Daiwa's View

10yr Treasury yield momentarily drops below 3%

- Tendency is less sensitivity to upward data surprises and more sensitivity to downward surprises

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10yr Treasury yield momentarily drops below 3%

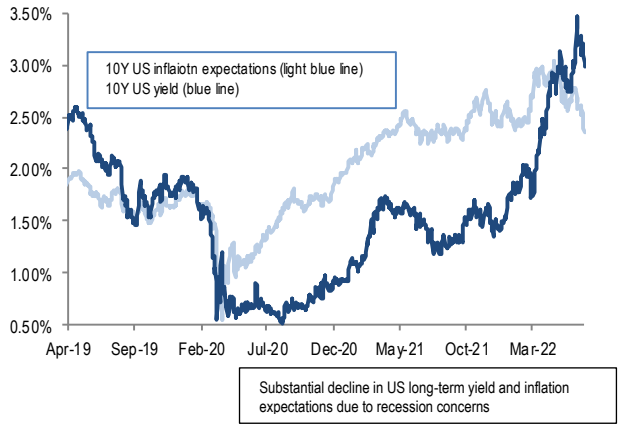
◆ Bond market is more sensitive to downward data surprises

The bond market's sensitive reaction to the weaker-than-expected CPI reading for the German state of North Rhine Westphalia on 29 June turned out to be an omen, and the market reacted strongly to a downward surprise in the data last night. The 10yr Treasury yield dropped below 3% for the first time in a while, the 10yr BEI is down to 2.35%, the 5yr forward 5yr BEI is down to 2.09%, and the 1yr forward 1yr yield dropped to 3.08%.

In the OIS market, the 3m forward (end-September 2022) OIS rate was at 3.13% and the rate 18 months forward of that declined to 2.79% (a 40bp yield inversion), while the forward rate for end-December 2022 is at 3.45% and the rate 18 months forward of that is at 2.58% (a 0.87bp yield inversion). The CMX copper price dropped to $369, its lowest since February 2021, a considerably different signal from the commodity inflation that has been seen as so important among market participants of late (*energy prices remain high because of the war in Ukraine). Although this market data is seen as indicating rising market concerns about a recession, it would be difficult at this point for the Fed, which is currently worried about the high level of actual inflation and rising inflation expectations (among consumers), to respond to these market signals preemptively with a rate cut or suspension of rate hikes.

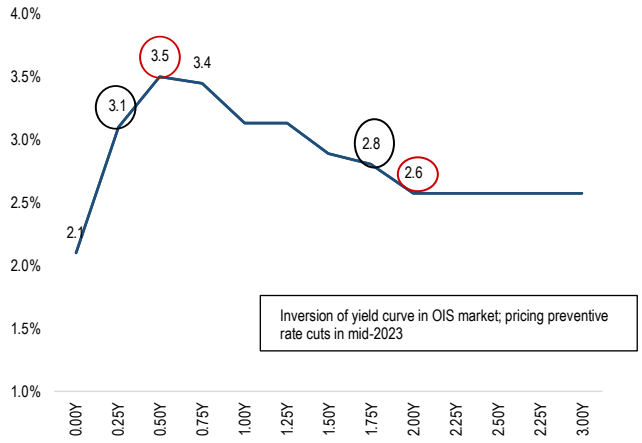
Howard Marks, the author of *Mastering the Market Cycle*, argues that "too much strength [in the economic cycle] can kindle inflation and take the economy so high that a recession becomes inevitable." It is commonly believed that if moves to suppress inflation do not begin until after the economy overheats to the point where the ISM nonmanufacturing index is at 68.4 (November 2021) and wage growth is above 6% (from October 2021 until now), a recession is the only way to tame inflation. If that is true, policymakers may not have missed the boat.

10Y US Yield, Breakeven Inflation Rate (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

US OIS 3M Forward Rate



Source: Bloomberg; compiled by Daiwa Securities.

◆ No changes to *Rinban* operations with upward yield pressures easing

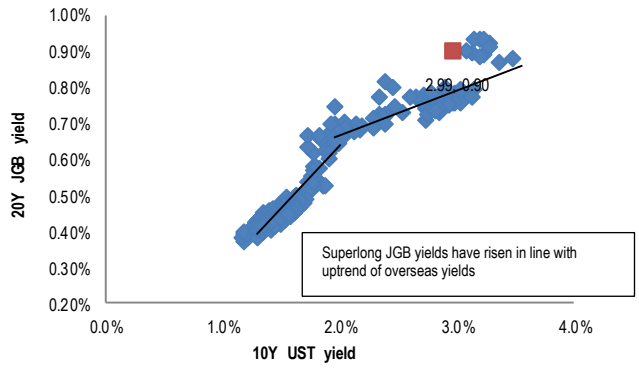
The BOJ decided yesterday to leave its long-term JGB purchase schedule (*Rinban* operations) for Jul-Sep unchanged. When the JGB yield curve is rising opinions are split roughly 50-50 on whether *Rinban* operations should be increased or left unchanged, and this suggests that the decision to leave them unchanged may have a slight upward impact on yields.

However, the 10yr yield targeted by the BOJ has been trading under 0.25% and there has been an increase in the number of periods when the CTD in the 7yr zone has recently been trading below 0.2%. Bidding in the BOJ's fixed-rate purchase operations has also settled down, and issuance at 5yr and 20yr JGB auctions held since the BOJ's closely watched June policy meeting has been absorbed somehow. Although not under the purview of the BOJ, the facts that the yen has weakened further and that temporary operations could be held at any point if necessary suggest that the BOJ has decided there is no need to add any juice to its quarterly purchasing plan at this stage.

There are also signs that US interest rates are peaking, and the BOJ may have considered the possibility that upward yield pressures originating overseas will weaken. Unlike the 10yr JGB, which is protected by the BOJ's fixed-rate purchase operations, superlong JGB yields and JPY swap rates have risen in direct reaction to increases in interest rates overseas, rather than on expectations of a policy change. We expect upward pressure on superlong JGB yields to soften in step with the pause in US interest rate increases, and this is probably one reason why the BOJ decided to leave its *Rinban* operations unchanged.

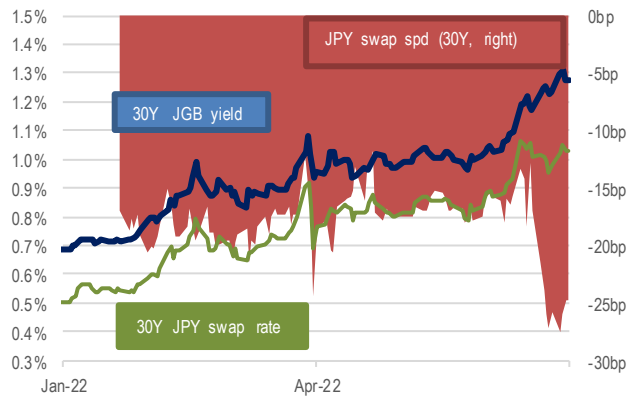
It is well understood that the BOJ's biggest fear is that JGB yields will decline excessively (which can lead directly to limits on monetary base expansion and side effects on financial institutions), and this provides one explanation for why the BOJ changed its policy framework from quantitative and qualitative monetary easing with negative interest rates to yield curve control. Leaving that aside, with declines in US interest rates expected to naturally lead to downward pressure on yields (and a significant decline is possible, depending on the depth of the US recession), at this point the BOJ probably wants to avoid any increase in flow and stock effects that would add to those pressures.

US Long-term Yield, 20Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

30Y JGB Yield, Swap Rate



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