

Daiwa's View

Forward rates factoring in substantial rate cuts

- If BOJ intends to deepen negative rates at Sep MPM, important newsflow may emerge soon

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Daiwa Securities Co. Ltd.

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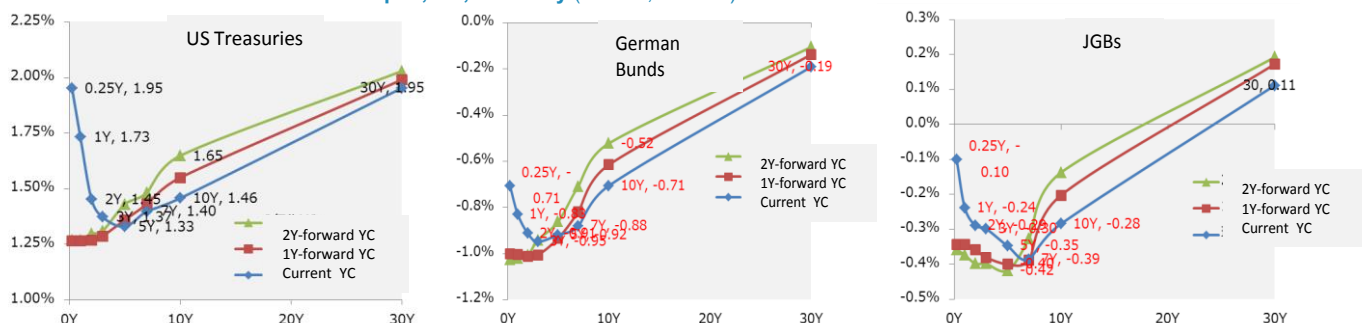
Forward rates factoring in substantial rate cuts

Yesterday, it turned out that the US ISM manufacturing index in August declined to 49.1, the lowest level in about three years, or since January 2016. The reading showed that part of US economic activities is contracting. Thus far, some had pointed out the lack of need for rate cuts, given the US economic condition. However, the ISM index at below 50 is critical, meaning that the market was correct as it had warned against a start of recession without rate cuts. We thus can say that the data reconfirmed the importance of humbly listening to the market's voice.

When the rational expectation theory is established, forward interest rates show undistorted projections for future interest rate levels¹. Forward rates are used when we observe the shape of the future yield curve, which is factored in by the current market. As shown in the charts below, we can find a common point in Japan, the US, and Europe that the current market is factoring in substantial rate cuts.

A major difference is that the yield curve in Europe and the US will no longer be inverted in around one year, but the yield curve in Japan will be inverted even in two years, as if the market is warning against the possibility that rate cuts in Japan will remain insufficient compared to those in Europe and the US. This can be simply interpreted as the appearance of distorted supply/demand conditions for JGBs due to the yield curve control (YCC) policy. However, if the YCC policy is preventing perception of the market's voice, this would be one of the hidden adverse effects of the policy.

Chart: Yield Curve of Gov't Bonds in Japan, US, Germany (current, forward)



Source: Bloomberg; compiled by Daiwa Securities.

¹ Of course, it is empirically proven that forward interest rates do not completely match projected rates. Divergence estimated by model is "term premium."

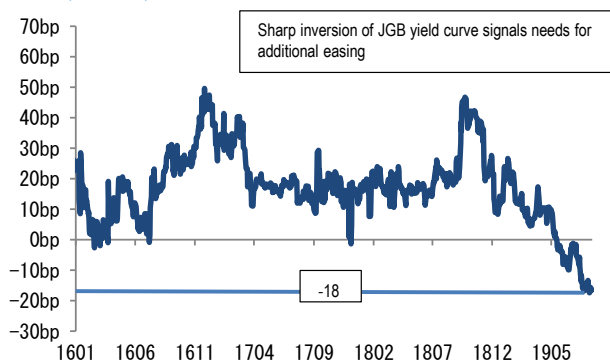
As one requirement for the successful reduction in negative interest rates is diligent advance preparations, the BOJ will make no surprising moves in revising the negative interest rate policy. In that sense, media reports and messages from the BOJ are currently quite important.

Looking back at media reports at the time of the widening of the operational range under the YCC policy on 31 July 2018, *Asahi Shimbun* published an article on 27 June 2018 entitled "It is difficult to easily achieve the 2% price target; BOJ deputy governor Masayoshi Amamiya implied policy revision in future". A follow-up article came out on 20 July—"BOJ considering flexible target for long-term interest rate; acceptance of certain degree of rise to be discussed at July meeting." The market then completely factored in a policy revision.

This time around, the article "BOJ to conduct two-step easing; decline in long-term rate to be accepted first and measures to address side effects to be conducted in case of additional easing" appeared on 27 August. If the BOJ intends to make an important policy revision at the monetary policy meeting (MPM) on 18-19 September, related media reports are expected to come out within several days.

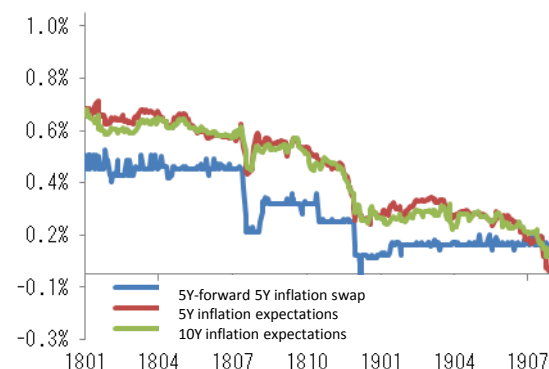
From this viewpoint as well, we need to be attentive to today's greeting remarks by BOJ governor Haruhiko Kuroda at the FIN/SUM 2019—even more so as speculation on the Fed's rate cuts is growing due to the ISM index falling below 50, alongside appreciation of the dollar to this level. In today's remarks, he may not send an important message on monetary policy. Moreover, if we assume a time frame until the MPM on 30-31 October, it can be said that the central bank still has time on its side. However, the market cannot avoid a deepening sense of urgency, in our view.

Chart: Differential Between Short-term and Long-term JGB Yields (10Y-3M)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Inflation Indicators in Japan



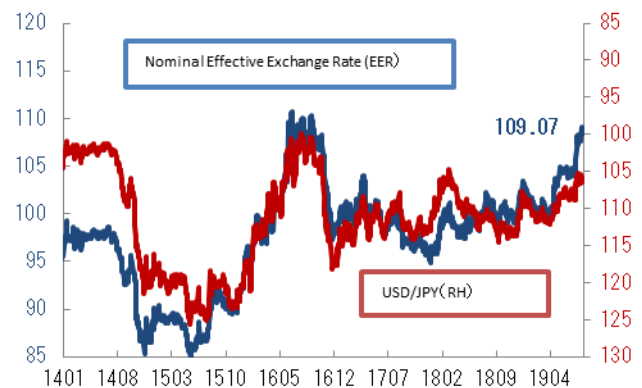
Source: Bloomberg; compiled by Daiwa Securities.

Chart: Dollar Index (DXY)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: USD/JPY and Yen's Nominal Effective Exchange Rate



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

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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.

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
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