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Daiwa's View

Yield of hedged 10-year US Treasuries has fallen into negative territory

- Reflecting the difference between domestic and foreign economic outlooks

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Daiwa Securities Co. Ltd.

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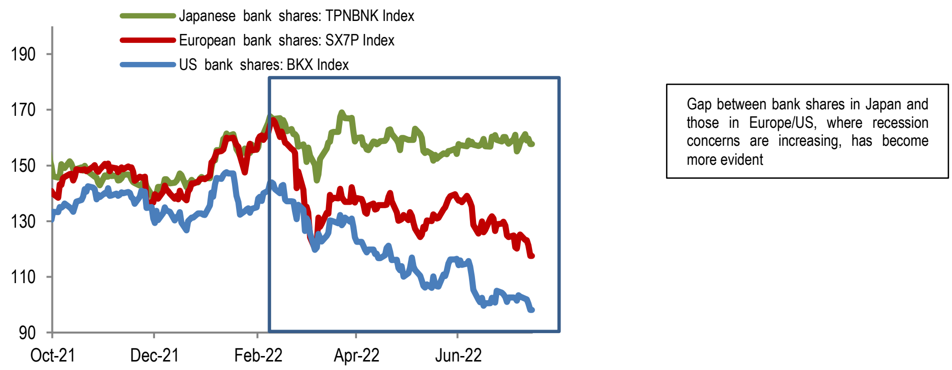
Reflecting the difference between domestic and foreign economic outlooks

◆ Bank shares mirror macro economy

One focus of attention in the news yesterday was that JPMorgan Chase, which announced earnings results ahead of peers in the US banking sector, released results that fell short of analysts' estimates and suspended share buybacks. (Its share price fell 4.4%.) The banking share index typically mirrors the macro economy. Confirming the performance since late 2021 shows that there is a large disparity between Japanese bank shares and European/US bank shares that have plunged by several tens of percent since the beginning of the year. This appears to be partially reflecting the contrast between Europe/US, where central banks are steering towards rapid tightening as people are struggling with rising inflation, and Japan (BOJ), which maintains an accommodative stance amid a negative output gap.

Bank Share Indices



Source: Bloomberg; compiled by Daiwa Securities.

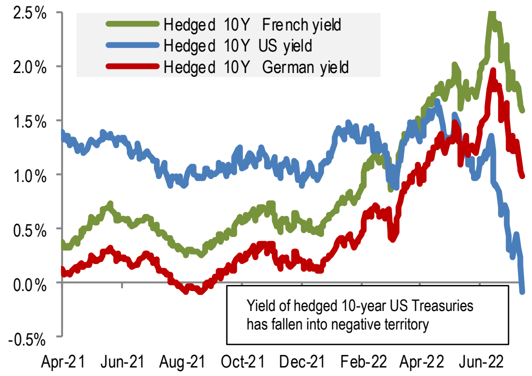
Of course, the relative difference in economic outlooks causes underperformance with JGBs and outperformance in Japanese stock/credit markets. That said, if Europe and the US were to actually fall into a recession, it would be difficult to imagine Japan's economy remaining unscathed. Therefore, we think it unlikely that we will see a prolongation of the negative correlation between JGBs and European/US yields (one-sided rise in JGB superlong yields) that has been seen recently in the bond market. In addition, at the moment, the Japanese credit cycle has not yet moved in a way that could be seen as imprudent. However, if the negative output gap were to widen due to a shift towards a tightening stance by the BOJ, (1) the outlook for Japan's economy would worsen, (2) share prices of Japanese banks would decline in line with those of European/US banks, and (3) JGBs would post twist-flattening.

◆ Yield of hedged 10-year US Treasuries has fallen into negative territory

A recent eye-catching phenomenon in terms of comparison with European/US bonds is that the yield of 3-month hedged 10-year US Treasuries has finally fallen into negative territory. While the 10-year US Treasury yield declined below 3%, 3-month dollar hedging costs finally exceeded 3%[1], resulting in a negative spread. Given the Fed's unconditional stance towards reining in inflation, the rate-hike stance is expected to be maintained going forward, alongside a peaking of the US long-term yield. Accordingly, it is highly likely that the yield of hedged 10-year US Treasuries will remain negative for the time being.

