

Daiwa's View

Market again demanding rate cuts

- Short-term and long-term interest rates again inverted

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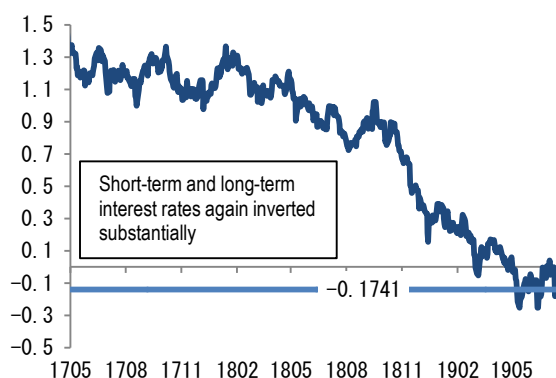
Short-term and long-term interest rates again inverted

Market again demanding rate cuts

The market is now facing an unfavorable situation. At the July FOMC meeting, Fed Chair Jerome Powell showed a slightly hawkish stance relative to market expectations, suggesting that the Fed is not in a long easing cycle. Then, the news that US President Donald Trump would impose the fourth round of tariffs on Chinese imports jumped in. This pushed down the US Treasury yield curve by around 10-15bp, while the US 3-month rate, which is expected to be influenced by further issuance of T-bills¹, rose by 2bp, again resulting in the substantial inversion of US short-term over long-term interest rates (10-year rate minus 3-month rate = -17bp).

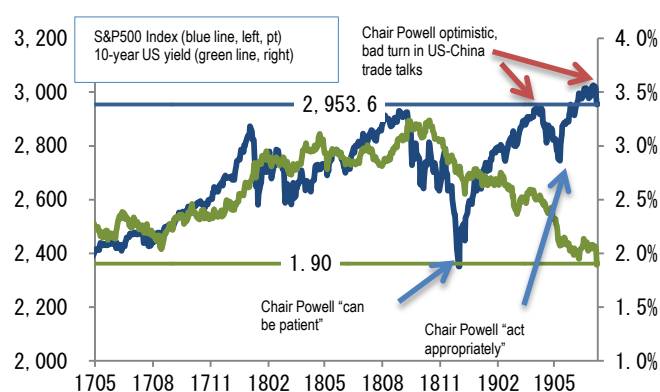
As witnessed by rapid appreciation of the yen to the mid-107 level and sharp flattening of the VIX index term structure, yesterday's movements partially include flight to quality. Consequently, it is probably excessive to interpret the yield decline as being caused only by "rate cut expectations." Still, it is true that the structure by which the negative impacts of US-China trade issues are curbed by rate cuts (a kind of policy mix?), which had supported market sentiment since 4 June when Chair Powell stated that the Fed would "act appropriately," has started to collapse. Going forward, it is highly possible that market sentiment will remain fragile until economic indicators improve or the Fed changes its stance to the dovish side. The market will likely put more focus on a change in the Fed's stance than on improvement in indicators. In short, the market is demanding rate cuts.

Chart: Differential Between US Short-term and Long-term Interest Rates (10-year – 3-month rate, %)



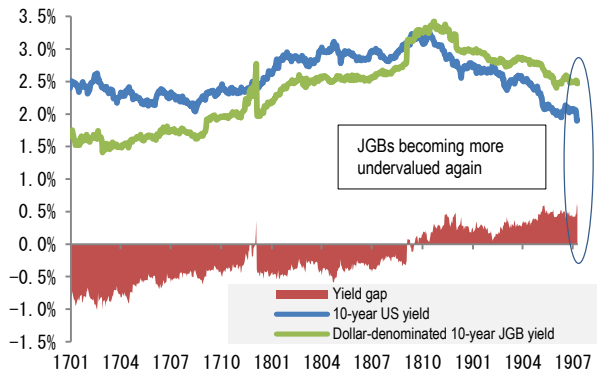
Source: Bloomberg; compiled by Daiwa Securities.

