

Daiwa's View

Second day of taper tantrum

- A third day of taper tantrum is unlikely

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Daiwa Securities Co. Ltd.

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Second day of taper tantrum

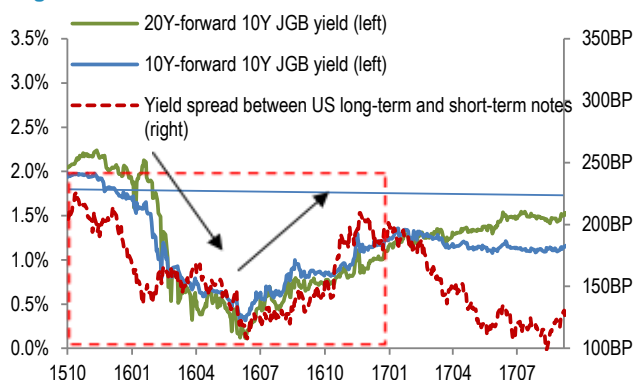
"When other investors are panicked and depressed and can't imagine conditions under which risk would be worth taking, we should turn aggressive." (Howard Marks, *Mastering the Market Cycle*).

The market appears to have been very cautious regarding the JGB purchase operation policy at the BOJ, which has one of the biggest balance sheets of the major central banks. Yesterday, long-term yields rose by 5-7bp worldwide at one point, reflecting the poor result of the 10-year JGB auction. It was a mini taper tantrum—a transmission of a surge in term premiums from Japan to the global bond market.

Due to the large fluctuation, some market participants are concerned about yield increases equivalent to those in 2016. We can, in fact, see some things in common between current movements and those in 2016. However, given the differences between now and 2016, we assume there is a low possibility of a return to the rise in yields that was seen in 2016.

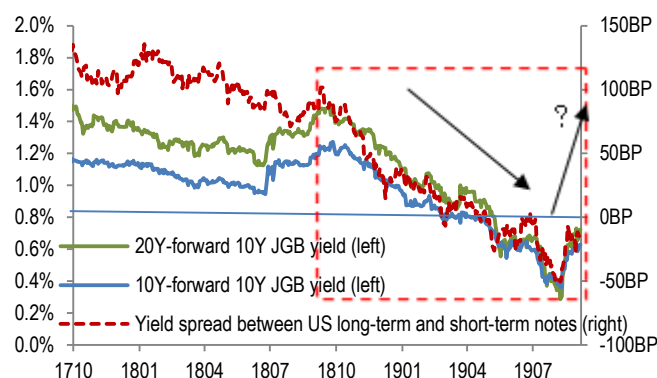
From end-2015 to 2016, the differential between US long-term and short-term interest rates (10-year minus 3-month) flattened substantially. 10-year JGB forward yields also trended down in line with the flattening of US rates. Subsequently, we saw a sharp rebound of JGB yields when excessive flattening reversed. Since the latter half of 2018, the bond market has been moving similarly to 2016. The degree of yield declines is also similar (Charts 1 and 2).

Chart 1: 10Y JGB Forward Yields and Yield Spread Between US Long-term and Short-term Notes



Source: Bloomberg; compiled by Daiwa Securities.

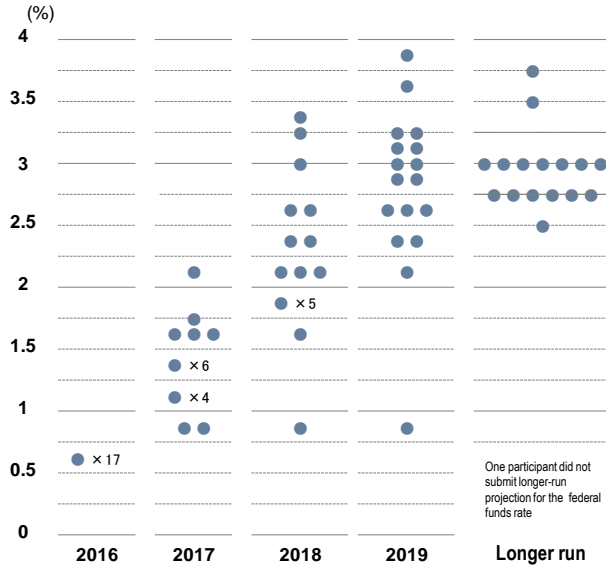
Chart 2: 10Y JGB Forward Yields and Yield Spread Between US Long-term and Short-term Notes



Source: Bloomberg; compiled by Daiwa Securities.

