Daiwa Securities

Daiwa's View

Is trimming of offer amounts combined with deepening of negative rates?

- Return lurks in uncomfortable investment, perils in comfortable investment

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Daiwa Securities Co. Ltd.

Is trimming of offer amounts combined with deepening of negative rates?

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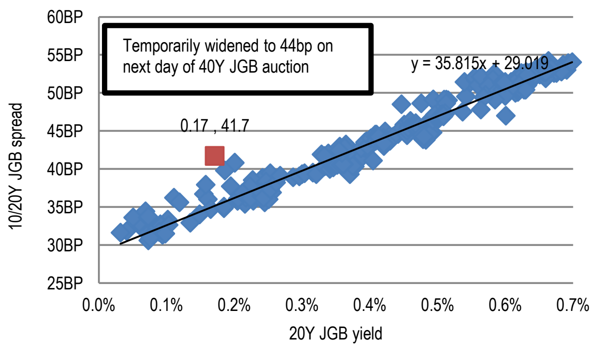
After BOJ governor Haruhiko Kuroda said that superlong JGB yields "have fallen a bit too far, the central bank has been aggressively trimming the offer amounts in its JGB purchase operations. In such a situation, market participants strongly feel that "now is not a good time to buy superlong JGBs."

In fact, the BOJ has been aggressively cutting the offer amounts, strongly showing its intention to steepen the yield curve as a series of measures to address the side effects of monetary policy. We therefore do not know how far superlong JGB yields will rise. It is natural to have the idea of waiting for a pause in the yield uptrend and an opportunity to buy without worry. On 25 September, the 10/20-year JGB spread momentarily widened to 44bp, an unprecedented level given the absolute 20-year JGB yield level (Chart 1).

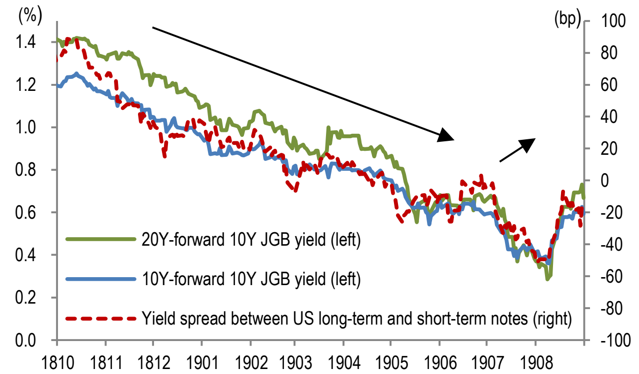
Although we tend to pay strong attention to the Japan-specific factor of JGB purchase operations, the flattening of the JGB yield curve has been in line with global flattening pressure thus far, as witnessed by the strong correlation between 10-year JGB forward yields and the US long-term/short-term yield spread (10-year minus 3-month rate; Chart 2). At end-August, the pause in global flattening pressure was a factor in reversing the JGB yield curve. On top of this, the BOJ (intentionally?) trimmed the offer amounts in JGB purchase operations, which was one reason for the relatively sharp steepening, in our view.

Chart 1: 20Y JGB Yield and 10/20Y JGB Spread



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: 10Y JGB Forward Yields and Yield Spread Between US Long-term and Short-term Notes (10Y-3M)



Source: Bloomberg; compiled by Daiwa Securities.

As usual, we think that the latest trimming by the BOJ was good timing because it cut the offer amounts to steepen the curve when globally excessive flattening pressure lost momentum. The trimming in the reversal phase amplifies the marginal steepening effects per operation. In that sense, the series of recent cuts in the offer amounts is not against the BOJ's YCC target of "maintaining a policy of monetary base expansion." On the contrary, it can be called skillful as a minimum cut enables to create the maximum effects to mitigate the side effects. We think that the intention of recent trimming is in line with the conclusion at the next October Monetary Policy Meeting (MPM) for reexamination of economic and price developments.

If so, it may be possible to read implications regarding the next MPM from the recent trimming, unlike cuts in usual operations. If we see only aggressive cuts in offer amounts and yield rises, they would mean an exit strategy. This conflicts with Mr. Kuroda's remark in his 24 September speech—"Factors that lie behind these decisions (change from normalization trend at overseas major central banks) are the prolonged slowdown in the global economy and heightening uncertainties, which Japan is also facing." We think that the BOJ must lean toward a dovish stance in tandem with overseas central banks.

◆ **Speech by BOJ governor Kuroda (24 Sep 2019)**

・On the other hand, monetary policy conduct of major central banks abroad has changed significantly from last year's moves toward normalization. This month, the European Central Bank (ECB) decided to lower one of its policy rates and restart its asset purchases, and the Federal Reserve also decided to lower its policy rate, following the rate cut in July. Factors that lie behind these decisions are the prolonged slowdown in the global economy and heightening uncertainties, which Japan is also facing.

In this context, current aggressive trimming is expected to exhibit the maximum effects, when combined with parameter adjustments under the YCC framework at the next MPM. The BOJ has now admitted that the first option among YCC parameter adjustments is the deepening of negative rates. The central bank appears to have laid the groundwork for the first option inside the organization, following the outside.

If so, investment in superlong JGBs needs to be evaluated alongside (1) the effects from the flattening due to deepening of negative rates and (2) an increase in the long-term stock effects to be derived from strengthened sustainability of monetary easing, not limited to the effects from trimming. I admit that it is uncomfortable to buy in the midst of trimming by the BOJ. However, there is an opinion that perils lurk in comfortable investment for everyone. We recommend thinking in a flexible way—regarding price declines thus far as evidence of asset undervaluation, rather than a concern for the future.

◆ **The Most Important Thing: Uncommon Sense for the Thoughtful Investor by Howard Mark**

・High-return investment without an uncomfortable feeling is a generally contradictory story. In the end, bargain prices are not set for products that everyone feels good about and wants to buy.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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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.

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