

Daiwa's View

JGB yields and strongly rooted global flattening pressure

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Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp



Daiwa Securities Co. Ltd.

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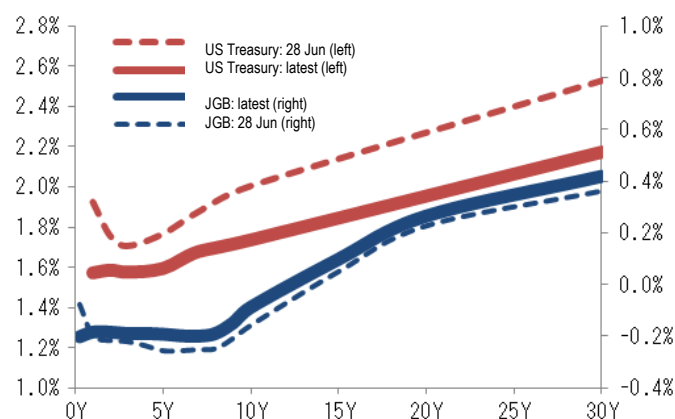
JGB yields and strongly rooted global flattening pressure

Yesterday's 40-year JGB auction, which was held amid concerns about an increase in the JGB issuance amount (led by gov't), went well partly thanks to pre-auction adjustments. Subsequently, we saw a bull flattening at a surprising level. Amid concerns about an increase in JGB issuance, it is difficult to explain this movement only by domestic factors.

Probably, there are overseas factors that are offsetting domestic factors. In fact, US yields are again posting a bull flattening—the overnight 10-year and 30-year yields fell to 1.74% and 2.18%, respectively. The 10-year forward 3-month yield, which shows the component specific to long/superlong yields, also fell by as much as 26bp in the last two weeks, from 2.76% on 11 November to 2.50%. It appears that this flattening pressure by US Treasuries is serving as one factor to prevent steepening of the JGB yield curve.

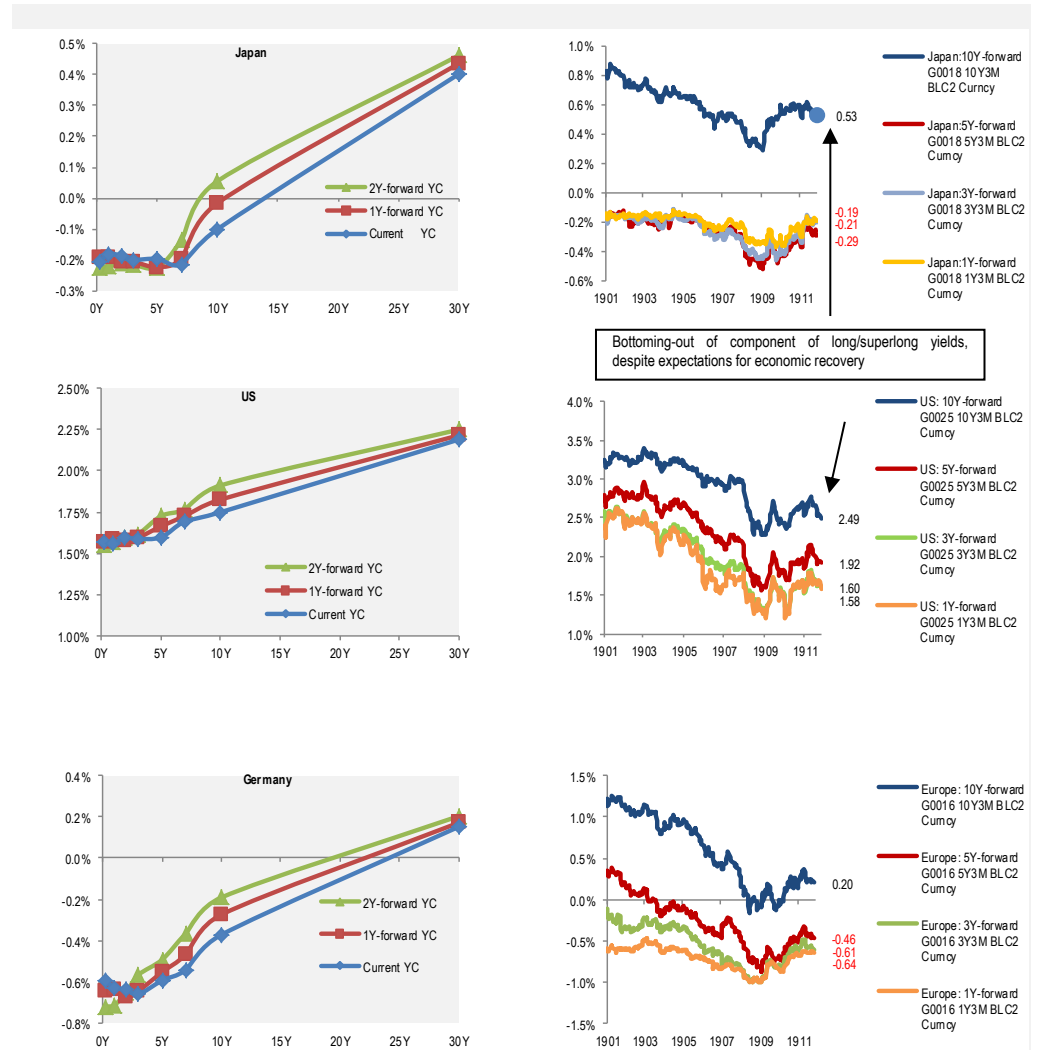
In fact, comparison of yield curves as of 28 June with the latest ones shows that the level/shape of the JGB yield curve has been unchanged despite the flattening of the US yield curve, which is surprising. Investors have been returning to JGBs due to flattening of overseas yields. This is being pushed back by a factor of deteriorating supply/demand conditions—i.e., reduction of offer amounts in the BOJ's purchase operations (and concerns about increase in issuance amount), which is managing to curb the flattening. In other words, macro fundamentals are creating flattening pressure, which is being curbed by supply/demand surprises created by the government side.

