Daiwa Securities

Daiwa's View

Is steepening sustainable?

➢ Risk-free risk premium being bought

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Daiwa Securities Co. Ltd.

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Risk-free risk premium being bought

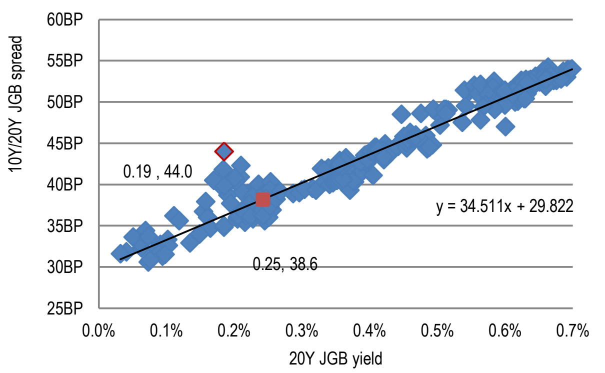
On the day after BOJ governor Haruhiko Kuroda's speech on 24 September, the 40-year JGB auction went poorly amid the confusion of the JGB market. The 10-year/20-year JGB spread thus widened to 44bp at one point. However, since then, we have continued to see a correction in the cheapness. The spread has now tightened to 39bp and recovered to a generally fair level. The background behind the rise in superlong yields from September was basically the rise in 10-year yield level. At the moment, there is no evidence that unusual steepening pressure still exists in the superlong zone.

Generally, yield rises should be formed by inflation expectations that reflect economic fundamentals and a change in the real neutral interest rate. What is the primary meaning of the steepening that is artificially created by operations of bond supply/demand conditions? I wonder whether the steepening will be sustainable.

Here, the rational expectations hypothesis (pure expectations hypothesis) gives us one yardstick. In this hypothesis, expectations are formed by the efficient usage of available information. If this hypothesis is strictly established, the yield curve would on average correspond to the future short-term interest rate and forward rates would accurately forecast the future policy interest rate level.

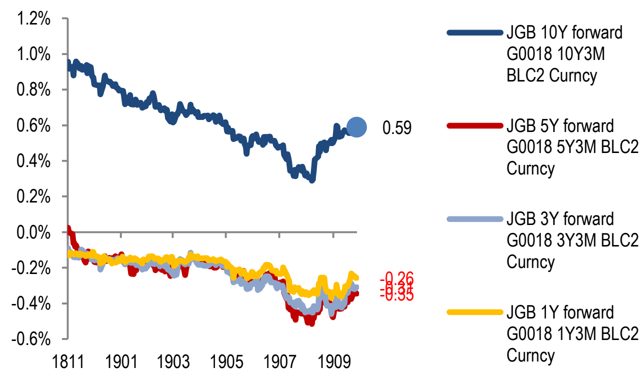
Let's confirm JGB 3-month forward yields in the current JGB market. While the 5-year forward 3-month yield stands at –0.35%, the 10-year forward 3-month yield is at 0.59%. The interpretation of the current forward yield level from the viewpoint of the rational expectations hypothesis suggests that (1) the deep negative interest rate policy will continue over the next five years, (2) an at least 90bp rate hike (in total) will be intermittently implemented over the subsequent five years, and (3) the short-term interest rate will eventually rise close to 0.6% in ten years.

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



Source: Bloomberg; compiled by Daiwa Securities.

Chart: JGB 3M Forward Yields



Source: Bloomberg; compiled by Daiwa Securities.

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Of course, it is difficult to intuitively expect realization of the aforementioned policy rate path. If so, there is divergence between the expected short-term interest rate based on the rational expectations hypothesis and actual interest rate level, meaning that the hypothesis is not established. This divergence is academically called the “term premium,” which is recognized as risk premium—compensation to take long-term risk amid the existence of risks such as a change in the real interest rate and inflation.

Based on the above context, we return to the topic of interest rates in Japan. In a situation where the future inflation expectations and anticipated policy interest rate are unlikely to change, the steepening of the yield curve due to supply/demand operations means that the central bank is artificiality raising the term premium. Under the monetary policy thus far, tightening the risk premium was a policy tool, but expanding the risk premium would become a tool going forward. In other words, the outline is to tighten only the long-term/superlong zone after segmentalizing the market[1].

One problem is whether the term premium in the long-term/superlong zone artificially created by the central bank via operations will be sustained. Since the global financial crisis, the term premium has been on a downtrend globally. We may again see global downward pressure on the term premium partly due to the resumption of QE by the ECB[2].

Looking at the September trading volume by investor type alongside the aforementioned factors, we are forced to be concerned about the prospect that foreigners' purchases of superlong JGBs may serve as a major constraint to the sustainability of the steepening in the superlong zone. According to the Trading Volume of OTC Bonds announced on 21 October, September net purchases of superlong JGBs by foreigners remained at a high level at Y407.9bn. Since the September remark by Mr. Kuroda, JGB yields have risen markedly from a global viewpoint due to rapid tapering by the BOJ. Foreigners (not speculative investors but real-money accounts) regarded it as undervaluation of superlong JGBs, and solidly bought on dips.

Of course, we are unable to make a judgment only by data in September alone. We need to at least confirm the data in October and if possible November after the October reexamination meeting. The September data suggests that, even if the central bank artificially raises the term premium, the premium would be tightened by overseas investors who know the non-existence of actual risk behind the risk premium. As the steepening is effective to address the side effects, the BOJ appears to be serious about steepening the curve. However, we doubt the sustainability at the moment. Our eyes are on whether the BOJ will announce measures to eliminate concerns about the sustainability at next week's reexamination meeting.

Chart: Net JGB Purchases by Foreigners (Y bn)

	Superlong	Long-term	Intermediate
Oct-18	-33.3	351.5	1,370.6
Nov-18	259.6	1,472.3	1,150.2
Dec-18	246.6	2,043.2	2,134.5
Jan-19	111.4	1,234.6	1,104.5
Feb-19	367.3	878.1	2,086.9
Mar-19	287.1	639.1	2,551.4
Apr-19	-98.1	1,113.8	897.7
May-19	338.8	664.1	1,267.4
Jun-19	319.5	138.1	823.3
Jul-19	484.7	259.2	2,134.9
Aug-19	289.9	892.9	-130.4
Sep-19	407.9	488.0	1,134.5

Source: JSDA; compiled by Daiwa Securities.

[1] Risk premium artificially created by operations categorized as not inflation risk premium (risk premium against rapid inflation fluctuations) but term premium for real interest rate (risk premium against surge in real interest rate in future). In fact, inflation expectations have not risen despite rise in 10-year yield. However, real interest rate has risen to highest level over past several years.

[2] If we imagine how Japanese investors will behave when differential between long-term and short-term interest rates in Europe and US steepens due to supply/demand operations by central banks, we can easily envisage that decline in term premium will have borderless impact.

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[Standard & Poor's]

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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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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 Y2bn worth of Daiwa Securities Group's common stock.

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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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