Daiwa Securities

Daiwa's View

Non-JGBs also entered era of issuance at negative yields

➢ Shattering of "glass floor"

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Daiwa Securities Co. Ltd.

Non-JGBs also entered era of issuance at negative yields

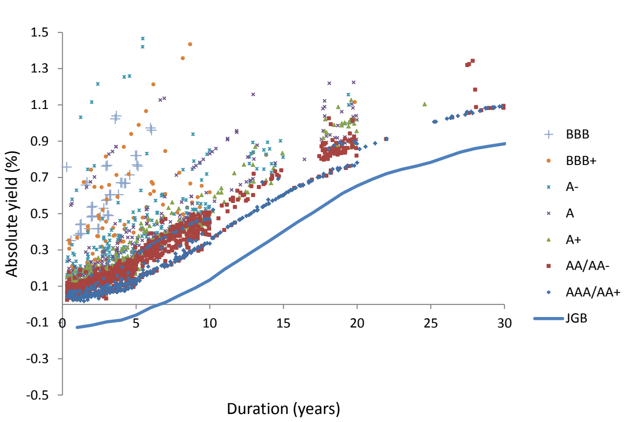
Shattering of "glass floor"

It appears that yen-denominated non-JGBs will be newly issued at negative yields for the first time[1]. The Japan Student Services Organization (JASSO), an independent administrative agency, (AAA rated by JCR) seems to have decided the terms/conditions of its 2-year social bonds worth Y30bn as follows: coupon of 0.001% and face value of Y100.003 (yield of around –0.0005%). If this is realized, Japan will also finally enter a phase in which the issuance of negative yielding non-JGBs will be diffused[2].

As overseas investors (having foreign currencies) are able to gain high yields from currency-hedged JGBs, JGBs are attracting demand from a wide range of investors even at negative yields. On the other hand, the lower end of the yield level of non-JGBs, most of which are held by Japanese investors, had been formed at 0%, the so-called "glass floor." The level is almost equal to the deposit interest rate level.

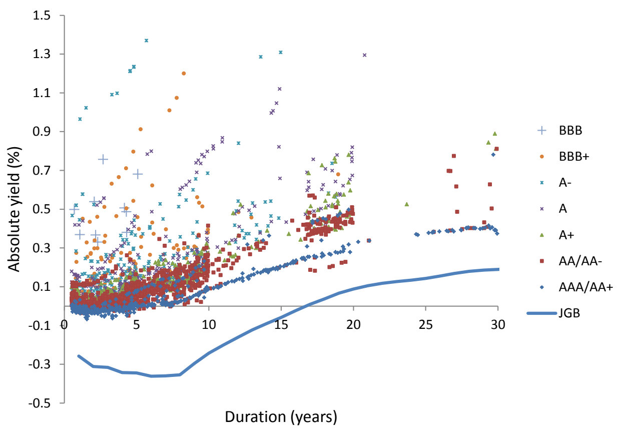
However, as yields in other regions have declined due to global monetary easing, we have observed a wider divergence between JGB yields, which have moved in line with global trends, and high-rated non-JGB yields, whose lower end has been stopped by the glass floor (right-hand chart below). Market participants had regarded the shattering of the glass floor as a matter of time, but it appears to have come earlier than expected.

Chart: Yields of Yen-denominated Bonds (as of end-Sep 2018)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Yields of Yen-denominated Bonds (as of 22 Aug 2019)



Source: Bloomberg; compiled by Daiwa Securities.

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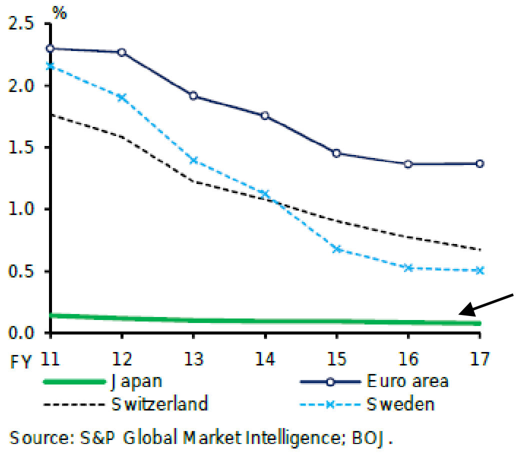
[1] Reported by several leading information vendors.
[2] In Europe, issuance of negative-yielding non-gov't bonds is not rare (e.g., Sanofi of France, Deutsche Bahn of Germany, Henkel of Germany).

As witnessed by yesterday's drop of the 2-year JGB yield to –0.31% , the lowest level since July 2016, market demand for safe assets in the short-term/intermediate zone is obviously strong. In the market-oriented economy, prices are determined by the supply/demand balance. If spreads vs. JGBs overly widen, demand from both domestic and overseas investors would eventually shift to non-JGBs. Therefore, the appearance of negative-yielding non-JGBs is inevitable.

Meanwhile, the fundraising cost at depository institutions has been hovering at around 0% even after the introduction of the negative yield policy (left-hand chart below). Accordingly, the launch of negative-yielding non-JGBs, symbolized by the JASSO case, would trigger further squeezing of earnings from fund management at financial institutions. This would accelerate yield-hunting activities to seek positive yields, putting flattening pressure on the yield curve.

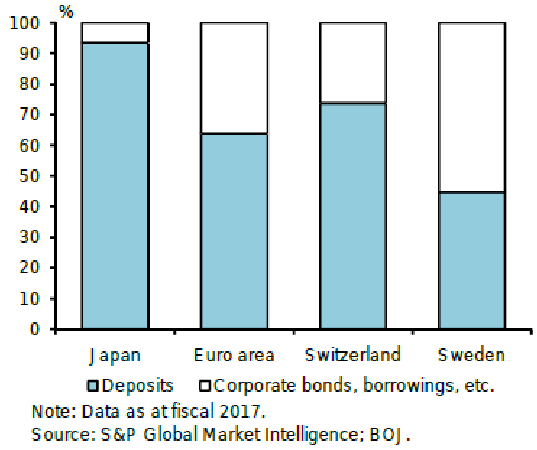
Of course, excessive flattening is likely to worsen the side effects from the monetary easing policy. In thinking of the future monetary policy operations as well, the JASSO case has become an epoch-making event.

Chart: Yields on Financial Liabilities



Source: BOJ's Financial System Report*; compiled by Daiwa Securities*

Chart: Breakdown of Financial Liabilities



Source: Extract from BOJ's Financial System Report.

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.

■ The Significance of Registration

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).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
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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Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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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)

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 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)

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 "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

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

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This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of May 13th, 2016, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Fitch Rating Japan Limited (https://www.fitchratings.co.jp/web/)

May 2018

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