Daiwa's View

Resurgence of risk-off sentiment

➢ 'Across-the-board selling' reminiscent of movements in 1H 2022

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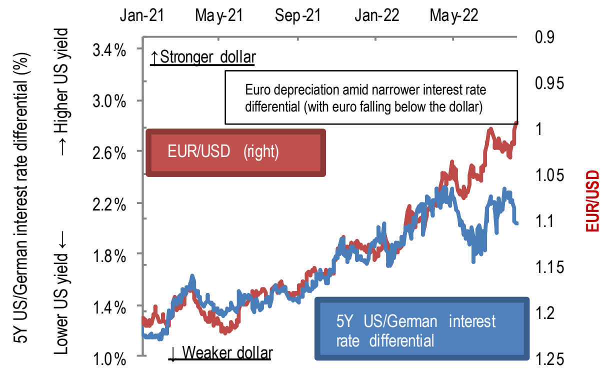
Yesterday, global markets were hit by a wide range of sell offs. Specific price movements were as follows: the DJIA dropped from $33,707 to $33,063 while the North American High-yield CDS Index rose from 466bp to 491bp, the VIX Index climbed from 20.6 to 24.1, and the US long-term yield went from 2.97% to 3.01%.Of note is that the market faced 'across-the board selling' (incl. bonds) similar to that in 1H 2022. We feel the market is being driven by a change in its understanding of the Fed's stance—i.e. as the Jackson Hole symposium approaches, the market has finally started listening seriously to Fed officials' repeated warnings against the optimistic view taken by the market after the July FOMC meeting.

What is different from 1H 2022 about the current situation is the growing trend for the euro to be sold despite rising interest rates. Since end-July, when the market had adopted the most optimistic view it has taken recently of central banks' positions, the 1-year forward 1-year German yield rose by 98bp (0.20→1.18%), compared to a rise of 51bp (2.84→3.35%) by the 1-year forward 1-year US yield. The euro fell below the dollar yesterday, despite rate hikes in Europe being forecast to be higher than in the US.

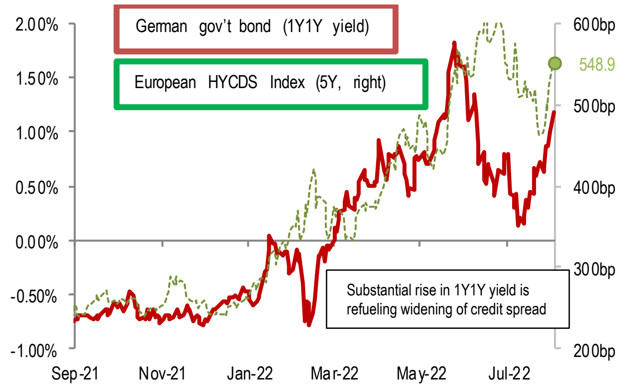
That said, given the relative deterioration of the economic outlook and widening of credit spreads (right-hand chart below), we can see the reason for euro depreciation, which is running counter to rising interest rates. However, if the focus remains on the impact that high inflation has on inflation expectations, the ECB will be forced to deal with the dilemma of having to continue with large-scale rate hikes that harm the economy.

5Y US/German Interest Rate Differential, EUR/USD Rate



Source: Bloomberg; compiled by Daiwa Securities.

1Y1Y German Yield, European High-yield CDS Index



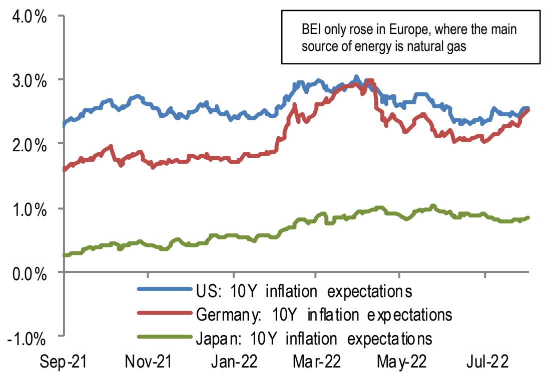
Source: Bloomberg; compiled by Daiwa Securities.

