Daiwa Securities

Daiwa's View

Good news is bad news

➢ FCI-G index indicates insufficient tightness

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.

FCI-G index indicates insufficient tightness

Good news is bad news

Last week's JOLTS and jobs data showed that the US labor market had broken free from overheated conditions, which I viewed as a game changer. Thus far, the overheated labor market had been a driver of sustained US inflation pressure. Therefore, the most important change with regard to inflation is that equilibrium has been restored in the labor market. In that sense, there is no change to my understanding that the change in employment indicators seen last week is a "game changer" from a long-term viewpoint. That said, of course, this also entails risks. There is a major risk of the employment market overheating again or of us seeing a rebound in the rate of wage hikes due to strong economic growth. From that perspective, the recovery of the ISM Services Index to 54.5, which was released yesterday, can be described as "good news is bad news."

FCI-G and Constituent Variables

		Dec-22	Jul-23
FCI-G 1-year (%)		1.59	0.06
FCI-G 3-year (%)		0.95	0.39
1	Effective FF (%)	4.32	5.32
2	10y UST (%)	3.87	3.96
3	MBS 30y (%)	6.58	6.93
4	Baa 10y (%)	5.6	5.74
5	US stock index ($)	38,521	45,970
6	Zillow ($1000)	340.9	348
7	Dollar Index ($)	103.5	101.9

Source: Zillow, Bloomberg; compiled by Daiwa Securities

That said, from the standpoint of "financial conditions," this rebound of the ISM Index could be said to be in line with expectations. The new FCI-G financial conditions index announced by the Fed on 30 June adopts seven variables used in the Fed's economic model (such as the FRB/US model). The index is derived by using impulse response analysis[1], enabling us to observe the impact of financial conditions on the growth rate. As of December 2022, the FCI-G with one-year lookback window and the FCI-G with three-year lookback window stood at 1.59 and 0.95, respectively, but they had fallen to 0.06 and 0.39, respectively, as of July 2023. Despite the Fed having implemented rate hikes totaling 1% since last year, financial conditions had become looser than before.

Of course, due to additional rate hikes since December 2022, we saw a rise in three of the seven indicators in the FCI-G index—the federal funds rate, the 10-year Treasury yield, and the 30-year fixed mortgage rate. This means that they moved in the direction of tightening compared to December 2022. However, the effects of this were more than offset by improvements in the four other indicators—the triple-B corporate bond yield, US stock price index, housing price index, and the dollar index—resulting in looser financial conditions. Unless these four indicators stabilize, the Fed may need to continue prolonged tightening and engage in additional interest rate hikes. (However, the rise in the long-term interest rate and mortgage rates, and the drop in stock prices seen in August may have obviated the need for additional rate hikes that might have otherwise been required.)

One challenging thing about the final stages of rate hikes is the risk of a rapid deterioration of the FCI-G index and financial conditions becoming excessively tight if corporate bond spreads rise or stock prices drop while the base interest rate has been raised substantially. In the sense that it justifies the need for further tightening of financial conditions, the firmness of the US growth rate indicated by the ISM Services Index data released yesterday can be said to have made it somewhat harder to achieve a soft landing.

[1] With regard to the impulse response function, we refer to the VAR model in chapter four of "Metric time-series analysis for economic and finance data" written by Tatsuyoshi Okimoto (Japanese only, Asakura Publishing).

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

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