Daiwa's View

Linkage between rate hikes and long-term yield weakening

➢ Trends with 1Y1Y yield and 5Y5Y yield have started to diverge

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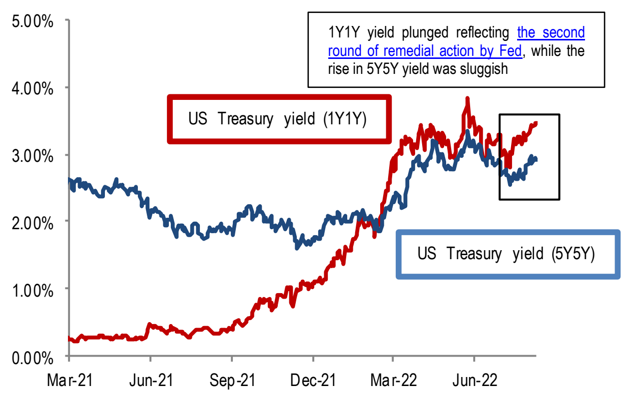
For three consecutive days since the Jackson Hole speech, US stocks have declined while US yields have risen. That said, while US short-term/intermediate yields have hit YTD highs, the long-term yield has remained at 3.11%, substantially lower than its peak (3.47%) logged on 14 June. This is clearly explained by observing the 1-year forward 1-year (1Y1Y) yield, which strongly reflects the terminal rate, and the 5-year forward 5-year (5Y5Y) yield, which mirrors the long-term perspective. The change was caused by the fact that the 5Y5Y yield stayed at 2.92% last night vs. 3.35% on 14 June, despite a rebound of the 1Y1Y yield to around 3.5% (left-hand chart below).

Factors behind the decline in the correlation between the 1Y1Y yield and the 5Y5Y yield, which had been strong since the outset of the year, probably include the drop in commodity prices after a temporary surge and the improved credibility of the Fed via its "unconditional commitment" announced after the June FOMC meeting (which was reconfirmed in the Jackson Hole speech). In any case, the fact that the correlation between the 1Y1Y yield and the 5Y5Y yield is weakening indicates that the rise in the 10-year US yield in line with the hike in the terminal rate is limited. This change provides support for the appropriateness of a buy-on-dip stance for the US long-term yield at the 3% level.

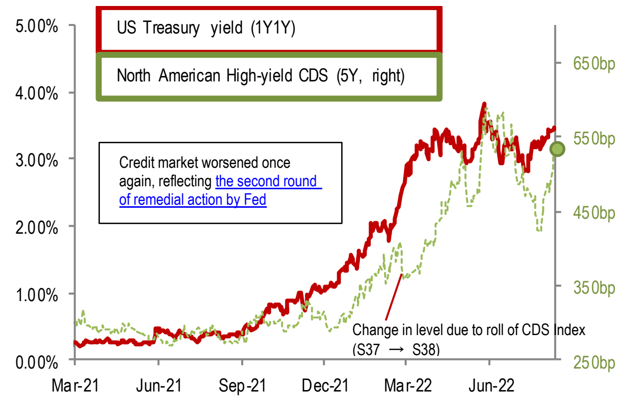
Furthermore, we have the impression that stock prices have posted a rather substantial decline in comparison with the US long-term yield. Deterioration of the credit market is probably what is behind this. The North American High-yield CDS Index, which had narrowed to 422bp on 15 August, has now widened to 528bp. The North American Investment Grade CDS Index also widened from 73.9bp to 90.8bp. That said, in light of the 1Y1Y yield level, the balance of credit spread as of now appears to be appropriate compared to that in mid-August. This means that, in mid-August, the entire risk asset market grossly underestimated the Fed's resolve and determination to accept pain.

US 1Y1Y Yield, 5Y5Y Yield



Source: Bloomberg; compiled by Daiwa Securities.

1Y1Y US Yield, North American High Yield Index



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