Daiwa Securities

Daiwa's View

Risk assets continue to send warning

➢ Neither excessive pessimism nor optimism warranted

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Daiwa Securities Co. Ltd.

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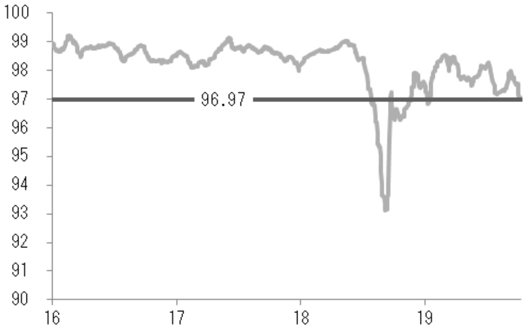
In the overnight US market, optimism about US-China trade talks has diminished in contrast to yesterday's mood. The market was thus somewhat dominated by risk-off sentiment. On top of this, Fed chair Jerome Powell announced that the Fed would technically re-expand its balance sheet, leading to bull steepening of US Treasury yields. As it turned out that the Fed would buy Treasuries mainly in the short-term zone, yields in the 3-month to 2-year zone declined by around 4bp. As the 1-year forward OIS fell by only 2bp, we attribute the bull steepening roughly evenly to (1) expectations for a rate cut in the short-term zone and (2) the news on the balance sheet.

Due to the September US jobs report announced last week, excessive caution about a recession (caused by shockingly weak ISM readings) has diminished. However, risk asset prices continued to send a warning even after the announcement of the jobs data. This shows that the jobs report is not serving as a game changer. The US Leveraged Loan Price Index, useful data in assessing the conditions of the US credit market, has declined to the $96 level. In addition, the USD high-yield corporate bond spread rose to 487bp. These figures are not sentiment indices and have an actual impact on fundraising costs at companies. Therefore, they are important also in checking economic conditions.

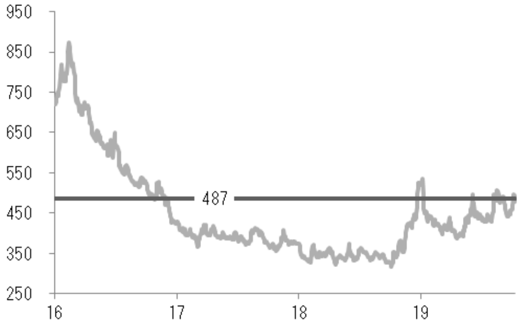
Looking at the OECD's Composite Leading Indicators (CLI) announced in such a situation, we found that the US CLI for August declined to 98.78, falling for 16 months in a row. On the other hand, the CLI in China for August recovered to 98.99, improving for the sixth straight month. Of course, due to a major difference in index components, a simple comparison is not necessarily practical. Given this economic trend, however, it is becoming difficult to say that the US is in an overwhelmingly advantageous position.

Chart 1: US Leveraged Loan 100 Index



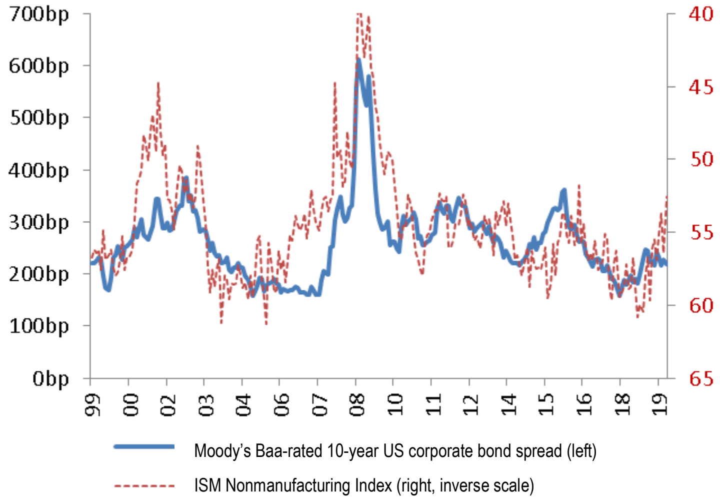
Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: USD High-yield Corporate Bond Spread (bp)



Source: Bloomberg; compiled by Daiwa Securities.

Chart 3: Baa-rated 10-year US Corporate Bond Spread and ISM Nonmanufacturing Index



Source: ISM, Bloomberg; compiled by Daiwa Securities.

As the US ISM indices are highly correlated with the corporate bond spread (Chart 3), we should focus on the news at the beginning of this month that the ISM nonmanufacturing index for September worsened to 52.6. If the index were to worsen further, corporate bond spreads would face substantial correction.

Although a US economic recession has not yet become a main scenario, risk assets are sending a warning. If the Fed postpones a rate cut at the October FOMC meeting amid deterioration of the US-China trade issue, we would be unable to deny the possibility that the economy will be negatively affected by a downward breakout of risk asset prices. Neither excessive pessimism nor optimism is warranted.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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May 2018

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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).

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* 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.
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