◆ Stable inflation expectations

Nevertheless, we have not seen a rise in US inflation expectations (breakeven inflation rate: BEI). Comparing data from end-July with that of last night, we found that the 10-year German BEI had risen significantly from 2.15% to 2.54% (up 39bp), while the 10-year US BEI remained roughly flat (rising from 2.55% to 2.57%). (The 10-year Japanese BEI rose from 0.83% to 0.84%).

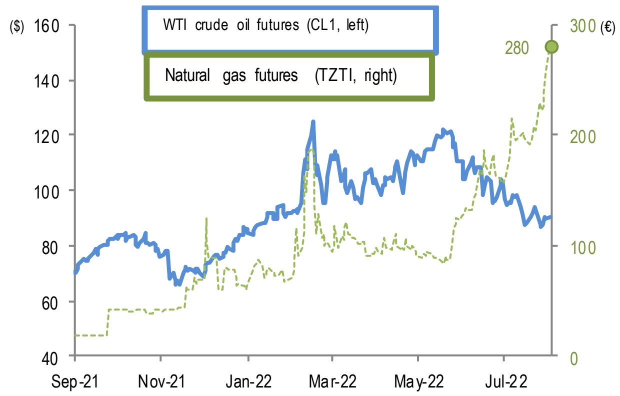
Of course, much of this is a reflection of trends in the price of each region's major source of energy (natural gas in Europe vs. crude oil in US). However, we continue to see the general view by market participants that, while the Fed will eventually be able to control inflation, the ECB won't be able to take the initiative required to control inflation. The rise in long-term yields amid stable BEIs means a rise in real yields. Recently, European yields have been rising more than US yields. However, we think that investment in US yields is probably becoming more attractive, given stable BEIs.

Breakeven Inflation Rate in Japan, US, Germany



Source: Bloomberg; compiled by Daiwa Securities.

WTI Crude Oil Futures, European Natural Gas Futures

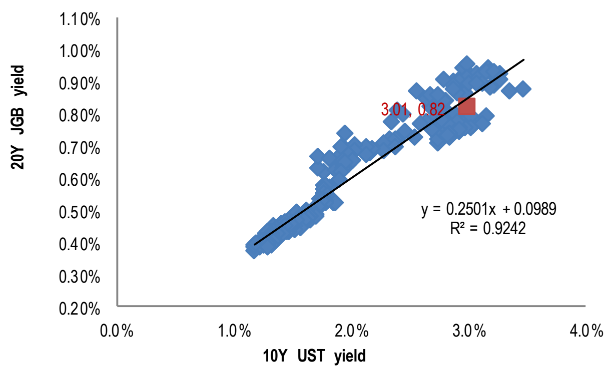


Source: Bloomberg; compiled by Daiwa Securities.

◆ JGB yields are rising, maintaining a balance with US yields

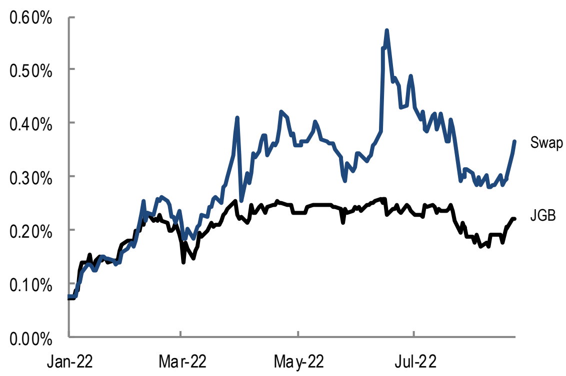
Yesterday, JGB yields posted substantial steepening in line with a rise in the US long-term yield. Prices moved in a way that felt like a resurgence of the attack on the yield curve control (YCC) policy due to (1) the swap rate in the 10-year sector, which is protected by fixed-rate purchase operations, rising significantly vs. the JGB yield, and (2) JGB futures being sold conspicuously on the curve. That said, it is unlikely the market will anticipate policy revisions by the BOJ within FY22. Therefore, we surmise that yesterday's movements were caused by concerns about another rise in European/US yields, rather than the BOJ. In general, global financial markets are moving together to a certain extent. It can be said that it is natural enough for JGB yields to rise following European/US yields. However, when the market senses regional characteristics of momentum such as inflation and rate hikes (wondering whether yields will move together even if BEIs don't), we need to adopt a perspective that views rising yields caused by this global linkage as an investment opportunity.

10Y US Yield, 20Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

10Y JGB Yield, JPY Swap Rate



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