Daiwa Securities

Daiwa's View

Rise in long-term yield does not mean risk-on movement

➢ Inconsistent price movements may warn of market irregularities

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.

Rise in long-term yield does not mean risk-on movement

Inconsistent price movements may warn of market irregularities

The US jobs report (released at the end of last week) was the complete opposite from the ADP report that was announced last Thursday and increased concerns about overheating of the labor market. In particular, the unemployment rate among African Americans, considered an early indicator of potential problems in the US labor market, rose to 6%. This makes us wonder if we are seeing a turning point in the US labor market, including the service sectors. With the latest jobs report not being that weak, it is unlikely to lead the Fed to take a wait-and-see stance regarding a rate hike in July. However, this data indicates evidence that the balance in the labor market is improving. In that sense, the report did not raise the probability of a second additional rate hike, which resulted in a slight decline in the 2-year yield from 4.98% to 4.95%.

◆ Rise in long-term yield does not mean risk-on movement

Meanwhile, immediately after the jobs report was announced, the US long-term yield declined to 3.999%, but then rose and closed at 4.06% (+3bp). A (forced) interpretation of the situation, drawing comparisons with price movements in the OIS market, would seem to indicate that the market had likely developed a greater sense that interest rates would remain high longer, harking back to the Fed's "higher for longer" motto. However, last Friday's market saw a relatively large depreciation in the US dollar (DXY: 103.11 → 102.27) and a drop in US stock prices. This feels slightly inconsistent when interpreted in the context of risk-on movements, such as stronger expectations for a soft landing and reduced concerns about a recession.

Obviously, price movements taking place on one day cannot be assessed entirely and with consistency using economic data from that one day. However, as a rule of thumb, these kinds of inconsistent price movements may warn of irregularities in the market, such as a decline in liquidity. Recently, I have got the impression that these kinds of price movements have continued for a while. If this trend is promoted going forward, it could be a sign that market prices will be more likely to diverge from fair values based on fundamentals for the time being. While this is a good investment opportunity from a long-term perspective, one must keep an eye out for greater divergence in the short term.

◆ Price movements following interview with BOJ Deputy Governor Uchida

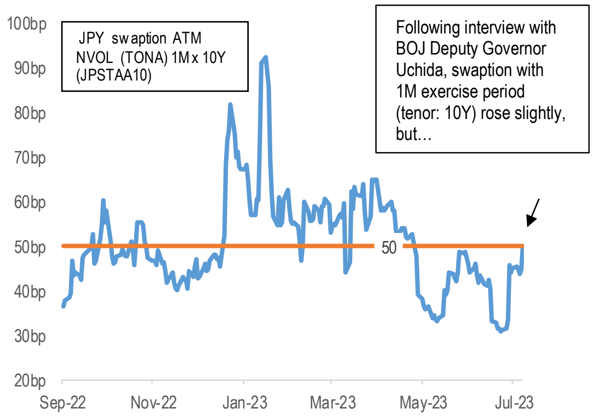
Speaking of inconsistent movements, the yen appreciated sharply at the end of last week (the USD/JPY rate went from Y144.07 to Y142.21 and the EUR/JPY rate from 156.9 to 155.94) amid a rise in the 10-year US real yield from 1.77% to 1.80%. The yen strengthened markedly, by nearly Y1.8, against the dollar. It also appreciated by nearly Y1 against the euro. It is important to point out here certain Japan-specific factors besides the difference in relative yields. I suspect the article about the interview with BOJ Deputy Governor Shinichi Uchida that was released by *Nikkei* at midnight last Thursday (6 Jul) might have slightly increased speculation about policy revisions by the BOJ.

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

Last Friday in her report, our chief market economist Mari Iwashita commented about the interview with BOJ Deputy Governor Uchida, stating "This interview has been perceived as an attempt to counteract speculation that the BOJ will remove its yield curve control (YCC) policy at the July Monetary Policy Meeting (MPM), which had been smoldering among some market participants" (our house view).

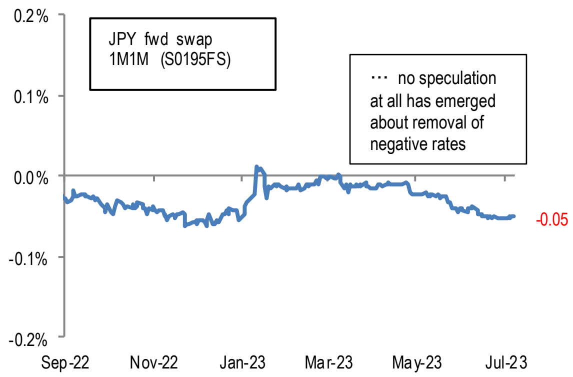
Meanwhile, looking at the JPY yield market at the end of last week, after the interview, there was a certain degree of caution regarding YCC revisions, as indicated by a somewhat large rise in the 10-year JGB yield from 0.405% to 0.435% and a jump in the 1M-forward 10Y swaption (JPSTAA10) from 44.76bp to 49.95bp. That said, the 10-year JGB yield has not yet reached the upper limit of the trading band of 0.5%, and the 1M-forward 10Y swaption remains at a level that is 10bp lower than what it was during Feb-Apr 2023. These movements indicate that (1) the interview with Deputy Governor Uchida slightly increased the market's caution regarding YCC revisions at the July MPM, but also that (2) the market is not entirely convinced that the YCC will be revised.
Even after the release of the interview, the 1M-forward 1M swap rate is roughly flat at -0.05%, meaning that no speculation at all has emerged regarding removal of negative interest rates at the July MPM. This seems to be evidence that a growing portion of the market holds the view that the YCC will be removed first, followed by negative interest rates later on. In his interview, Deputy Governor Uchida discussed removal of negative rates, asserting that it was a 0.1% rate hike, and that given the current economic and price conditions, the BOJ thought there was still a long way to go before it would be able to make a decision about the issue. Appropriately decoupling long-term interest rates from short-term rates in this way during policy revisions constrains the extent to which long-term interest rates rise when making YCC revisions. This will be an important foundation from which the BOJ will make revisions to the YCC going forward without causing market confusion.

JPY Swaption (1M10Y)



Source: Bloomberg; compiled by Daiwa Securities.

JPY Forward Swap Rate (1M1M)



Source: Bloomberg; compiled 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