Daiwa Securities

Daiwa's View

Powell's speech completely lived up to expectations

- Powell ≠ Burns

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In Daiwa's View reports, we had discussed several times whether Fed Chair Jerome Powell was a new Arthur Burns, the former Fed Chair who caused high inflation to become entrenched in the 1970s. However, we will likely never say that again. In this year's Jackson Hole speech, Chair Powell referred to the accomplishments of past legendary Fed chairs such as Paul Volcker and Alan Greenspan while stating candidly that (1) the Fed had learned a lesson from the stop-and-go policy in the 1970s that caused high inflation to become entrenched via premature removal of tightening policy, (2) the unconditional commitment that was announced after the June FOMC meeting remained unchanged, and (3) the process to rein in inflation would bring some pain. In my opinion, this year's speech was courageous and laudable, and completely lived up to my expectations without sugarcoating the possibility of pain. It left me feeling that people will come to realize that Powell is not another Burns.

There were stark contrasts in the way the market reacted to the Jackson Hole speech—US stocks (DJIA) plunged by more than $1,000, and the North American High-yield CDS index rose from 475bp to 493bp, but the 10-year US yield was largely flat. As symbolized by yield movements that were largely flat, it appears there were no decisive surprises among market participants who had carefully interpreted the real intentions of Fed officials. However, it would seem that some participants in the risk asset market felt the hawkish shift by the Fed was somewhat abrupt. If this speech served as an opportunity to accurately communicate the Fed's intentions far and wide, the second round of remedial action by the Fed can be said to have been successful.

For reference, the 10-year US yield was largely flat (3.03% → 3.04%), which can be broken down into a 3bp drop in inflation expectations and a 4bp rise in the real yield. Forecasts for the rate hike at the September FOMC meeting remain largely unchanged at 2.6 times. (Forecasts for a 50bp hike and a 75bp hike are roughly even.) The ceiling (terminal rate) for the OIS yield is also unchanged at a level slightly below 3.8%. However, the period during which the federal funds rate is expected to remain high was extended slightly, as expected, which led to a rise in the 2-year US yield from 3.37% to 3.40% and slightly deepened the negative spread between the 2-year/10-year yields (from -34.6bp to -36.2bp). These reactions in the bond market appear to have generally reflected the Fed's improved credibility regarding inflation control as well as the pain that will come with the measures for taming inflation.

Currently, the federal funds rate is expected to remain high after being raised substantially. Therefore, the 10-year US yield is unlikely to plunge in the near term. However, seen over the long term, the rise in the Fed's credibility regarding inflation control will serve as a favorable factor stabilizing the viewpoint of bond investors, making it easy to continue seeing a 10-year yield above 3% as a good opportunity to buy. Regarding JGBs as well, the fact that the Fed has candidly acknowledged there will be some pain serves as a factor for worsening the outlook for the external environment when BOJ Governor Haruhiko Kuroda's term in office ends in April 2023. As with US Treasuries, we judge that it has become easier to buy JGBs than it was before the Jackson Hole conference.