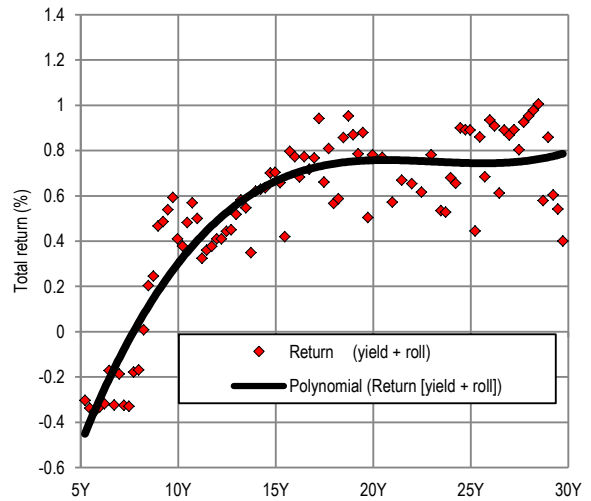
However, there is a major difference between now and 2016—the Fed is in a rate cut cycle now, whereas in 2016 it was in a rate hike cycle. The latest dot chart shows that as many as seven members project another rate cut by the end of the year. However, the dot chart in 2016 was dominated by the projection of a sharp rate hike (Chart 3).

Chart 3: Dot Chart (Dec 2016)



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: JGB Total Return (as of 1 Oct, annualized)



Source: Bloomberg; compiled by Daiwa Securities.

Yesterday, it was announced that the US ISM manufacturing index for September fell to 47.8 (market consensus: 50; August index: 49.1), the lowest level in more than a decade. This raised market expectations for a rate cut, which appears to have again reinforced the impression that the cycle is different. In the current cycle, the inverted yield curve is expected to vanish due to preventive rate cuts. However, it is difficult to imagine a return to the “100bp” steepening that was seen in 2016. This is one reason for the outlook that the current rebound will not be of the same level as in 2016.

Another major difference between now and 2016 is that the JGB yield curve (specifically, the two points of short-term and long-term rates) is being carefully managed by the BOJ's yield curve control (YCC) policy. Yesterday, JGB yields also surged in the 5- to 10-year zone, in addition to superlong yields which have relatively large discretion. However, as the 5- to 10-year zone is within the YCC target, it is obvious to all that the surge cannot continue. In other words, although the term premium of 10-year US Treasury yield surged by 100bp (from -0.70% to 0.30%, ACM model) in 2016, the possibility is low that we will again see a similar surge in the term premiums emanating from Japan under the YCC.

Yields rose for a second straight day in a tantrum manner due to caution regarding the Japan-specific factor of BOJ's JGB purchase operations. However, given the aforementioned conditions, we are unlikely to see a third day of this. Because a sense of caution remains regarding the supply schedule, purchasing is somewhat difficult. However, once yield fluctuations settle down, it will be possible to secure attractive returns of around annualized 0.8% in the 15-year zone and longer zones from the viewpoint of carry & rolldown (Chart 4). It may be necessary to move aggressively now, particularly because other investors are panicked and becoming excessively cautious.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")

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[Fitch]

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- 1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies. As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter's outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.
- 2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Nippon Healthcare Investment Corporation (3308), Japan Rental Housing Investments (8986).
- 3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.
- 4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of ¥10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.
- 5) Daiwa Securities Group and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group is to acquire up to 5.01% of Credit Saison's total common shares outstanding (as of 31 Jul 2019), while Credit Saison is to purchase up to ¥2bn worth of Daiwa Securities Group's common stock.
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- 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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