

Daiwa's View

Yields are unlikely to continue to rise without inflation

- Inflation-adjusted real interest rates reached their highest level since introduction of YCC

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Daiwa Securities Co. Ltd.

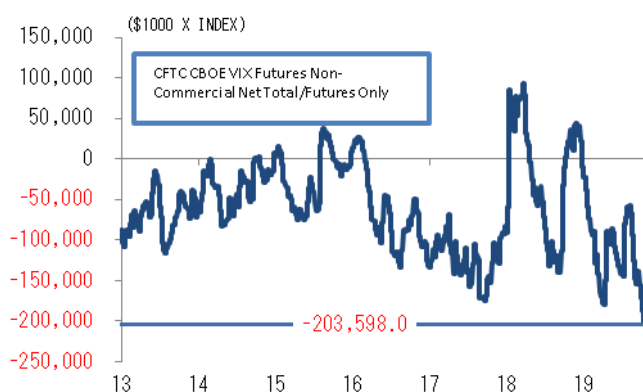
Inflation-adjusted real interest rates reached their highest level since introduction of YCC

Yields are unlikely to continue to rise without inflation

Stock prices are continuing to climb both in Japan and the US. In fact, the improvement in risk sentiment is striking. The North American High Yield CDS Index, a canary in the coal mine, declined to 327bp, a record-low level. Short open interest in options on VIX Futures by speculative investors appears to have reached 203,598 contracts, the highest level since 2013. This also confirms the remarkable improvement in investor sentiment. The increase in the short open interest in October 2017 and October 2018 signaled a subsequent plunge in stock prices. However, the market appears to be more convinced that this time is different.

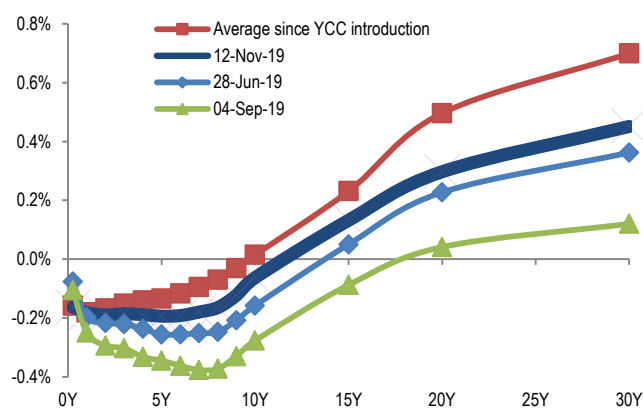
This extreme improvement in investor sentiment seems to be leading to pessimism among bond investors. The price of JGB futures declined to Y152.60, in the same range as December 2018 to May 2019. The absolute yield of the 7-year JGB yield (cheapest: JB345) rose to -0.150% . And with the yield curve as well, the short-term to intermediate zone recovered to the average since the introduction of yield curve control (YCC) policy. The intermediate to long-term zone is also just 4bp lower than the average. Given the fact that the 7-year and 10-year JGB yields were at -0.40% and -0.295% , respectively, just two months ago, we can say that this is a remarkable gain. Presumably, expectations for bottoming-out of fundamentals appear to be strong.

Chart: Short Open Interest of VIX Futures by Speculative Investors



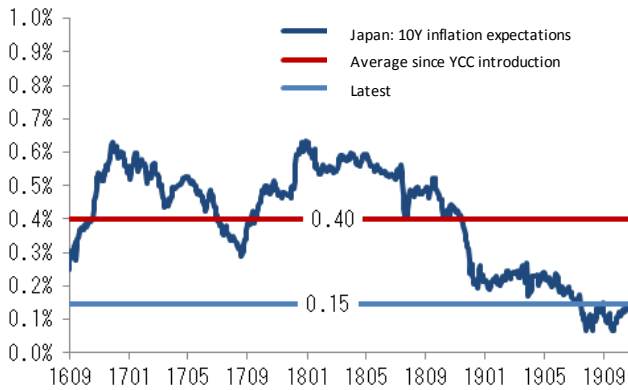
Source: Bloomberg; compiled by Daiwa Securities.

