

Daiwa's View

Excessive cheapness will not continue

- Converging to global balance

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.

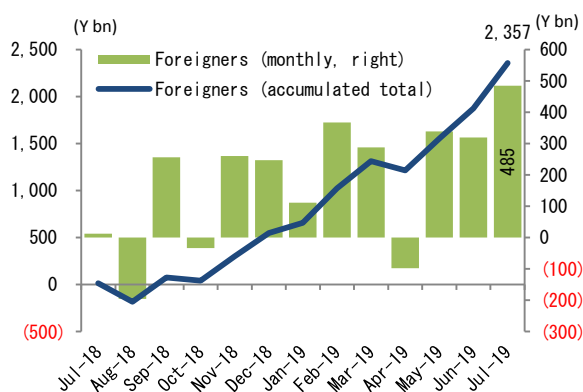
Converging to global balance

Excessive cheapness will not continue

It is apparent that overly cheap products are being bought. One focal point in the market was how far/how long JGBs will be undervalued after the BOJ put the brakes on the yield downtrend last Friday by cutting the offer amount in its JGB purchase operation. Due to yesterday's favorable performance of 20-year JGBs and the subsequent yield declines, the series of moves for further undervaluation appear to have paused.

As it has become that much harder to find products to invest in, foreign investors seem to be focusing on the cheapness of JGBs. According to data for the trading volume of public/corporate bonds announced by the Japan Securities Dealers Association on 20 August, foreigners' net investment in superlong JGBs in July 2019 expanded to Y484.7bn, the largest amount since November 2014. Accumulated net purchases over the 12 months came in at around Y2.3tn.

Chart: Foreigners' Investment In Superlong JGBs



Source: Bloomberg; compiled by Daiwa Securities.

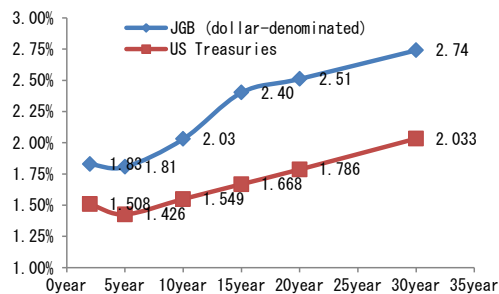
Chart: JGB Trading Volume by Foreigners (Y bn)

| | Superlong JGBs | | | Long-term JGBs | | | Intermediate JGBs | | |
|--------|----------------|---------|-------|----------------|---------|---------|-------------------|---------|---------|
| | Buying | Selling | Net | Buying | Selling | Net | Buying | Selling | Net |
| Nov-18 | 1,292.7 | 1,033.1 | 259.6 | 3,206.8 | 1,734.5 | 1,472.3 | 2,571.7 | 1,421.5 | 1,150.2 |
| Dec-18 | 1,265.4 | 1,018.8 | 246.6 | 3,672.6 | 1,629.4 | 2,043.2 | 3,728.4 | 1,593.9 | 2,134.5 |
| Jan-19 | 1,236.6 | 1,124.2 | 111.4 | 3,250.0 | 2,015.4 | 1,234.6 | 4,029.0 | 2,924.5 | 1,104.5 |
| Feb-19 | 1,631.4 | 1,264.1 | 367.3 | 2,988.2 | 2,110.1 | 878.1 | 3,825.6 | 1,738.7 | 2,086.9 |
| Mar-19 | 1,436.1 | 1,149.0 | 287.1 | 3,661.6 | 3,022.5 | 639.1 | 5,385.7 | 2,834.3 | 2,551.4 |
| Apr-19 | 1,606.4 | 1,704.5 | -98.1 | 3,863.2 | 2,749.4 | 1,113.8 | 4,205.6 | 3,307.9 | 897.7 |
| May-19 | 1,632.2 | 1,293.4 | 338.8 | 2,603.0 | 1,938.9 | 664.1 | 3,130.7 | 1,863.3 | 1,267.4 |
| Jun-19 | 1,689.7 | 1,370.2 | 319.5 | 2,701.7 | 2,563.6 | 138.1 | 3,168.2 | 2,334.9 | 823.3 |
| Jul-19 | 1,672.5 | 1,187.8 | 484.7 | 2,239.6 | 1,980.4 | 259.2 | 4,730.5 | 2,596.6 | 2,134.9 |

Source: Japan Securities Dealers Association; compiled by Daiwa Securities.

