Daiwa's View

China shock causing further decline in US and European yields

➢ German yields fall below zero; making JGBs more undervalued

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Daiwa Securities Co. Ltd.

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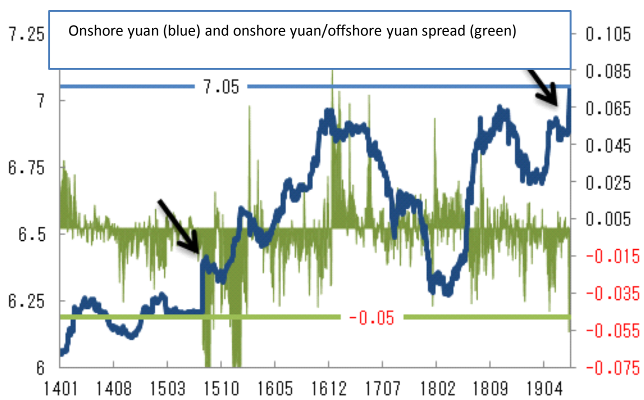
Yesterday, the People's Bank of China (PBOC) fixed the yuan above 7 per US dollar, a threshold level. In addition, government-owned companies were requested to suspend imports of US agricultural products. Amid deepening concerns about US-China trade friction due to China's retaliations, alongside the initiation of currency depreciation, the US government has designated China a currency manipulator. The two nations are launching fierce tit-for-tat measures. The market is facing a "China shock" as witnessed by yesterday's moves—the 10-year US Treasury yield declined to 1.71% and the USD/JPY rate fell to the 105 level. Reflecting the deteriorated situation, the 1.5-year forward 3-month rate declined to 1.4%. The rate has now factored in a 1% rate cut (25bp x four).

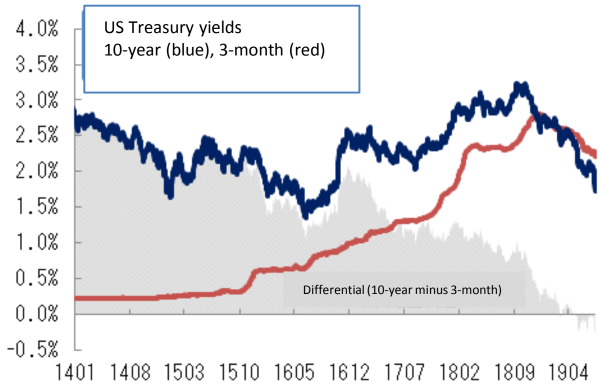
The China shock during 2015-16 can be generally divided into three stages of stock plunges. The first stage was the plunge in the Shanghai Composite Index from a record-high 5,166 on 12 June to 3,507 on 8 July. The second stage was the fall from 3,993 on 19 August to 2,927 on 26 August caused by the PBOC's devaluation of the yuan fixing. The third stage was the decline from 3,539 on 31 December 2015 to 2,656 on 28 January 2016. During the first stage, the US long-term interest rate declined from 2.38% on 11 June to 2.26% on 8 July 2015. Similarly, the rate fell from 2.19% on 19 August to 2.07% on 25 August during the second stage, and from 2.29% on 30 December 2015 to 1.99% on 27 January 2016 during the third stage. During the second stage caused by yuan devaluation, the US interest rate fell by 12bp, which is almost the same as the decline in yesterday's US rate. This may serve as a factor for judging that the rate level was largely corrected by yesterday's plunge, although we need to be careful in the midst of market confusion.

Chart: Chinese Yuan



Source: Bloomberg; compiled by Daiwa Securities.

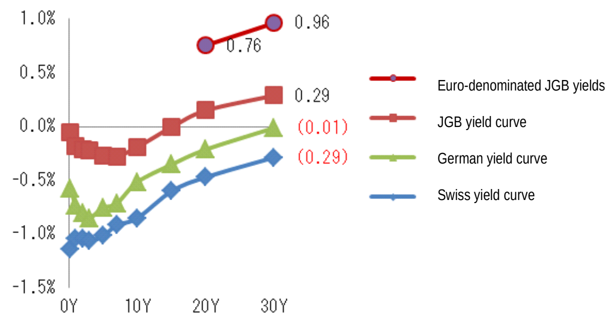
Chart: US 10-year Treasury Yield and 3-month Yield



Source::Bloomberg; compiled by Daiwa Securities.

