Daiwa Securities

Daiwa's View

Second round of remedial action by Fed to begin

- In order to correct market's misinterpretation of a dovish stance by the Fed after July FOMC meeting

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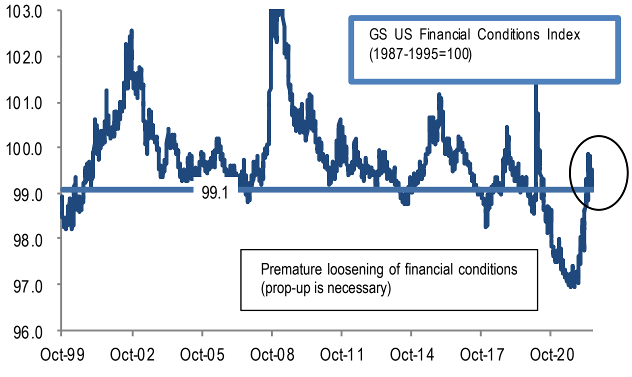
At the July FOMC meeting, the Fed indicated a data-dependent policy reaction, and stated that it would not provide clear guidance. Since then, the asset market has interpreted this as a dovish stance, and the financial conditions have loosened significantly (left-hand chart below). Neel Kashkari, the president of the Federal Reserve Bank of Minneapolis, remarked "I'm surprised by markets' interpretation" (after the FOMC meeting), and Fed officials hastily aligned their messages in order to try to push back on the market's misinterpretation that it had adopted a dovish stance. However, the financial conditions index is continuing to loosen (rising stock prices and tightening credit spread). The Fed's actions to push back on the market's misinterpretation have not been successful so far.

However, yesterday's market saw a sharp rise in the 2-year yield (3.18% → 3.26%, the highest level since 14 Jun), as well as the first slight reversal of the North American High-yield CDS Index and slight underperformance of high-tech stocks in a while. This was probably caused by some market participants anticipating the start of a second round of remedial action by the Fed triggered by the minutes of the July FOMC meeting (to be released tonight) and next week's Jackson Hole conference.

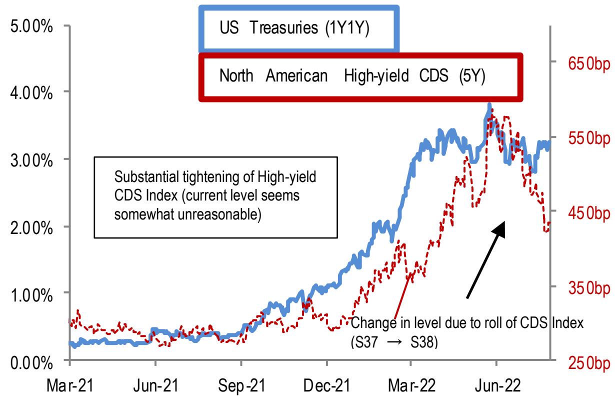
There is little doubt that the Fed will use tonight's FOMC minutes and next week's Jackson Hole conference as an opportunity to achieve a full-scale correction of the market's misinterpretation that it has adopted a dovish stance. I am focused on whether the 1-year forward 1-year (1Y1Y) yield will rise substantially from the current level of 3.25% and whether credit will follow the rise. With the Fed becoming more hawkish, the High-yield CDS Index temporarily exceeded 600bp when the 1Y1Y yield was rising towards 4%. However, the index has declined sharply to the 400-450bp range with the spread of the market's misinterpretation that the Fed had adopted a dovish stance since the July FOMC meeting (right-hand chart below). If the second round of actions by the Fed to correct the market's misinterpretation is successful, we will see another rise in the 1Y1Y yield towards 4% and a resumption of the widening of the High-yield CDS Index. If that were to happen, these movements would symbolize (1) appropriate tightening of financial conditions that have become loose and (2) progress towards regaining credibility about measures to tame inflation.

US Financial Conditions Index



Source: Bloomberg; compiled by Daiwa Securities.

1Y1Y US Yield, North American High Yield Index



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