

Daiwa's View

Overflowing money supply

- Market heading for bubble territory

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Daiwa Securities Co. Ltd.

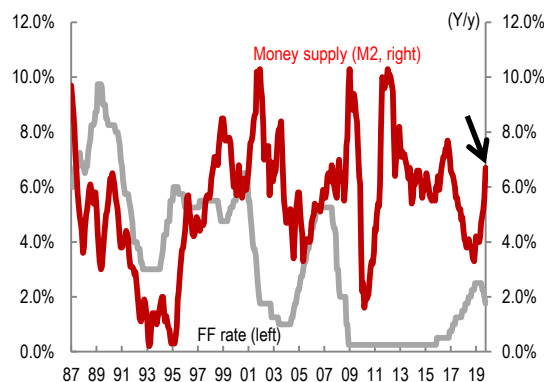
Market heading for bubble territory

Overflowing money supply

While US stocks again set record highs yesterday, interest rates declined. Although market participants tend to become uncomfortable with the divergence between stocks and interest rates from the simple viewpoint of risk-on/risk-off, these moves are appropriate because interest rates are defined as “inflation expectations” + “natural rate of interest.” If interest rates rise suddenly, the current market cannot be called a Goldilocks market.

That said, we may have to point out the impact of money supply (M2) as a factor behind such a strong stock performance. In the US, where loan demand is brisk, rate cuts by the Fed led to a change in the growth rate of money supply, although it is difficult to realize this change in Japan, where loan demand is weak. In fact, M2 in the US grew 6.8% y/y in October 2019, the highest growth rate since December 2016 (up 7.1%).

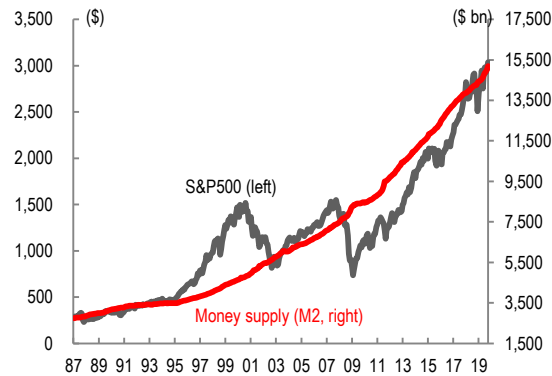
Chart: Federal Funds Rate and Growth of Money Supply (M2)



Source: Bloomberg; compiled by Daiwa Securities.

Generally speaking, when the growth rate of money supply becomes lower than that of GDP, stock prices tend to decline and vice versa. Of course, we do not argue that money supply is the only determinant of stock prices. However, stock prices tend to move in tandem with money supply over the long term, which is an undeniable fact. In that respect, the chart below (plotting money supply and stock prices) shows that US stocks have largely returned to a fair level after the completion of the catch-up stage from the weakness since the Lehman crisis. Currently, stock prices and money supply are basically fairly balanced.

Chart: US Stock Price and Money Supply (M2)



Source: Bloomberg; compiled by Daiwa Securities.

However, if stock prices rise further, they are likely to enter a dangerous zone. According to the data since 1987, the balance between the S&P 500 Index and money supply collapsed twice—in 1997 and 2007—and these were bubbles in both cases. There is a possibility that we are now at the threshold of a third bubble.

That said, it is really difficult to wait patiently, rather than pointing out the bubble. According to media reports yesterday, Daniel Ivascyn, Pacific Investment Management Company's (PIMCO) group chief investment officer, pointed out that "Now is the time to stay patient because assets are expensive, volatility is likely to rise and growth is slowing." He also stated that "We are patient and defensive, maintaining portfolio flexibility with almost every decision we make so we can go on offense on behalf of investors when we see attractive opportunities." Regarding corporate results, it was reported that cash on hand at Berkshire Hathaway, run by Warren Buffett, set a record in Jul-Sep.

Investors with a stellar reputation like PIMCO and Mr. Buffett may be able to be patient. However, it is not easy or realistic for general investors to wait for the correction of richness over several years. The best measure is to recognize that stocks are about to enter the bubble stage and to maintain neutral or higher weighting on stocks. Then, we recommend considering a shift in funds from stocks to bonds when interest rates rise in response to a stock gain. Now is the time to "wait."

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

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[Fitch]

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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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- 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.

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Corporate Name: Daiwa Securities Co. Ltd.

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

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