

Daiwa's View

Moving to new Goldilocks market

- JGB market expected to become jittery, reflecting Governor Kuroda interview

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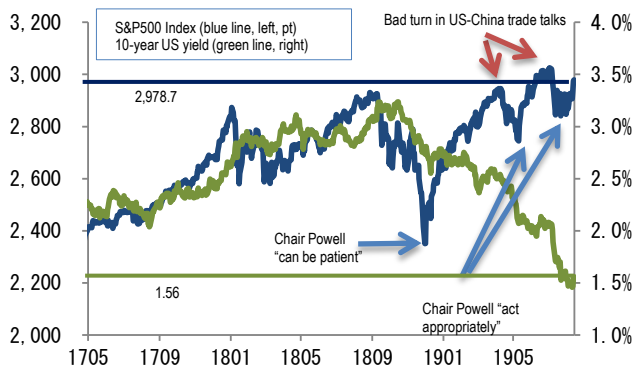
JGB market expected to become jittery, reflecting Governor Kuroda interview

Moving to new Goldilocks market

The stronger-than-expected non-manufacturing ISM index (announced 5 Sep) and the weaker-than-expected US jobs report (6 Sep) led to a rise in US stocks and tightening of corporate bond spreads. Generally speaking, the interpretation of these market reactions can be explained as the former being a positive reaction to a strong US economy and the latter reflecting increasing expectations for rate cuts due to concerns about the US economy. However, they contradict each other, and both factor in only the 'positive effects' of events.

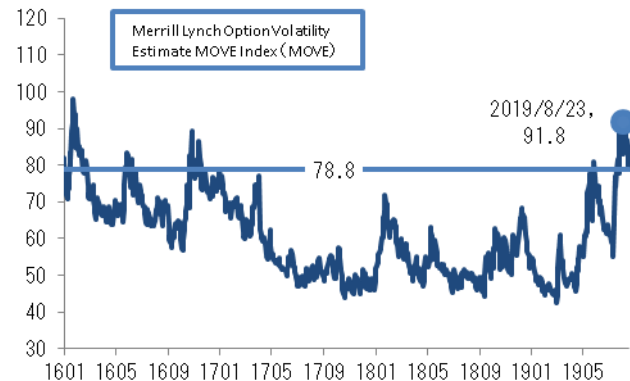
As the MOVE index shows (right-hand chart below), the market is increasingly factoring in 'positive effects' compared to before, breaking free of a panicked mindset in which the market tends to pay attention to 'negative effects.' If improvement in the US-China trade issue, rather than US economic indicators, were taken as a factor, the aforementioned market reactions would be a swing back from a pessimistic view about the US-China issue. Investors are becoming used to hearing negative information, but if they start to pay attention to the positive effects of monetary easing being strengthened in Japan, the US, and Europe, there could be a return to a Goldilocks market.

Chart: US Stock Price and Long-term Interest Rate



Source: Bloomberg; compiled by Daiwa Securities.

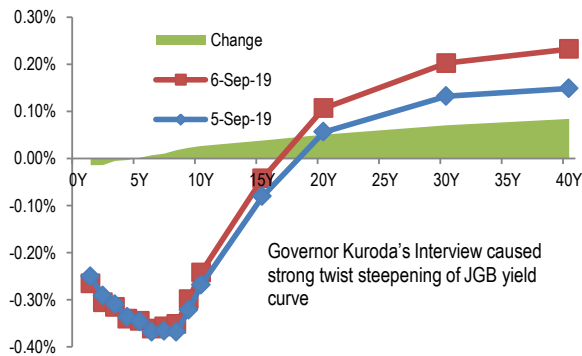
Chart: MOVE Index



Source: Bloomberg; compiled by Daiwa Securities.

With regard to monetary easing, our projection was correct that, "If the BOJ intends to deepen negative rates at September's monetary policy meeting (MPM), important news may emerge soon." Reflecting Nikkei's 6 September article on an interview with BOJ governor Haruhiko Kuroda, the JGB market posted an extraordinarily major action.

Specifically, yields declined slightly in the short-term zone, while superlong yields surged, leading to sharp twist steepening of the yield curve (left-hand chart below). In the interview, Governor Kuroda clearly stated that (1) lowering interest rates further into the negative zone was an option, showing (2) a flexible stance regarding the operational range under the YCC policy, and (3) expressed concerns about an excessive decline in superlong yields. The market reacted to (1) and (3) in a straightforward manner.

Chart: Change in JGB Yields (5 Sep vs. 6 Sep)


Source: Bloomberg; compiled by Daiwa Securities.

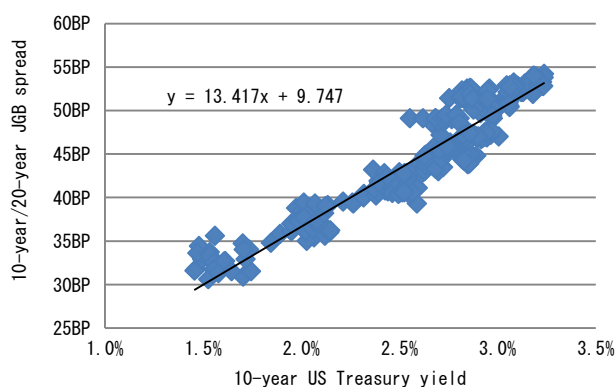
Chart: Contents of BOJ Governor Kuroda's Interview

- Cutting interest rates further into negative territory is always an option among four options
- If market functions are flexible, it may be unnecessary to forcefully control yield curve
- Yield curve control of around 0% would become meaningless without a limit
- Superlong JGB yields have fallen a bit too far
- Returns for life insurers and pension funds have fallen significantly, which could hurt consumer sentiment
- BOJ will naturally adjust amount and timing in superlong JGB purchase operations if needed

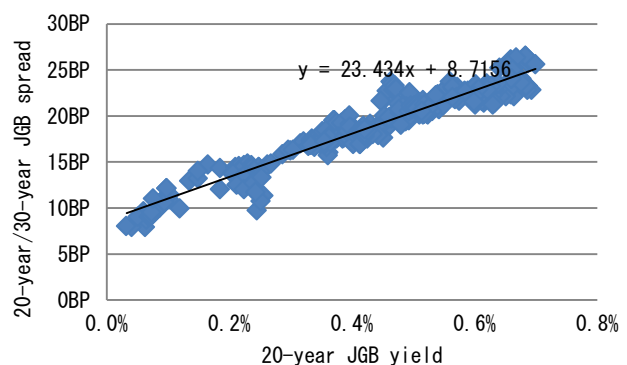
Source: Extract from Bloomberg and Nikkei.

The governor's remark that lowering interest rates further into the negative zone was an option is not surprising. However, we must not downplay the significance of the governor explicitly reconfirming an obvious policy option at this time, ahead of the MPM on 18-19 September. It would be difficult to take aggressive action until the market clears its doubts about the new shape of the yield curve.

Nevertheless, Japan-specific factors are unlikely to continue to push up JGB yields. This is because JGBs are expected to eventually converge with the global balance. Due to panicked yield rises at the end of last week, the 10-year/20-year JGB spread has diverged from the past balanced level. As we always observe distortions when the market is volatile, we may see various chances in the market for the time being.

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


Source: Bloomberg; compiled by Daiwa Securities.

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


Source: Bloomberg; compiled by Daiwa Securities.

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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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■ 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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Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108

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