Daiwa's View

"Still" implies "no longer"

➢ Inflation will likely still remain high, but yields will likely no longer rise

Fixed Income Research Section
FICC Research Dept.

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

Daiwa Securities Co. Ltd.

"Still" implies "no longer"

Inflation will likely still remain high, but yields will likely no longer rise

◆ Market reaction to CPI in Land Nordrhein-Westfalen, Germany

Yesterday, the 10-year US yield substantially declined to 3.09% (down 7bp), with the continued drop in the breakeven inflation rates (10Y BEI to 2.38%, 5Y5YBEI to 2.19%). In *Daiwa's View* report dated 28 June, we anticipated a peaking of US long-term yield. Yesterday's price movements were quite suggestive, giving us more confidence in this outlook. Of course, yesterday's biggest event was the remarks by Fed, ECB, and BOE officials in Sintra. Meanwhile, a point that should not be overlooked is the drop of around 5bp in European and US long-term yields when the news was released at 13:30 JST that May CPI in Land Nordrhein-Westfalen, Germany declined by 0.1% m/m (from +0.9% in previous month).

Here, it is not important whether this m/m drop in CPI is correct (the decline may be a temporary one due to the contributions from measures to lower fuel taxes). What should be noted are the facts that (1) yields have declined to some extent in reaction to the drop in CPI in Land Nordrhein-Westfalen and that (2) after the subsequent release of a new data of May CPI in Spain, which remained high, yields did not rise or even show movements to recoup the declines. This implies that the market has mostly finished factoring in rising inflation and hawkish stances among central banks (or has already factored them in excessively).

According to Howard Marks, market prices are a beauty contest. The market moves when a change in the situation is perceived not by "only a few unusually perceptive people' but by "most investors" (and the former realize returns at this timing). Yesterday's price reactions to CPI in Land Nordrhein-Westfalen might have been initial signs that, alongside "most investors" having started to take the continued high inflation for granted (assuming that it will be permanently high), "only a few unusually perceptive people" have shifted their interpretation of the current situation to a peaking of inflation and long-term yields, and the market (interpretation of the current conditions by "most investors") has started to move towards such a view.

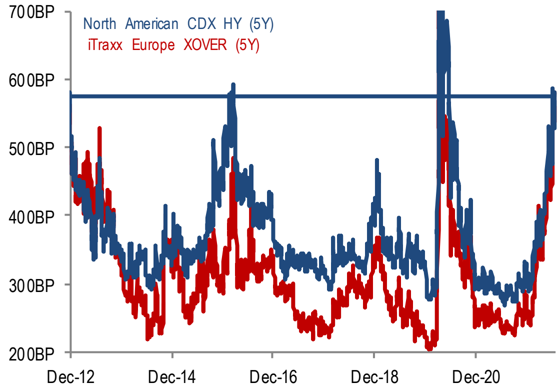
To put it simply, "still" implies "no longer" ("not yet" means "already"). Although inflation will likely still remain high, most investors are already fully aware of it. Accordingly, it is highly likely that yields have reached a point where they no longer rise. If so, the Fed and ECB (and short-term/intermediate yields, which reflect the policy interest rates) are likely to sensitively react to factors that suggest rising inflation. Meanwhile, the long-term yield is likely to move in the opposite direction—it is expected to be insenstive to factors that suggest rising inflation, while it should react to factors that imply lower inflation. As a result, this would inevitably lead to an inversion of the yield curve, which would cause concern about a recession.

◆ Credit market is worsening drastically

As the Fed has now shifted to an "unconditional" stance to rein in inflation, the market's new topic is no longer inflation itself. It appears to be shifting to recession concerns and deterioration of the credit market in the process of taming inflation.

Yesterday, the credit market worsened substantially once again. It is important to recognize that the North American High Yield CDS Index (CDX.NA.HY) widened to nearly 580bp. However, it is also striking that the European High Yield CDS Index overtook the North American High Yield CDS Index at 580bp, its highest level since the European debt crisis. This appears to be reflecting that, despite the ECB considering measures to control spreads of Southern European sovereign bonds, more people anticipate that (1) the private-sector economy will not fully benefit from such measures and (2) the ECB's hawkish stance will cause an economic recession.

US/European High Yield CDS Indices



Source: Bloomberg; compiled by Daiwa Securities.

From the standpoint of the global economy, these data imply that not only the US but also Europe may fall into a recession next year. If such concerns increase further, this would become the external environment hurdle affecting realization of deep-rooted speculation on the BOJ's policy revision (rate hike) in April 2023, when Governor Kuroda's term in office is to end, seen in the current JGB market.

IMPORTANT

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:
https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association