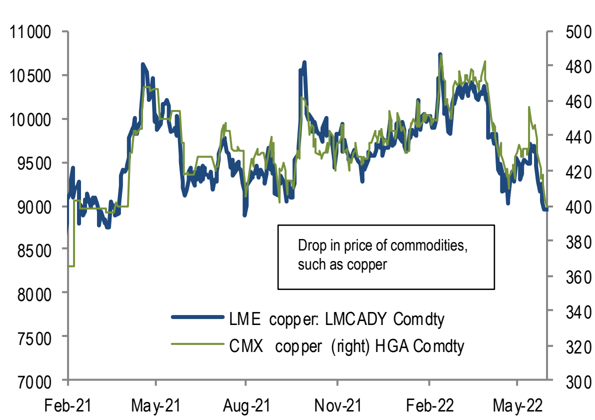
◆ Economic concerns lead to lower commodity prices, which lead to declining inflation expectations

The level of US yields rose, reflecting the May CPI, which dashed hopes for a slowdown in inflation, and upward revisions to rate-hike projections by the Fed. However, we are seeing a rise in the range to 3-3.5% for now, rather than the resumption of a full-fledged uptrend. Possible factors behind this are economic concerns, lower commodity prices, and a drop in inflation expectations.

The price of copper (also known as "Dr. Copper") is an effective reference indicator for the economic outlook, and its downtrend is accelerating. The LME copper price and its 3-month futures price fell to $8,950 and $8,961, respectively, with a decline in the CMX copper price to below $400 at one point. As such, trends remain bearish (chart below). Iron ore prices are also weak, as witnessed by the drop in the DCE (Dalian Commodity Exchange) iron ore futures price (IOE1) to its lowest level since March 2022.

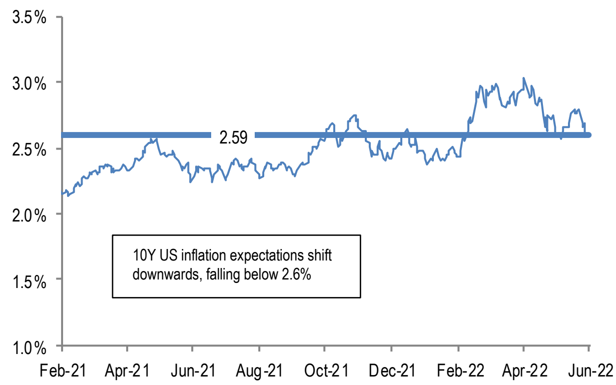
What is important is that this drop in commodity prices appears to be contributing to the decline in the BEI. In synchronization with lower commodity prices, 10-year US inflation expectations (BEI) declined to 2.59%, the level seen before the deterioration of the situation in Ukraine. In the US, the combination of higher yields and lower BEI is promoting a substantial rise in real yields, which is further increasing concerns about the economic outlook. Considering the cycle in which economic concerns lead to lower commodity prices, which lead to lower BEI, which leads to higher real yields, which lead to economic concerns, we think that "economic concerns" caused by the more hawkish stance by the Fed are key for the US yield outlook.

Copper Prices ($)



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Inflation Expectations



Source: Bloomberg; compiled by Daiwa Securities.

◆ Use of "unconditional" constitutes declaration of war by the Fed

In this respect, the Fed has emphasized its **"**unconditional**"** commitment to restoring price stability in its *Monetary Policy Report*, which was released before the congressional testimony by Chair Jerome Powell. This reconfirms the Fed's prioritization of prices over the economy (change in stance). Assuming that economic concerns worsen as long as inflation continues to rise, and that such concerns constrain inflation expectations (via the aforementioned cycle), use of the wording "unconditional" gave us the impression that the current phase of higher yields has finally started to show signs of coming to an end**.** The combination of lower inflation expectations and a sharp hike in interest rates is likely to create flattening pressure on the yield curve (inversion of yield curve).

◆ Fed *Monetary Policy Report* (17 Jun 2022)

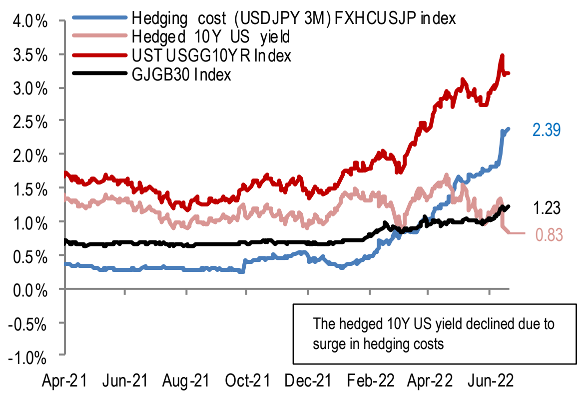
・The Committee is acutely aware that high inflation imposes significant hardship, especially on those least able to meet the higher costs of essentials. The Committee's commitment to restoring price stability—which is necessary for sustaining a strong labor market—is unconditional.

◆ Reversal of hedged 10-year US yield and superlong JGB yields

This change in the Fed's stance also has an indirect impact on yen bonds. Due to the change in the Fed's stance (leaning towards a 75bp rate hike) since the release of the May CPI and deepening of the basis, hedging costs when investing in foreign bonds from the yen have surged. USD funding costs (hedging costs) have risen to 2.39% (3M), and this is expected to rise going forward. The hedged 10-year US yield (= 10-year US yield minus hedging costs) has declined to 0.83%, far below yesterday's 20-year JGB yield of 0.915% on a closing basis, and, of course, below the 30-year JGB yield of 1.21%. This is the first time for the hedged 10-year US yield to fall below superlong JGB yields since December 2020-January 2021.

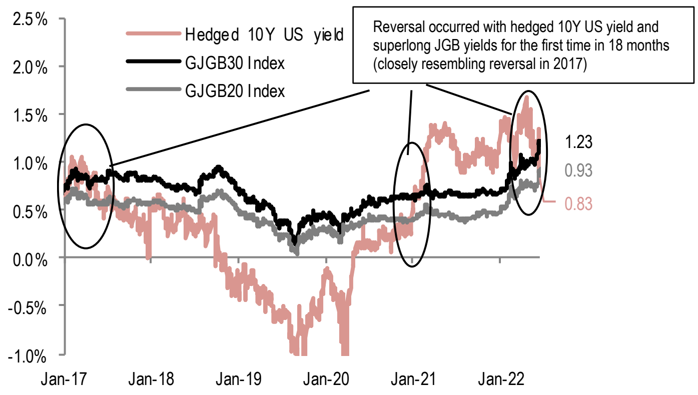
In cases since 2017 when the hedged 10-year US yield started to fall below JGB yields, similar to now, yen bonds continued to face downward pressure. And when the Fed shifted to preventive rate cuts due to increased concerns about the economy, the JGB market found itself in a nightmarish situation in which the 20-year JGB yield was about to fall into negative territory. Of course, the current situation (in which the key theme is inflation concerns) is different from then (when disinflation pressure was strong). Moreover, amid low liquidity and concerns about policy revisions by the BOJ, most JGB market participants appear to have no time for comparing returns from hedged foreign bonds. From a slightly longer-term perspective, however, this disruption of relative value often provides a good opportunity to earn excess returns. Long-term investors who are looking ahead to the outlook of JGBs after the end of market turmoil are recommended to focus on this change in relative value.

10Y US Yield and Hedging Cost, 30Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Hedged 10Y US Yield, 20Y and 30Y JGB Yields



Source: Bloomberg; compiled by Daiwa Securities.

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