Daiwa's View

Simultaneous rise in stock prices and yields unlikely to continue

➢ Yield rises appear to be in final phase

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Daiwa Securities Co. Ltd.

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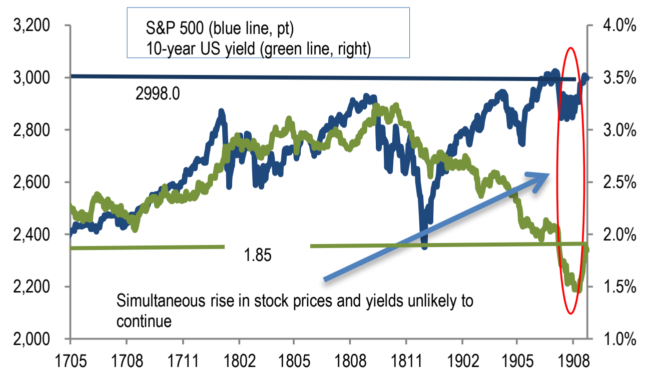
According to *Mastering the Market Cycle* by Howard Marks, when prices (and risk) are at the bottom, investors who have been hit by the declines thus far tend to intensify their risk-avoidance stance and stay on the sidelines.

When I wrote the report *Signs of risk-on* on 27 August, few market participants pointed out the possibility of a rise in stock prices/yields. Since the beginning of September, the situation has turned over. Amid the rise in the Nikkei Stock Average for nine consecutive business days, few pointed out the possibility of a decline in stock prices/yields. As the sharp yield increases and continued rise in stock prices showed the reversal of the pessimism thus far, such a move appears to have been the result of a rapid swing of the pendulum. We think that the current yield rises are in the final phase due to the following reasons:

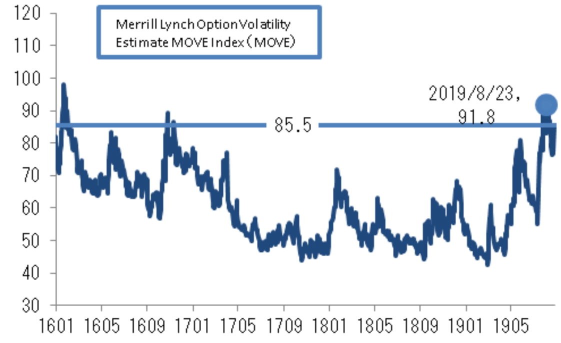
(1) The basic trend in 2019 is the yield decline plus the rise in stock prices. This reflects the fact that the Fed is currently in a rate-cut stage. The current rise in yields/stock prices since the beginning of September is not a sustainable scenario under the Fed's rate cut stage;
(2) The longer-run federal funds rate is currently projected at 2.5%. Going forward, the figure is expected to remain flat or decline slightly. Due to the rise in yields at the end of last week (30-year yield climbed to 2.37% at one point), corrections appear to have proceeded reasonably (or somewhat excessively);
(3) As a result of the sharp rise in yields, the US real interest rate rose by around 30bp compared to two weeks ago. The price of investment-grade corporate bonds declined by around Y3.5. The MOVE Index (shows interest rate volatility) climbed to 85.5, close to its highest level recorded in September 2016, owing to the resurgence of panic. If the real interest rate continues to rise sharply going forward, such a move would lead to an economic slowdown. However, this is an undesirable circumstance for both the Fed and President Donald Trump.

Chart: US Stock Price and Long-term Interest Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart: MOVE Index



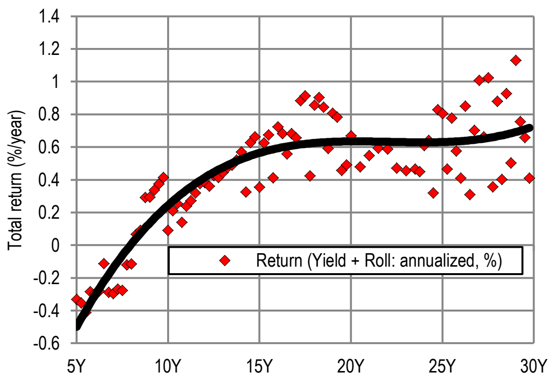
Source: Bloomberg; compiled by Daiwa Securities.

