

Daiwa's View

Green shoot

- Points of reference for rebound of 10-year and 20-year JGBs estimated at -0.2% and 0.1%

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Daiwa Securities Co. Ltd.

Points of reference for rebound of 10-year and 20-year JGBs estimated at -0.2% and 0.1%

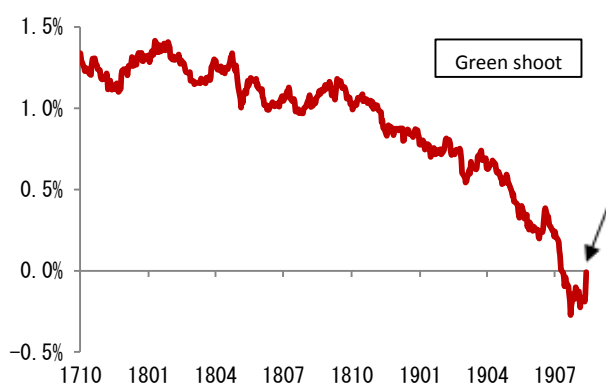
Green shoot

As expected, "signs of risk-on mood," which have been seen since last week, appear to have been correct. Yesterday, we saw a rally in global stock markets alongside about a 10bp upward shift in the entire US Treasury yield curve. While 2-year German Schatz yield rose by only 2bp, the 30-year German government bond yield rose by as much as 14bp, leading to sharp bull steepening. We can say that yesterday's market was clearly in risk-on mood.

During the downtrend thus far, few people have pointed out the confusion in Hong Kong as a cause. Nevertheless, many media reports in the Asian market yesterday regarded eased tension in Hong Kong as one reason for the stock rally. As shown by this contradiction, we attribute the rise in stock prices/yields largely to the easing of fears brought to panic level, rather than to any concrete market factors. If so, this is an important initial signal that should be called a "green shoot."

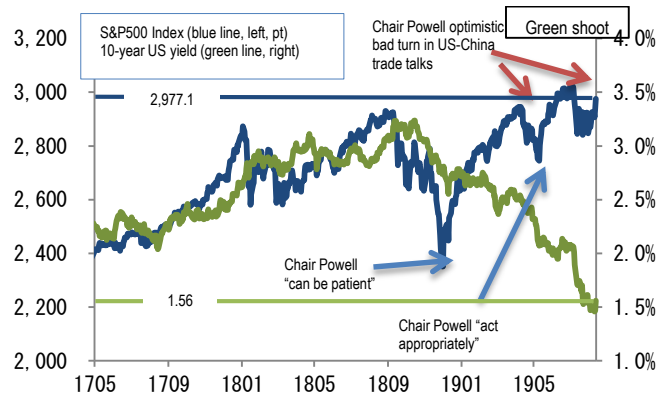
This is because the past patterns show the momentum of the market's swinging back strengthened in proportion to the degree of initial swing, like a pendulum. Although I will not repeat details, market sentiment has recently been at panic levels. If such market sentiment starts to swing back, record highs in US stock prices are in sight and such a move would provide a long-awaited dip-buying opportunity in the bond market.

Chart: 30-year German Government Bond Yield



Source: Bloomberg; compiled by Daiwa Securities.

Chart: US Stock Price and Long-term Interest Rate



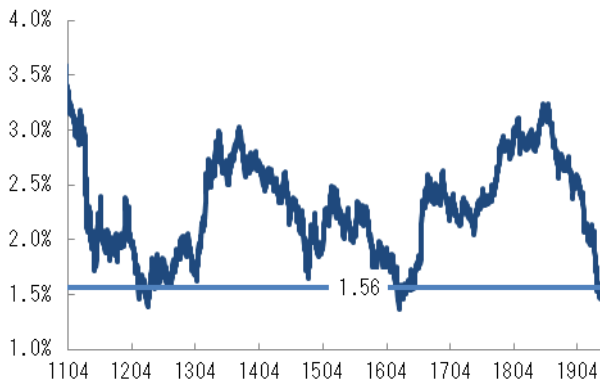
Source: Bloomberg; compiled by Daiwa Securities.

That being said, yields are unlikely to rise as high as a rebound of stock prices would suggest. This is because recent yield declines have been led by muted inflation expectations, the decline in the natural rate of interest, and additional easing by central banks. We cannot expect yields to return to past levels. Yields are expected to rebound to only slightly above the theoretical median.

If we assume that (1) the effective federal funds rate declines to 1.4% in the future due to four rate cuts by the Fed in total (three more quarter-point cuts) and (2) at that time, the inversion of the yield curve will vanish, a near-term appropriate median of the 10-year US interest rate is estimated at 1.5-1.6% (if outlook for total no. of rate cuts changes due to unpredictable de-escalation of US-China trade tension, this level may change).

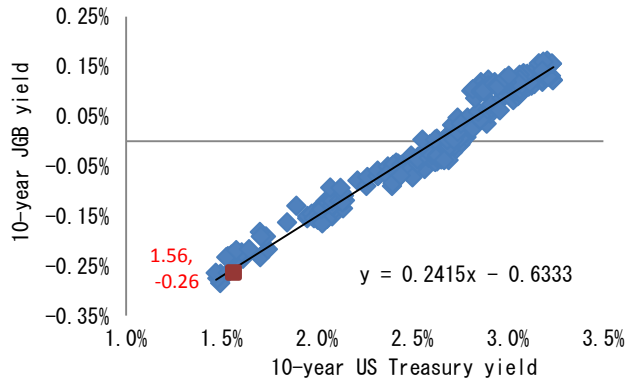
It is difficult to accurately project the degree of fluctuation of market sentiment. However, if we factor in a swinging back of panicked market sentiment, the US long-term interest rate is expected to rise to the 1.7% level in the current dip-buying opportunity. Based on the past relationship between the US and Japanese rates, the 10-year and 20-year JGB yields corresponding to the current US rate level are calculated at around -0.2% and 0.1%, respectively. In the current rebound phase, we intend to check whether additional factors will emerge, regarding these levels as points of reference.

Chart: 10-year US Treasury Yield



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Long-term Interest Yields in Japan and US



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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The Financial Futures Association of Japan
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