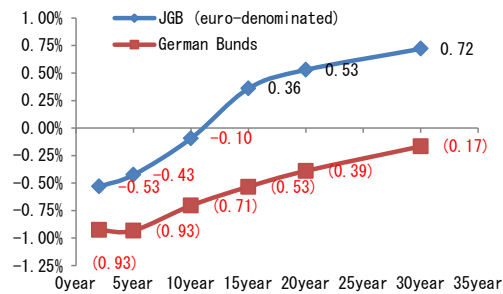
As we have stated, the current yield level of JGBs is relatively high from a global comparison. In particular, the 15- to 20-year zone appears remarkably undervalued. For example, we can say that 20-year JGBs (auction conducted yesterday) are high-yield bonds if we convert all cash flows of 20-year JGBs to foreign currencies, as shown by the dollar-denominated yield of 2.51% (+72.5bp vs. US Treasuries) and the euro-denominated yield of 0.53% (+91.9bp vs. German Bunds). As the yield level of superlong JGBs is high like this, the inflow of funds from overseas investors is natural.

Chart: Dollar-denominated JGB and US Treasury Yields



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Euro-denominated JGB and German Bund Yields



Source: Bloomberg; compiled by Daiwa Securities.

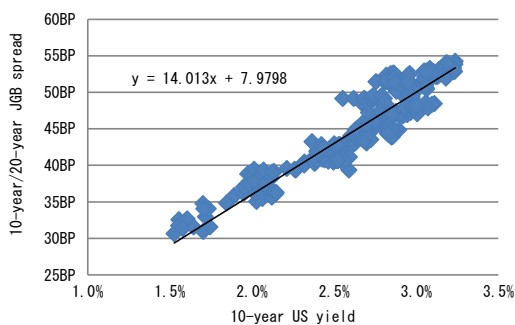
Chart: JGB Yields on Foreign Currency Basis (% , bp)

| | 2-year JGB | 5-year JGB | 10-year JGB | 15-year JGBY | 20-year JGB | 30-year JGB |
|---------------------------|------------|------------|-------------|--------------|-------------|-------------|
| JGB (yen-denominated) | -0.30 | -0.33 | -0.24 | -0.06 | 0.09 | 0.19 |
| JGB (dollar-denominated) | 1.83 | 1.81 | 2.03 | 2.40 | 2.51 | 2.74 |
| JGB (euro-denominated) | -0.53 | -0.43 | -0.10 | 0.36 | 0.53 | 0.72 |
| Spread vs. US Treasuries | 32.0 | 38.0 | 48.0 | 73.3 | 72.5 | 70.7 |
| Spread vs. German Bunds | 39.5 | 50.6 | 61.0 | 89.3 | 91.9 | 88.7 |
| Yen/dollar currency basis | 45.2 | 59.3 | 75.5 | 85.6 | 92.8 | 107.2 |
| Yen/euro currency basis | 17.9 | 26.2 | 34.8 | 40.6 | 46.8 | 55.6 |

Source: Bloomberg; compiled by Daiwa Securities.

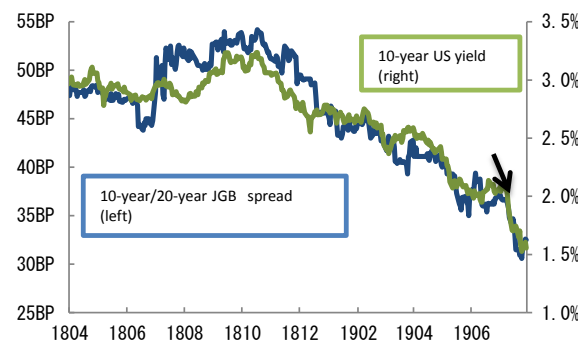
Although it is obvious to check the figures on a foreign currency-denominated basis, a simple comparison with US Treasuries also confirmed the cheapness of JGBs. Yesterday, the 10-year/20-year JGB yield spread widened to as much as 34bp before the 20-year JGB auction. The correction proceeded to a level that is unlikely to be sustained unless the 10-year US Treasury yield is projected to stay above 2% (due to post-auction rally, spread narrowed to around 33bp). As expressed by Adam Smith's "Invisible hand," excessive cheapness beyond the global balance will not continue. It is important to buy solidly on small dips.

Chart: 10-year US Yield and 10-year/20-year JGB Spread (scatter plot)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: 10-year US Yield and 10-year/20-year JGB Spread



Source: Bloomberg; compiled by Daiwa Securities.

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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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- 2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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[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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