Chart: JGB Yield Curve



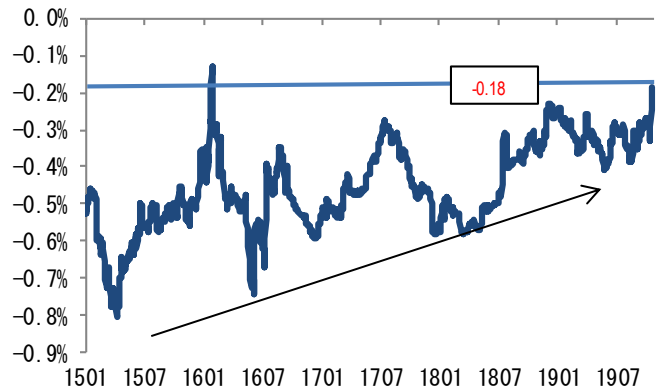
Source: Bloomberg; compiled by Daiwa Securities.

Chart: 10Y JGB Breakeven Inflation Rate (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

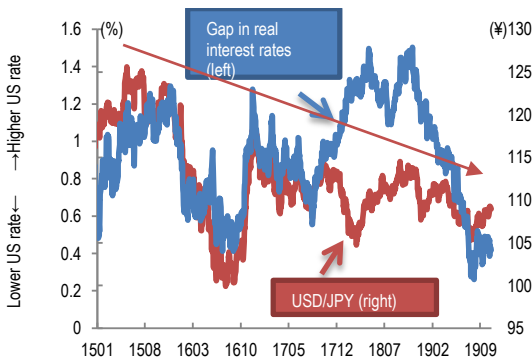
Chart: 10Y JGB Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

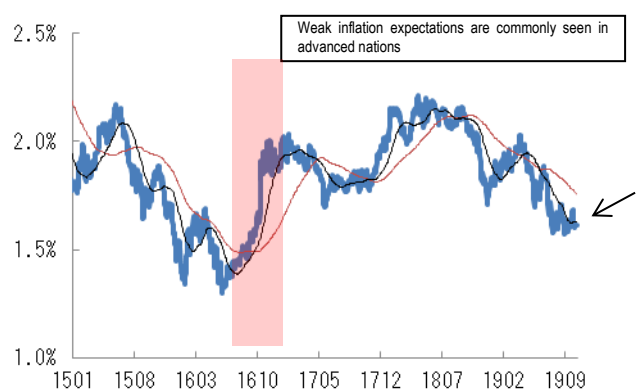
One point to note is that the mean reversion of the nominal interest rate level is proceeding without a rise in inflation expectations. The current breakeven inflation rate (BEI) is at 0.15%, which remains in the bottom range since the introduction of YCC, despite a slight rise from its lowest level of 0.07%. The differential between the current BEI and the average since the introduction of YCC (40bp) is as much as 25bp. In this way, although the gap in inflation expectations has not been filled, the yield curve has approached the average since the introduction of YCC. This means the tightening of real interest rates. Real interest rates tend to create a long-term forex trend. In fact, looking at the forex rate since 2015 when real interest rates began to rise, we find that the yen has been consistently strengthening, except for some fluctuations. It is difficult for appreciation pressure on the yen to emerge in a risk-on phase like the current market. However, if the Fed were to make a serious cut in the federal funds rate in the future, this would create potentially strong appreciation pressure on the yen. We do not think that yields will continue to rise in a one-sided way without inflation.

Chart: USD/JPY and Differential Between Japanese and US Real Interest Rates



Source: Bloomberg; compiled by Daiwa Securities.

Chart: 5Y-forward 5Y BEI in US



Source: Bloomberg; compiled by Daiwa Securities.

Meanwhile, a comparison of the current yield curve and the average since the introduction of YCC shows substantial divergence in superlong yields. The differential between the current 30-year JGB yield (0.5%) and the average since the introduction of YCC (around 0.70%) is 20bp. The gap for 20-year JGB yield is around 18bp (= average—around 0.50%—minus current 0.32%). These differential levels are similar to the degree of decline in observed inflation expectations in Japan. As flattening is a common trend throughout the world, the reversion of superlong yields to the average since the introduction of YCC would necessitate a rise in inflation expectations, if our thinking here is correct. Moreover, if we assume that inflation expectations will remain weak, we can say that substantial correction has been confirmed. Therefore, the current yield level is attractive, in our view.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody'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).
- 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 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.

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Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

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