Daiwa's View

Implications of US long-term yield stabilizing right above 3.3%

➢ Has the market finally started sensing the third phase (after rate hikes end)?

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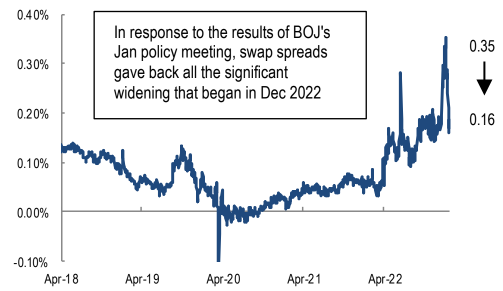
◆ Swap spreads narrow in response to the enhancement of pooled collateral operations

It is accepted as fact that one of the purposes of the BOJ enhancing its funds-supplying operations against pooled collateral at its January policy meeting was to deal with the divergence between JGB yields and swap rates (BOJ governor Kuroda mentioned swap rates in his press conference). Despite the BOJ not yet having conducted any 5yr pooled collateral operations since this enhancement (the first one will be on 23 Jan), swap spreads in the 5yr zone have already narrowed 19bp, from 35bp right before the January policy meeting to 16bp (see Chart below). We will not know how sustainable the policy's impacts will be until we see how the actual operations go starting next week, but it looks safe to say that conclusions regarding the effectiveness of the pooled collateral operations are already coming out.

JGB-Swap (OIS) Spread



Source: Bloomberg; compiled by Daiwa Securities.

BOJ Governor Haruhiko Kuroda (18 Jan 2023)

Because the financial institutions availing themselves of these operations (author's note: funds-supplying operations against pooled collateral) can expect them to work in markets outside of the cash market via conducting swaps as noted as well as various other arbitrage activities, we think the operations will be able to pull longer-dated yields lower without directly impacting the supply-demand of cash JGBs.

Source: Excerpted from BOJ materials.

◆ The relationship between a real 10yr Treasury yield of 1.1% and the pivot

While Japan-specific catalysts were being digested in the JPY bond market, the US long-term rate dropped suddenly into a range right above 3.3% and the real 10yr yield fell to right above 1.1%. In November 2022, Fed Vice Chair Lael Brainard expressed satisfaction that the real yield curve was above 1% from the 1yr to the 10yr sector, and assuming no change in the Fed's stance a real yield of 1.1% is close to the level where the Fed would start pushing back (a level where it would have to consider selling on strength). What bears noting here, however, is that share prices have been soft despite the decline in real yields, and this suggests the possibility that recession concerns have been rising since the disappointing US retail sales data was announced on 18 January. In that case, the Fed would likely be hesitant to push back unnecessarily. In a speech she gave yesterday, Ms. Brainard confirmed that the focus of debate at the Fed has shifted to the phase following the end of rate hikes. Once the market senses the end of rate hikes, there is a possibility that the real 10yr Treasury yield floor of 1% will change to being a ceiling (see our US yield outlook for 2023). Although the 10yr Treasury yield is settling in right above 3.3%, there is also a possibility that the market is finally starting to sense the beginning of a third phase, the one that begins after rate hikes end.

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