Chart: JGB and US Treasury Yield Curves



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Yield Curve of Government Bonds and 3M Yields in Japan, US, and Europe



Source: Bloomberg; compiled by Daiwa Securities.

However, the flattening pressure from US yields is very strong. In terms of the longer-run projection for the federal funds rate, the current level has apparently started to factor in a decline to “2.00%” beyond a fall to “2.25%” from “2.5%” that was disclosed in the dot chart at the September FOMC meeting. This is slightly stronger than [our estimate for the fair value of the US interest rate](#). The main scenario is a decline of the longer-run neutral rate to such a level. However, we have the impression that factoring in the longer-run rate of 2.00% is somewhat early amid signs of bottoming out of the economic cycle and stock prices continuing to set record highs.

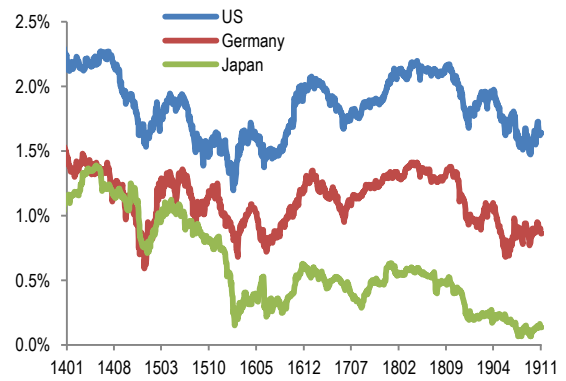
However, it may be appropriate to attribute this week’s intensified movements to a supply/demand factor. There is a possibility that overseas investors are reducing positions ahead of the Thanksgiving and Christmas holidays. Specifically, short-term players who assumed higher yields are covering shorts, while real-money investors who had held off are buying in a resigned tone ahead of holidays. That said, the main cause is the unexpected lack of upward momentum for yields (inflation expectations) despite increasing expectations for an economic recovery. The root is short-covering, in our view.

Chart: US Stock Price and Long-term Interest Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Breakeven Inflation Rate* in Japan, US, and Europe



Source: Bloomberg; compiled by Daiwa Securities.
*10Y inflation expectations.

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[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%.
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- 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.
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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.

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Corporate Name: Daiwa Securities Co. Ltd.

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