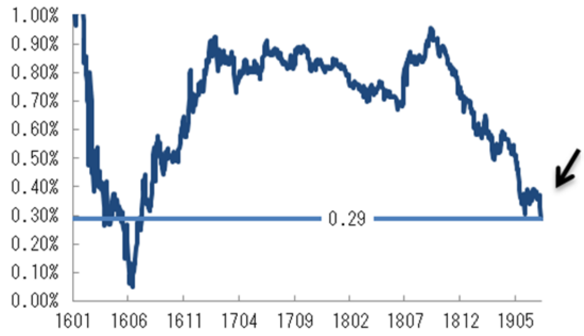
Yesterday, 30-year German and Dutch yields fell to negative territory. This has prevented investors from gaining positive yields from euro-denominated safety assets, even when extending durations. In Europe, the 30-year Swiss yield has already been in deeply negative territory, but yields of safety assets denominated in the quasi key currency the euro fell below zero for the first time. Yield curve comparison with these European nations shows that yield levels in Japan are surprisingly high relative to those in Switzerland and Germany. Of course, the yield level should vary from currency to currency. However, if superlong JGBs are fully hedged and converted to the euro, the yield after the conversion can be calculated at 0.76% for 20-year JGBs (+97bp vs. German gov't bonds) and 0.96% for 30-year JGBs (+97bp vs. German gov't bonds). Although the 30-year JGB yield fell into the 0.2% level yesterday, the JGB yield level still appears to be high.

Chart: Euro-denominated JGB Yields and Yield Curve in Japan, Germany, and Switzerland



Source: Bloomberg; compiled by Daiwa Securities.

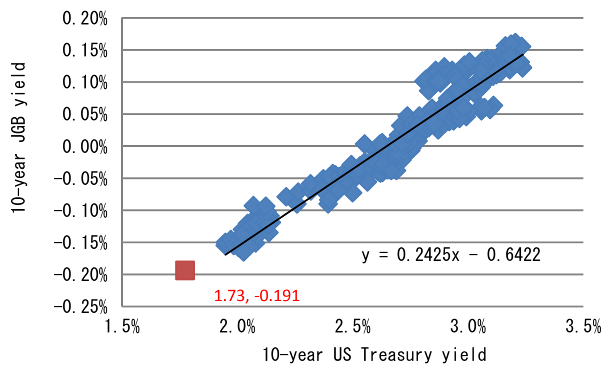
Chart: 30-year JGB Yield



Source::Bloomberg; compiled by Daiwa Securities.

The JGB market is also facing a test. Yesterday, after the 10-year JGB yield touched on –0.20% at one point, it rebounded slightly due to caution about higher prices. However, the 10-year US yield fell below 1.75% overnight, suggesting that the 10-year JGB yield will also decline in Tokyo time. When the BOJ widened its operational range for the long-term interest rate under the yield curve control (YCC) policy in July 2018, it described it as "around double" that of the previous range. Therefore, the central bank is unlikely to regard –0.20% as a strict floor for the fluctuation band, with respect to the downside where easing effect is especially strong. On the other hand, even if we interpret the expression "around double" in a broad way, continuation of a level below –0.25% would make YCC less convincing. Either way, the upside of 10-year JGBs is limited. At the current level, profit-taking appears to be appropriate. However, the outlook is grim as we do not know how far this risk-off pendulum will swing. It would be worth considering switching out from 10-year JGBs approaching the lower end of the fluctuation band to the superlong zone (such as 20-year and 30-year JGBs), given the large scope for yield declines. As the 20-year/30-year curve appears slightly undervalued at the current level, today's 30-year JGB auction may provide a good opportunity.

Chart: 10-year US Treasury Yield and 10-year JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Chart: 10-year/20-year JGB Spread and 20-year/30-year JGB Spread

Source: Bloomberg; compiled by Daiwa Securities.

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Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

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Registered Credit Rating Agencies are subject to the following regulations:
1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

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■ Credit Rating Agencies

[Standard & Poor's]

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The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings are Moody's Investors Service's ("MIS") current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. MIS defines credit risk as the risk that an entity may not meet its contractual, financial obligations as they come due and any estimated financial loss in the event of default. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk, or price volatility. Credit ratings do not constitute investment or financial advice, and credit ratings are not recommendations to purchase, sell, or hold particular securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information, is given or made by MIS in any form or manner whatsoever.

Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.co.jp/web/)

Assumptions, Significance and Limitations of Credit Ratings

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

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 (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.

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