Daiwa Securities

Daiwa's View

An end to "inflation trade"

➢ Fierce market reactions indicate a change in the situation

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Reflecting weaker-than-expected US CPI, yesterday's market posted fierce reactions, such as a 29bp drop in the US long-term yield and appreciation of the yen by nearly Y6 (Y146.3→Y140.5). Of course, part of this is a reflection of increased speculation that there will be a slowdown in the pace of rate hikes at the December FOMC meeting in light of CPI data. Yesterday, over 90% of the market priced in a 50bp rate hike in December (i.e., a slowdown in the pace). This indicates that the slowdown in the pace of rate hikes has become a done deal in one fell swoop. The slowdown officially became an item for consideration in the November FOMC statement with the addition of factors to be considered when determining the pace of future increases in the target range (cumulative effects, time lags, and economic and financial developments).

Factoring in projections for rate-hike suspensions in Jan-Mar 2023, the estimated terminal rate also declined to around 4.85% yesterday. This strong reaction to data for a single month seems somewhat excessive. However, this is probably a reflection of the fact that "non-housing core inflation" has turned downwards m/m. On 6 October, Fed Governor Christopher Waller stated that "Such a step-down in non-housing core inflation, if sustained over several months, would be a big improvement in inflation." This was achieved with October CPI. Although this is still just the results for a single month, this data could be seen as "a big improvement in inflation" by Fed Governor Waller, if sustained over several months. Therefore, it should not be taken lightly.

Fed Governor Christopher Waller (6 Oct 2022)
·Such a step-down in non-housing core inflation, if sustained over several months, would be a big improvement in inflation, and I think it is quite possible to get there because of the considerable tightening of monetary policy that has occurred so far and additional anticipated tightening.

Moreover, October CPI data included irregular factors related to medical care services, so we may see a rebound in November CPI. That said, the Fed was successful in regaining a forward-looking perspective at the November FOMC meeting. Therefore, even if November CPI were to exceed market estimates, we would be less likely to see the kind of chaotic rise in the terminal rate that occurred until October. Meanwhile, since the cumulative effects and time lag effects the Fed pointed out as factors to be considered will intensify over time, it will become easier for the market to sense downward yield reactions to lower-than-expected CPI readings. Of course, at this stage in which monetary tightening is being implemented, the Fed will pursue a positive real yield (around 1.5%) across the curve. Therefore, if a premature decline in yields were to occur, moves to push back such a decline would be expected. For that reason, it is too early to expect a decline to the 2% level. But the change in market trends itself is clear, and reactions to yield projections in the face of surprises involving jumps or drops in inflation are becoming asymmetric. It turns out that the remarks by St. Louis Fed President James Bullard on 21 October have served as a turning point.

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