

Daiwa's View

US November CPI: No downside surprise, but no upside surprise either

- Steady progress for disinflation process with some “bumps” along the way
- Largely neutral impact on UST yields, monitoring impact on JGB yields
- Narrowing LCH-JSCC spread suggests JGB short covering by foreign investors

FICC Research Dept

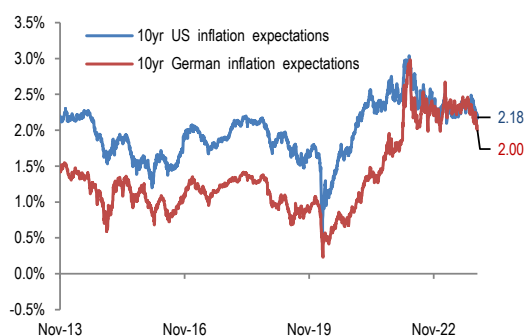
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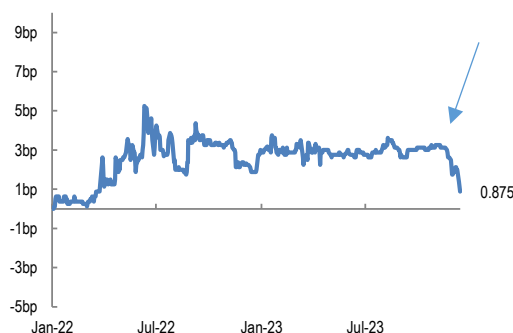
US CPI data released on the evening of 12 December (Japan time) was roughly in line with market expectations and the UST yield curve twist-flattened. The 10-year UST yield traded around 4.2% on that day. Also on 12 December, the WTI price dropped just below the \$70 line and the break-even inflation rates (BEI) fell to 2.18% in the US and 2% in Germany, which we think contributed to the yield curve flattening. From the perspective of steady progress for the disinflation process and consistency with the 2% inflation target, BEI moving into slightly lower territory will probably encourage the Fed/ECB to shift toward greater balance.

Our focus is on how these developments might impact the JGB market. There was very strong bidding at the 12 December 5-year JGB auction, which triggered an extensive short covering rally. This was, of course, due in part to the 11 December media reports that BOJ officials see little need to rush into scrapping its negative interest rate and yield curve control (YCC) policy in December. However, such a market move for that reason alone seems unreasonable.

Of note, the LCH-JSCC spread has fallen to less than 1bp for the first time since March 2022 (bottom-right chart). This suggests extensive unwinding of JGB short positions that were built up by foreign investors through LCH's swap clearing. Expectations regarding the degree to which the BOJ will move its negative interest rate into positive territory may be rapidly receding due to the combination of speculation about an early policy pivot by the Fed and Japan's political turmoil (see Scenario (2) in [our 12 Dec report](#)). Of course, at the very least, the BOJ will end its negative interest rates. However, if speculation about barely positive interest rates for a prolonged period (so-called “low for long”) strengthens, the appeal of the 5-year C+R would stand out and the impact of lower interest rates would spill over into the medium-term zone. Of course, if the 5-year JGB yield does not reach 0.5% even after the ending of negative interest rates, a 10-year JGB yield of 1.0% would also feel like a goal that is just out of reach.

10yr Breakeven Inflation Rate in US and Germany

Source: Bloomberg; compiled by Daiwa.

LCH-JSCC Spread

Source: Bloomberg; compiled by Daiwa.

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