Of course, market sentiment is the most important factor over the short term. If sellers get panicked and buyers conservatively require high margins, yields would climb. This shows the situation implied by Howard Marks' observation at the outset of this report. However, if we look at the market calmly (difficult to do in time of panic), we can now find a lot of reasons for the doubt about continued yield rises.

Regarding JGBs, if the 20-year yield rises to the 0.2% level, Japanese investors would easily find reasons to buy in terms of their viewpoint, instead of overseas investors, who were the major buyers thus far. The annualized total return (carry + rolldown) has risen to the 0.6% level[1], which can cover costs at regional financial institutions (left-hand chart below). In addition, the absolute yield level of 20-year JGBs (0.2% level) is reasonable for co-operative financial institutions in comparison with their deposit interest rates (currently lower 0.1% range). Moreover, a large amount of JGBs are to be redeemed on 20 September. If yields stay at this level for another week, a relatively large amount of JGBs are expected to be purchased. Furthermore, currency hedge costs are expected to worsen substantially around 27 September due to the regular need to secure dollar funds at the end of the year. As this leads to purchases by overseas investors, a decline in yields in the short- term zone appears almost certain.

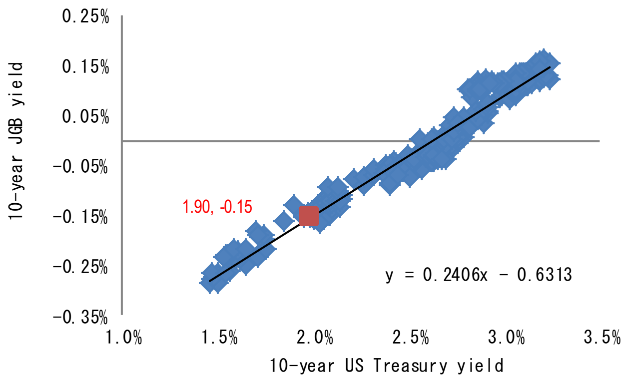
Under the assumption of the 10-year US Treasury yield of 1.9%, the 10-year JGB yield is currently at around the fair value. Yields in the 10- to 30-year zone thus show no signs of overvaluation. Assuming that the current yield rises are in the final phase, we intend to continue to probe buying and consider the timing of full-fledged buying to grasp the peak of the current yield uptrend, which is expected to come within two weeks.

Chart: JGB Total Return (carry & rolling)



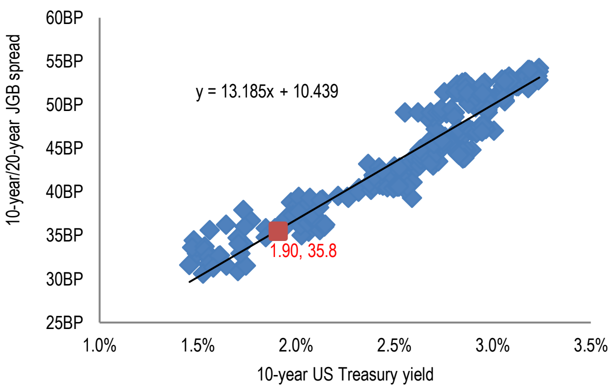
Source: Bloomberg; compiled by Daiwa Securities.

Chart: 10-year US Treasury and JGB Yields



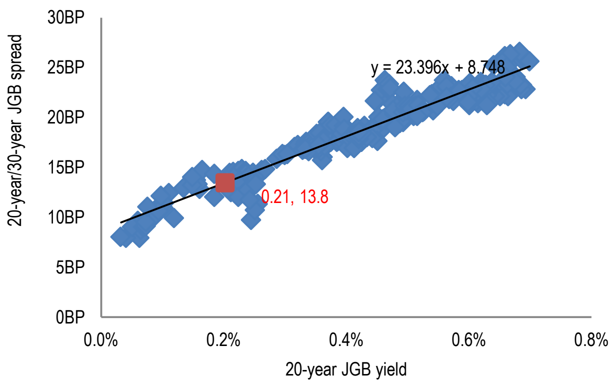
Source: Bloomberg; compiled by Daiwa Securities.

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.

[1] This figure calculated under assumption that current shape of yield curve will continue. As BOJ governor Haruhiko Kuroda recently showed concerns about decline in superlong yields, yield curve unlikely to flatten sharply, which is disadvantageous for rolling return.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

The Name of the Credit Rating Agencies group, etc

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The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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May 2018

IMPORTANT

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.

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The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association