Daiwa's View

Background behind surge in JGB yields

➢ JGB yield curve likely to revert back to normal, lagging Europe and US

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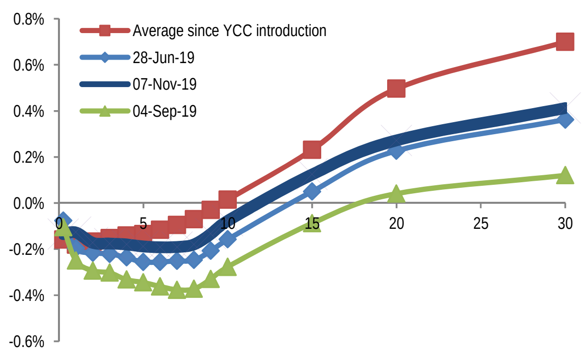
In the JGB market, yields rose remarkably for two consecutive days. Given the historical sensitivity of JGB yields to US Treasury yields (approximately 1: 0.20-0.25 = UST: JGB), the reaction over this two-day period was extraordinary. A particularly marked movement was the trend in the intermediate/long-term zone, where the yield curve had been inverted thus far. The cumulative rise over these two days reached as much as 10bp. Yield curves were no longer inverted in Europe or the US, with only the JGB yield curve remaining inverted, posting a deep bottom in the 7-year sector. This inversion was corrected sharply over this two day period.

On the other hand, the rise in the short-term and superlong zones was relatively curbed compared to the intermediate/long-term zone. As for the short-term zone, the reason is probably just an improvement in risk reward. First, the current level in the short-term zone is appropriate in light of the average since the introduction of the yield curve control (YCC) policy (average yield curve based on yield level since the introduction of YCC). In addition, the BOJ has clarified its downward bias with regard to the short-term interest rate by adding the wording “or lower” in its forward guidance. Therefore, risk reward in the short-term zone improves sharply when the yield level exceeds –0.2%. As long as yields are on an uptrend, we will probably continue to see a tendency for the short-term zone to outperform the intermediate zone.

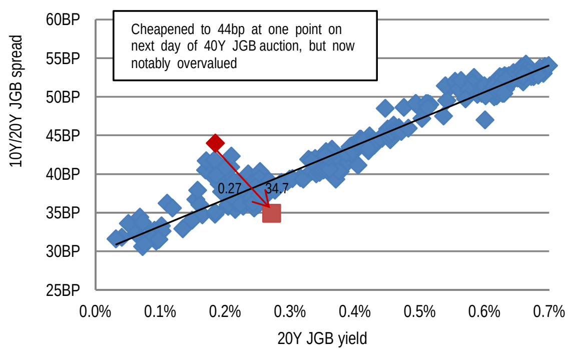
Another point to keep in mind is the overwhelming strength of the superlong zone. After BOJ governor Haruhiko Kuroda stated that superlong yields had “fallen a bit too far” in early September, superlong JGBs were greatly undervalued at one point. However, now we can say that they are overvalued, rather than undervalued, given the current 10-year/20-year spread level vs. the 20-year JGB yield level (Chart 2).

Chart 1: US Treasury Yield Curve



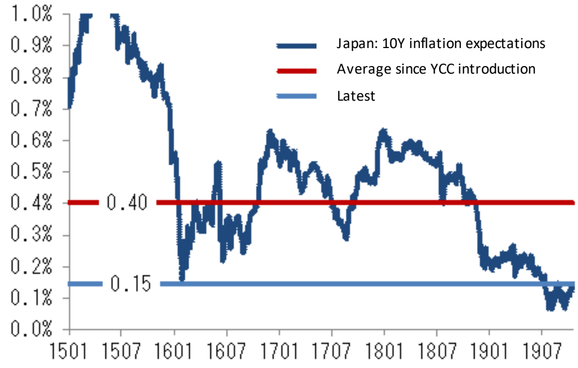
Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: 20Y JGB Yield and 10/20Y Spread



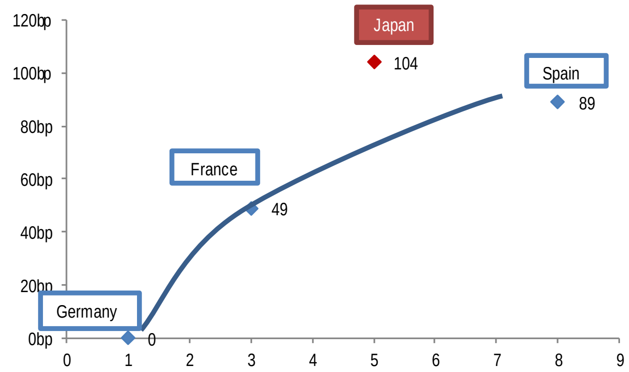
Source: Bloomberg; compiled by Daiwa Securities.

Chart 3: JGB Breakeven Inflation Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: Spread of Euro-denominated 20Y JGBs vs. German Bonds



Source: Bloomberg; compiled by Daiwa Securities.

We can indicate the following three reasons for the outperformance of superlong JGBs.

First is the weakness of the 10-year zone. The rise in the 5-year to 7-year zone was weak while the inverted yield curve was being corrected, and the neighboring 10-year zone appears to have been strongly affected by this weakness. We assume that one reason for the narrowing of the 10-year/20-year spread was undervaluation of the 10-year zone, rather than overvaluation of the superlong zone.

The second reason is weak inflation expectations. Since the introduction of the YCC, bond market participants have had a strong tendency to keep in mind the average nominal interest rate level. For example, the average for the breakeven inflation rate since the YCC introduction is 0.4%, but the rate is now 0.15%, as much as 25bp lower than the past average. Of course, muted inflation expectations are a global trend, but this implies that the basis for a yield uptrend is fragile. The outperformance of superlong JGBs is, in part, factoring in "the lack of inflation," in our view.

The third reason is the cheapness of superlong JGBs from the standpoint of overseas investors. The short-term/intermediate zone has been becoming less undervalued for overseas investors. However, superlong JGBs have remained undervalued and are becoming more undervalued at an accelerated pace. If we convert the current 20-year JGB yield to the fixed yield of the euro, it can stand as high as 0.998% (German Bund + 104bp). This is remarkably attractive even when compared to the French government bond[1] (German Bund + 49bp) and Spanish government bond[2] (German Bund + 89bp). Of course, the outperformance of European government bonds appears to be partially influenced by resumption of QE by the ECB. However, it is very possible that this influence will spread to JGBs due to yield hunting and attempts to cope with the difficulty of fund management by European investors. As long as this perception of cheapness by overseas players is not corrected, it is very possible 20-year JGBs will remain strong on the curve. Even if the BOJ were to cut the offer amounts in the 10-year to 25-year zone in its JGB purchase operations, it probably would not produce a major impact.

[1] FRTR 1 ¾ 06/25/39 Gov't.
[2] Pro-rata basis of SPGB 1.85 07/30/35 Gov't and SPGB 4.9 07/30/40 Gov't.

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[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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