Chart: S&P500 Index and 10-year US Yield

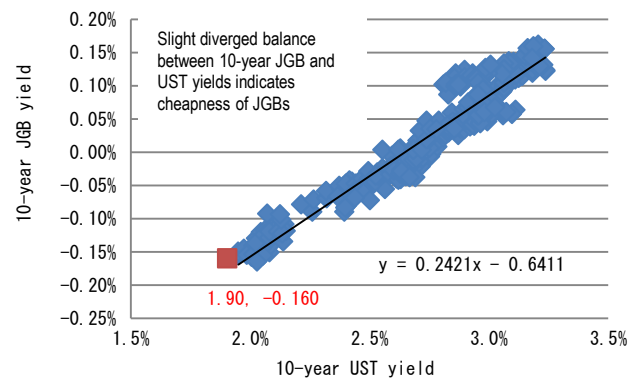


Source: Bloomberg; compiled by Daiwa Securities.

¹ A bill to suspend the debt ceiling through 31 July 2021 was enacted. It appears that US Treasury Department plans to procure \$160bn via T-bills over eight weeks.

Chart: 10-year US Yield and Dollar-hedged 10-year JGB Yield


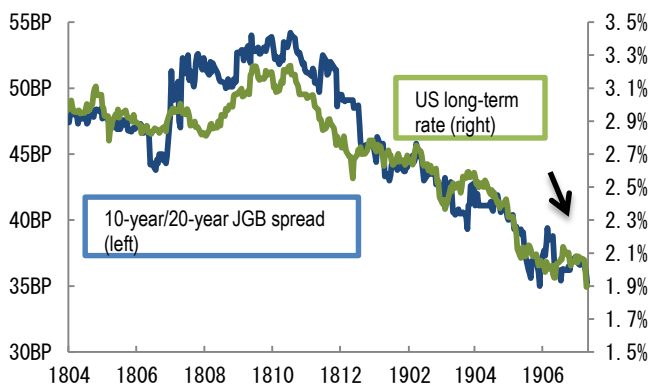
Source: Bloomberg; compiled by Daiwa Securities.

Chart: 10-year UST and JGB Yields (from Apr 2018 to date)


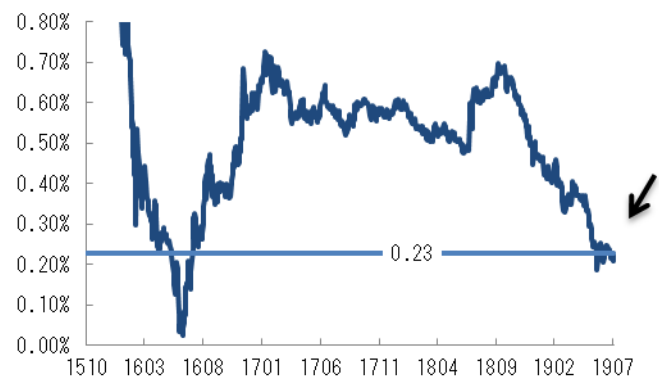
Source: Bloomberg; compiled by Daiwa Securities.

We tend to focus on a decline of the 10-year US interest rate, which fell below 1.9% at one point. However, the 10-year German Bund yield also hit a record low at -0.45%. This global yield downtrend may spread to JGBs. Due to the rise in JGB yields after yesterday's 10-year JGB auction, alongside the plunge in US yields overnight, the differential between 10-year JGB and US Treasury yields on a dollar basis has returned to the highest range over the past several years, again highlighting that JGBs are undervalued vs. foreign bonds.

Even if 10-year JGB yields decline to around -0.18% going forward, we cannot necessarily say that the level is excessive, given the relationship with US Treasuries in the past. In addition, if we assume that the 10-year/20-year JGB spread will maintain a strong correlation with US long-term rates as before, the spread may decline to around 35bp. Based on this figure, a reference point for the absolute yield of 20-year JGBs can be calculated as 0.17% ($= -0.18\% + 0.35\%$). By around the time when the current rate cut speculation-driven market ends, the 20-year JGB yield may be consistently below 0.2%.

Chart: US Long-term Rate and 10-year/20-year JGB spread


Source: Bloomberg; compiled by Daiwa Securities.

Chart: 20-year JGB Yield


Source: Bloomberg; compiled by Daiwa Securities.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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- 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 (including tax) 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.

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Corporate Name: Daiwa Securities Co. Ltd.

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Chief of Kanto Local Finance Bureau (Kin-sho) No.108

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The Financial Futures Association of Japan
Japan Investment Advisers Association
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