Daiwa Securities

Daiwa's View

Another factor behind risk-on mode

➢ Preventive liquidity injection by Fed

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Daiwa Securities Co. Ltd.

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At the end of last week, the three US stock indices all set record highs. The DJIA topped $28,000 for the first time ever, which President Donald Trump boasted about on Twitter. Many people attribute the background of the stock rally to expectations for progress in US-China trade talks. However, there appears to be another hidden factor—the easing effect from liquidity injection by the New York Fed.

On 14 November, the New York Fed announced that it would conduct a series of overnight and term repurchase agreement operations, including 28-day and 42-day operations. A point of focus is three operations starting on 25 November (42 days), 2 December (42 days), and 9 December (28 days), totaling $55bn[1]. These operations end in January 2020, meaning a supply of funds past the end of the year.

The New York Fed explained that these operations are intended to "ensure that the supply of reserves remains ample even during periods of sharp increases in non-reserve liabilities" and "mitigate the risk of money market pressures that could adversely affect policy implementation."

Chart: Schedule of Term Repurchase Agreement Operations

TERM OPERATION DATE	MATURITY DATE	TERM	AGGREGATE OPERATION LIMIT
Tuesday, 11/19/2019	Tuesday, 12/3/2019	14-days	At least $35 billion
Thursday, 11/21/2019	Thursday, 12/5/2019	14-days	At least $35 billion
Monday, 11/25/2019	Monday, 1/6/2020	42-days	At least $25 billion
Tuesday, 11/26/2019	Tuesday, 12/10/2019	14-days	At least $35 billion
Wednesday, 11/27/2019	Thursday, 12/12/2019	15-days	At least $35 billion
Monday, 12/2/2019	Monday, 1/13/2020	42-days	At least $15 billion
Tuesday, 12/3/2019	Tuesday, 12/17/2019	14-days	At least $35 billion
Thursday, 12/5/2019	Thursday, 12/19/2019	14-days	At least $35 billion
Monday, 12/9/2019	Monday, 1/6/2020	28-days	At least $15 billion

Source: Extracted from New York Fed website.

[1] https://www.newyorkfed.org/markets/domestic-market-operations/monetary-policy-implementation/repo-reverse-repo-agreements/repurchase-agreement-operational-details#_blank

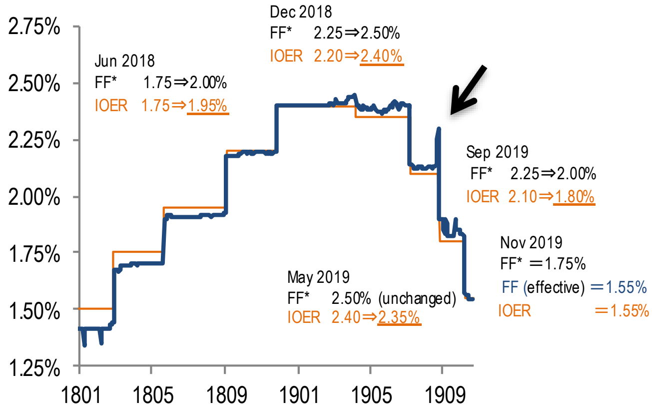
The Fed has a reason to preventively inject liquidity. In mid-September 2019, the Fed lost control of repo rates in the short-term market. The direct cause was a decline in the excess reserve to below a level where the Fed can control rates appropriately. At the initial stage, the Fed projected that a $1.1-1.25tn reserve would be enough for appropriate rate control.[2] However, the authorities lost control at a much earlier stage. It appears that the impact from regulations on G-SIBs (e.g., liquidity coverage ratio) was greater than initially expected.

As US short-term rates (especially repo rates) faced significant confusion, the New York Fed has been containing the turmoil via extraordinary fund supplies since late September. In order to stabilize the financial market and to regain market confidence, alongside the intention to maintain the current rate control method, the authorities need to offer a larger amount of excess reserve. In early October, Fed chair Jerome Powell announced a plan to technically expand balance sheets to that end.

However, risk events are on the horizon—the UK parliamentary election, which controls the destiny of Brexit, on 12 December, the next day of the FOMC meeting slated for 10-11 December, and the fourth round of US tariffs on Chinese imports to be imposed from 15 December. Uncertainty about these very large risk events may make operations at G-SIBs, which are facing strict financial regulations, more conservative, ahead of the assessment at the end of the year. As Brexit and US-China trade talks are not controllable by the Fed, the only method that the Fed can do is to offer a large buffer via a preventive liquidity injection. In particular, securing of funds at around the change of the year is a sensitive issue for private-sector financial institutions, the Fed conducted a preventive measure in November, which is a very conservative response.

The supply of funds by the Fed in preparation for unforeseeable circumstances leads to ample liquidity in the US money market. In fact, since 6 November, the effective federal funds rate has declined to a level corresponding to the IOER (1.55%). Since 19 April 2019, the effective federal funds rate has exceeded the IOER by around 5bp on average. In other words, the extraordinary supply of funds by the Fed has a similar effect as a 5bp cut in the federal funds rate. The hidden rate-cut effect is another background factor behind the current risk-on mode, in our view.

Chart: Effective Federal Funds Rate and IOER

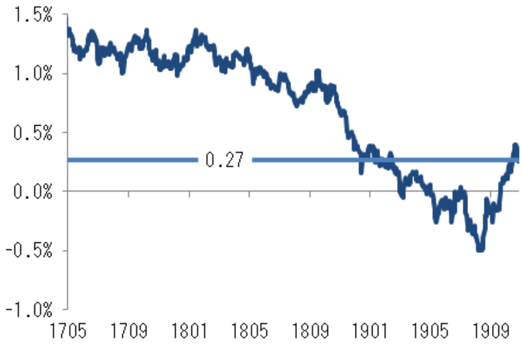


Source: Bloomberg; compiled by Daiwa Securities.
**Upper limit.*

[2] https://www.newyorkfed.org/medialibrary/media/markets/omo/SOMA-Projections-Report-2018Addendum-092019.pdf

In addition to the decline in the effective federal funds rate due to the supply of ample funds by the Fed, the 3-month US rate has also declined to 1.55%, the IOER level. This appears to be a temporary phenomenon. Once liquidity injections end next year, the effective federal funds rate and the 3-month US rate are expected to rise to around 1.625%, the median of the effective federal funds rate target range. Currently, the US yield curve has returned to an upward slope, with the 27bp spread between the 10-year and 3-month yields. This appears to be somewhat exaggerated by the liquidity injection.

Chart: Spread Between US Long-term and Short-term Interest Rates (10Y – 3M)



Source: Bloomberg; compiled by Daiwa Securities.

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2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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May 2018

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Conflicts of Interest: Daiwa Securities Co. Ltd. may currently provide or may intend to provide investment banking services or other services to the company referred to in this report. In such cases, said services could give rise to conflicts of interest for Daiwa Securities Co. Ltd.

Daiwa Securities Co. Ltd. and Daiwa Securities Group Inc.: Daiwa Securities Co. Ltd. is a subsidiary of Daiwa Securities Group Inc.

Other Disclosures Concerning Individual Issues:
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 Y10bn. 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 Y2bn worth of Daiwa Securities Group's common stock.

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- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- 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.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

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