# Daiwa's View

## Decline in US Economic Surprise Index

➢ Risks are loosening financial conditions and raising BEI in Japan

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Recently, we have seen an increase in the number of cases in which US economic indicators have been weaker than expected, leading to a decline in the US Economic Surprise Index. Although the November US PMI released at the end of last week was largely in line with market estimates, the data was mixed. This has increased expectations of a "cooling" of the labor market.

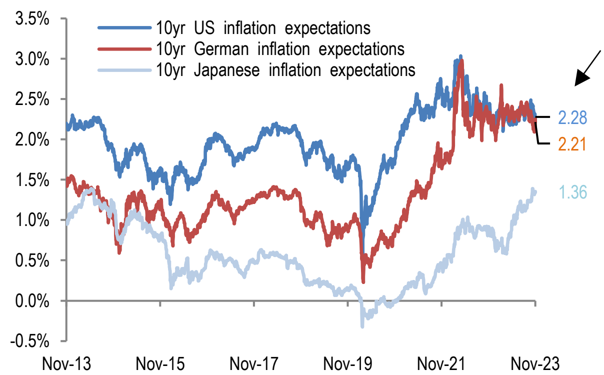
The decline in commodity prices also backed up scenarios that inflation would subside. The WTI crude oil futures price has dropped from the $120 level in June 2022 to the mid-$70 level. The Bloomberg Commodity Index (BCOM), which covers prices in a wider range of commodities, has also declined from 135 in June 2022 to 101.4.

Due to the impact of these projections for economic slowdown and lower costs of raw materials, the breakeven inflation rate (BEI) in the US and Europe has declined by more than 10bp, from slightly below 2.4% two months ago to around the 2.25% level. Weakening pressure on the Fed and ECB, which is mirrored by the BEI, justifies the recent cautious stance (skipping rate hikes) at central banks in the US and Europe. At the moment, things appear to be going well heading towards a soft landing. However, we probably need to pay attention to (1) loosening financial conditions caused by greater expectations of a soft landing, and (2) rising BEI in Japan.

**Economic Surprise Index in US and Europe**


*Source: Bloomberg; compiled by Daiwa.*

**Breakeven Inflation Rate in Japan, US, Europe**



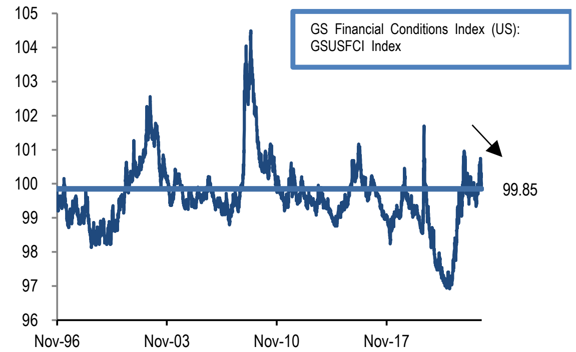

*Source: Bloomberg; compiled by Daiwa.*

## Loosening financial conditions

The US Financial Conditions Index (GSUSFCI) fell below 100, declining to 99.85 at the end of last week. The loosening of financial conditions is a factor that could lead to upward revisions to US growth forecasts and concerns about a resurgence of inflation. In fact, the consensus among private-sector economists regarding the 2024 growth rate has been revised upwards to 1.1%, from its bottom of 0.6% in August 2023. If financial conditions continue to loosen, we will have to keep an eye out for additional rate hikes in 2024, as well.

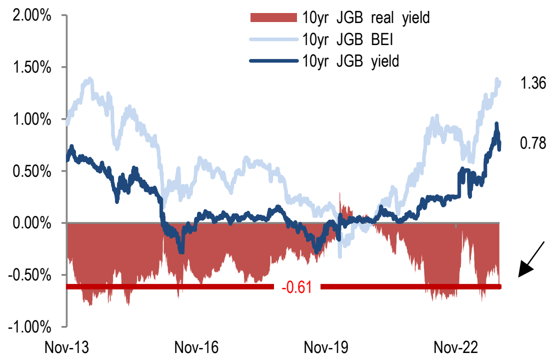
As former Kansas City Fed President Esther George pointed out, the biggest factor behind the surprising growth in 2023 is the several trillion dollars in fiscal expenditures to the economy implemented by the US fiscal authorities. If we assume that this has already been dealt with in past rate hikes, we do not know whether additional rate hikes will also be needed next year amid the current level of loose financial conditions. Next year, we will see the cumulative effects and time-lag effects of past rate hikes, as well as the effects of balance sheet reductions that have been conducted behind the scenes. That said, given the loosening financial conditions, we can say that there is a slightly greater chance that we will see a more hawkish tone than expected at the December FOMC meeting, the last meeting in 2023.

**US Financial Conditions Index**




*Source: Bloomberg; compiled by Daiwa.*

**10yr JGB Yield**




*Source: Bloomberg; compiled by Daiwa.*

## Rising BEI in Japan

In contrast to BEI in the US and Europe, BEI in Japan has been rising, and rose to 1.36% at the end of last week. This suggests that, unlike the Fed and ECB, the BOJ may be subject to increasing pressure. Last week, the BOJ reduced the purchase amounts for *Rinban* operations once again, indicating Y525bn/offer in the 5-10 year zone. This led to a sharp rebound in the 10-year JGB yield to the upper 0.7% level. However, when deducting an BEI of 1.36% from this yield level, the real yield comes to around -0.60%. If the purchase amounts for *Rinban* operations were not cut, it can be calculated that the real yield would have fallen even further into negative territory to about -0.7%, which I regard as a point of reference for excessive easing.

If we assume that the real yield rises to -0.50% with the 10-year BEI staying at 1.36%, an appropriate value for the 10-year JGB yield would be 0.86%. Similarly, if the real yield were -0.40%, an appropriate value for the 10-year JGB yield would be 0.96%. If we were to use roughly -0.35%, which is the average value of Japan's equilibrium real yield over the next ten years based on trial calculations by IMF staff, an appropriate value for the 10-year JGB yield would be about 1%. Of course, a further rise in BEI should raise the level of the 10-year JGB yield. The problem is that, if JGB yields were to rise to these levels, many Japanese investors (incl. Japan Post Bank, which has indicated a policy of restructuring its JGB portfolio) would allocate their funds to JGBs. It is gradually becoming increasingly necessary to keep an eye on Japanese inflation trends, even when checking US and European yields.

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