Daiwa Securities

Daiwa's View

10-year US yield returned to 3.5% level in just four business days

- The Fed's intentions have been understood
- Fundamentals are slightly negative

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

10-year US yield returned to 3.5% level in just four business days

The Fed's intentions have been understood

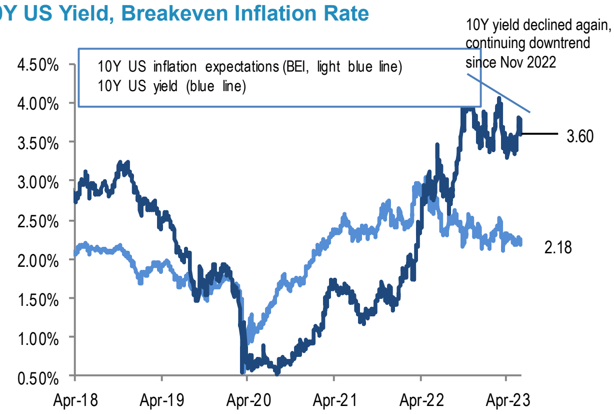
Yesterday, the 10-year US yield declined to 3.595%, returning to the 3.5% level just four business days after logging 3.85% on 26 May. The MOVE Index, which shows bond volatility and had risen to 145.4 on 26 May, fell to 124.6 yesterday. It was a rapid decline due to the emergence of market factors from both the Fed and fundamentals.

The market's pricing in of a rate hike in June had temporarily exceeded a 60% probability, but that appears to have declined to below 25% as of last night. I think the Fed's true intentions were generally made clear by changes in the statement at the May FOMC meeting and by Fed Chair Jerome Powell's comment that the Fed could afford to look at the data for careful consideration, which he made on 19 May, pushing back against market speculation (when the market's pricing in of a rate hike in June exceeded a 50% probability). The Fed's intentions appear to have finally been understood, with (1) several Fed officials making remarks accepting a pause in rate hikes in June and (2) Wall Street Journal reporter Nick Timiraos (who may be unofficially putting out messages for the Fed?) writing an article implying that the Fed would skip a rate hike in June. The Fed is currently grappling with the very difficult challenge of deferring rate hikes in June without conveying the message that it intends to put an end to rate hikes. So, the market probably needed time to digest this.

Fundamentals are slightly negative

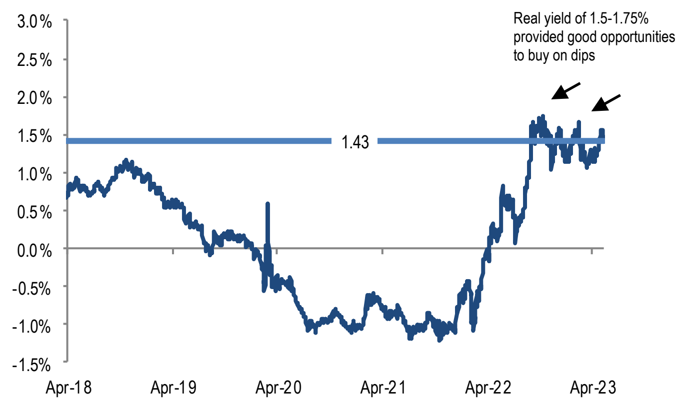
Meanwhile, what was also striking yesterday was the sluggishness of the ISM Manufacturing Index as well as the sharp drop in the Backlog of Orders, Customers' Inventories, and Prices subindexes. About seven months have passed since November 2022, when the 10-year yield minus the federal funds rate became negative. Therefore, we would not be surprised if we started to catch a glimpse of cumulative effects from tightening. However, it is surprising to see the ISM Manufacturing Index, which should be in a cyclical recovery phase thanks to significant dollar depreciation (Dollar Index: DXY 114→101), currently being suppressed to this degree.

10Y US Yield, Breakeven Inflation Rate



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

Important disclosures, including any required research certifications, are provided on the last page(s) of this report.

FICC

If tightening effects (pressure), equivalent to the impact of 10% depreciation of the dollar, are emerging at this time, it would be easy to imagine a worsening of data in 2H FY23, when we could see a concentration of negative factors, such as (1) cumulative tightening effects starting to make a full-scale contribution towards the end of the year, following a one-year lag after the emergence of negative yields, (2) the widely-expected depletion of excess savings, and (3) an approximately $1.5tn cut in expenditures (in new fiscal year from Oct), which is an additional factor due to the debt ceiling agreement.