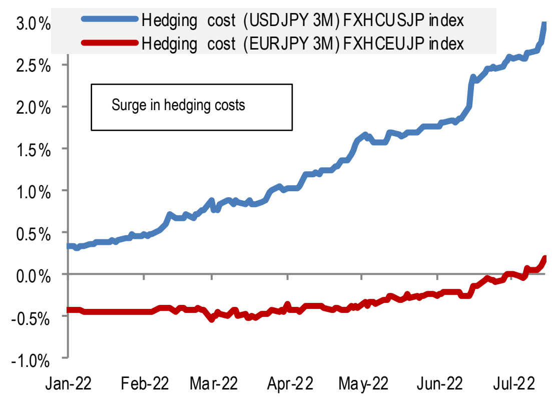
Of course, the yield of hedged 10-year US Treasuries dropping into negative territory is unlikely to lead to fast developments like JGBs being immediately snatched up. (The market topic is currently "recession concerns," not "search for yields.") From a slightly longer-term perspective, however, it is almost certain that the increased barrier for investment in foreign bonds will bring improvements in the supply/demand conditions for JGBs.

Yields of Hedged Foreign Bonds



Source: Bloomberg; compiled by Daiwa Securities.

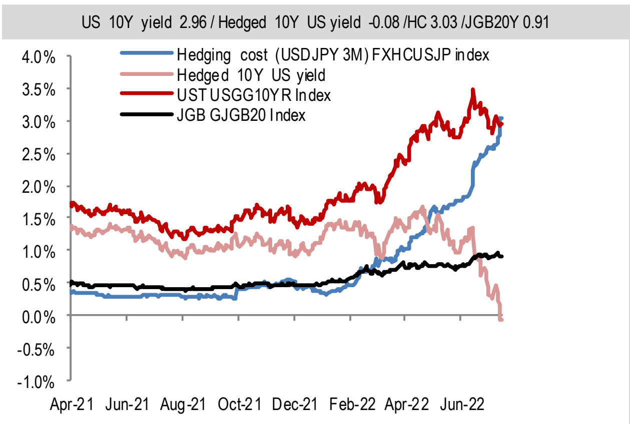
Hedging Costs (foreign currencies vs. yen)



Source: Bloomberg; compiled by Daiwa Securities.

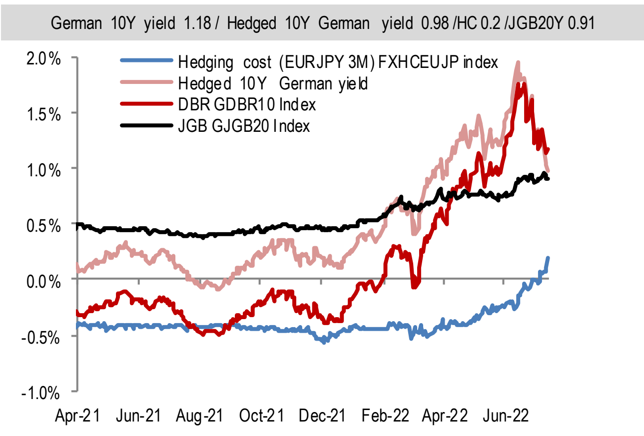
Given the difference between domestic and foreign economic outlooks, which is mirrored by bank shares, it is safe to say that JGB yields will decline later than European/US yields. If we regard the time lag as about several months, we should be aware of the possibility that the latter half of the Jul-Sep quarter or the Oct-Dec quarter could be a buying opportunity for JGBs. A turning point may come during the selection process for the next BOJ governor (post-Kuroda).

Hedged 10Y US Yield, 20Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Hedged 10Y German Yield, 20Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

[1] 6-month dollar hedging cost worsened to 3.71%.

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