Substantial improvement in Bond Market Survey

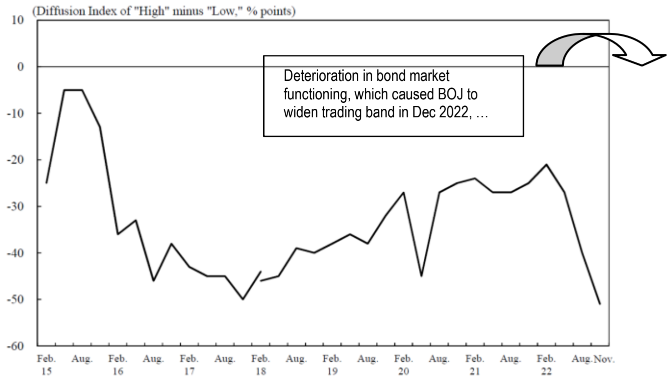
Incentive for YCC revisions in June appears to have diminished

◆ Substantial improvement in Bond Market Survey

Yesterday, the BOJ announced its quarterly Bond Market Survey. The DI for bond market functioning came in at -46, confirming a remarkable rebound from -64 in the previous February survey, although there is still room for improvement. It showed an improvement even when compared with the November 2022 results in the survey, immediately before the decision to widen the trading band in December 2022. At the end of last year, the BOJ made clear that its stance was to engage in a waiting game, recognizing that time would be needed for the functioning of the bond market to recover. Measures have probably produced a certain degree of results.

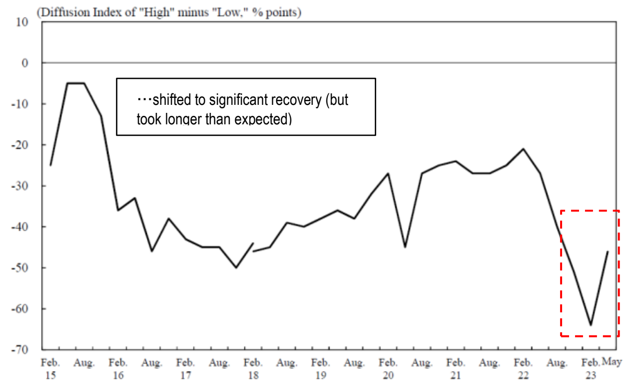
This recovery in functioning of the yen bond market has also clearly manifested in the municipal bond market. The spread of regularly-issued 10-year municipal bonds vs. JGBs was only T+12 in July 2022, which widened to +30bp in April 2023. But, it improved to +29bp in May and it is expected to continue to improve to +25bp to +26bp in June. That said, the extent of the recovery is still less than half the total change, suggesting that there is still great room for improvement. Having the aim of boosting recovery of the functioning of the corporate bond market, the BOJ would seem to have little incentive to risk stopping the trend towards recovery in market functioning that has just begun by causing a surprise with the YCC policy at the June Monetary Policy Meeting.

Degree of Bond Market Functioning: Current Situation (Nov 2022 survey)



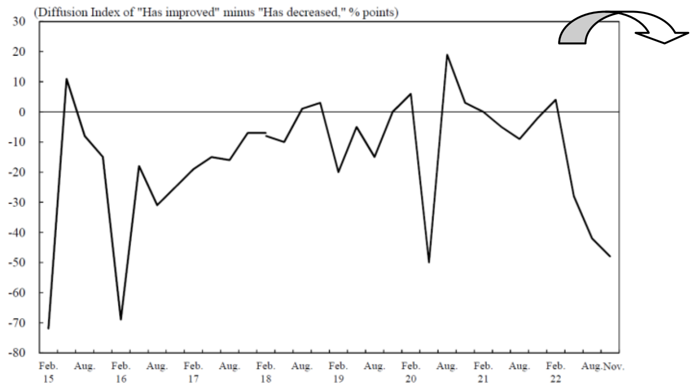
Source: Excerpted from BOJ materials.
Note: Comments and graphics added by Daiwa Securities.

Degree of Bond Market Functioning: Current Situation (May 2023 survey)



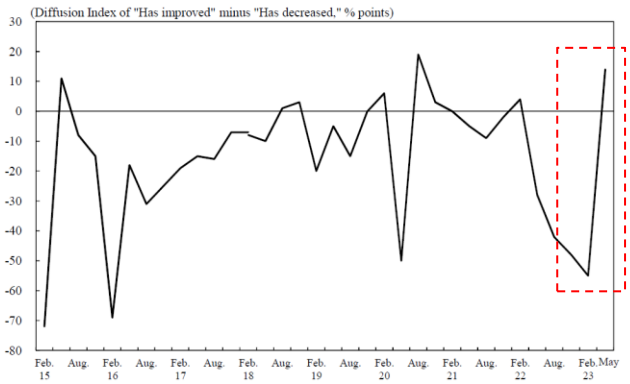
Source: Excerpted from BOJ materials.
Note: Comments and graphics added by Daiwa Securities.

Degree of Bond Market Functioning: Change from Three Months Ago (Nov 2022 survey)



Source: Excerpted from BOJ materials.
Note: Graphics added by Daiwa Securities.

Degree of Bond Market Functioning: Change from Three Months Ago (May 2023 survey)



Source: Excerpted from BOJ materials.
Note: Graphics added by Daiwa Securities.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:
https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association