

Daiwa's View

Risk-off mode due to greater pessimism about US-China trade agreement

- US-China conflict has strong influence on superlong yields via decline in neutral interest rate

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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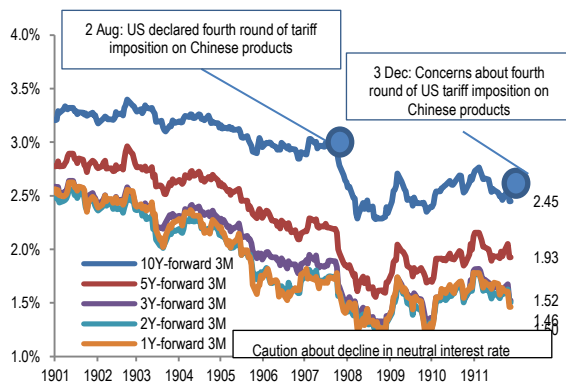
Risk-off mode due to greater pessimism about US-China trade agreement

Last night, we saw full-scale risk-off mode after a long interval due to greater pessimism about the US-China trade agreement. Regarding the US imposition of punitive tariffs on Chinese products scheduled for 15 December, the market consensus was “postponement,” and it reacted negatively to the severe outlook for negotiations suggested by White House officials’ remarks and some media reports. One concern is that the VIX Index has jumped to 16 after a long interval. Thus far, a large amount of short positions have accumulated due to excessive optimism. Once reversals start, they may become relatively widespread.

As [the US-China conflict has a strong influence on the global growth rate and neutral rate](#), yesterday’s bond market also posted reactions mainly in the long-superlong zone. The 10-year forward 3-month US Treasury yield, a point of reference for the neutral interest rate, declined by 11bp from 2.56% to 2.45%. The 10-year and 30-year Treasury yields also fell to 1.71% (down 11bp) and 2.16% (down 10bp), respectively.

This 10-year Treasury yield level is slightly lower than [our-calculated fair value of 1.75-1.85%](#) (note: our estimated range is 1.65-1.95%). When we calculated the fair value, we took into consideration the Fed’s policy stance and the differential between long-term and short-term interest rates. Therefore, the downward shift from the fair value means a rate cut or concerns about the inversion of the yield curve. If we were to believe in a US-China agreement and bottoming-out of the global economic cycle, we would recommend profit taking. However, if the US and China fail to reach an agreement, it may have an impact on the economic cycle, necessitating caution about excess optimism. In such a case, safety asset positions would serve as a lifeline.

Chart: US Treasury Yields (3M)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: 30Y US Treasury Yield

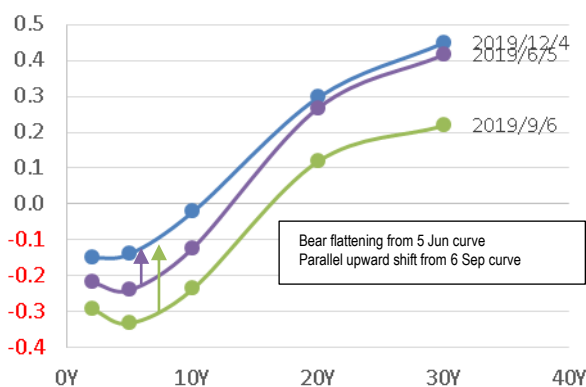


Source: Bloomberg; compiled by Daiwa Securities.

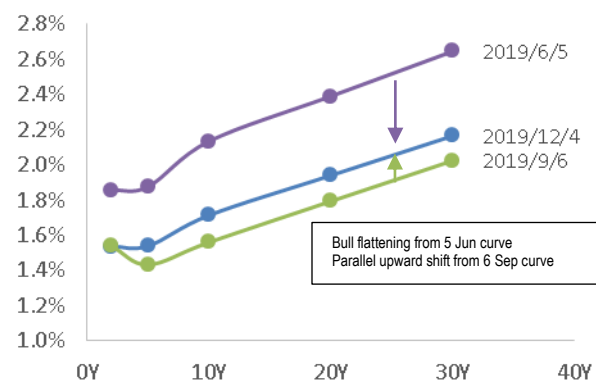
Now, JGB yields and global yields are showing a clearer contrast as the former are continuing to rise and the latter are flattening on the back of the decline in the neutral interest rate. As shown in the charts below, global yields have been steadily flattening, reflecting the fall in the neutral rate.

Of course, we need to view the current rise in intermediate/long-term JGB yields in the big picture—i.e., a change in the BOJ's monetary easing stance (shift in policy framework for global monetary easing). The current fine-tuning via the reduction in offer amounts in JGB purchase operations would not be enough to help us understand the entire view of the discussion to change this framework.

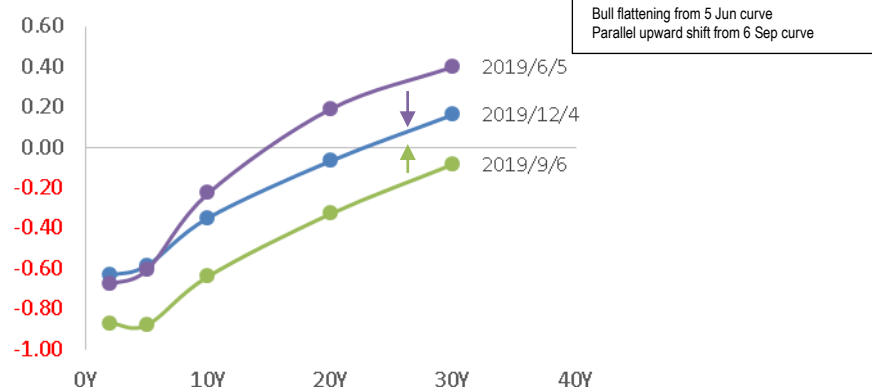
While the BOJ's monetary easing stance has a strong influence mainly on intermediate/long-term yields (strongly contained by easing measures), the most influential factor on superlong JGB yields is the neutral interest rate. Therefore, if superlong yields face upward pressure in parallel with intermediate/long-term yields, without entailing a rise in the neutral interest rate (= rise in inflation expectations or natural rate of interest), this would provide an investment opportunity for superlong JGBs. Given increasing uncertainty about the policy framework review, we recommend buying on dips in a leveling manner.

Chart: JGB Yield Curve (%)


Source: Bloomberg; compiled by Daiwa Securities.

Chart: US Treasury Yield Curve


Source: Bloomberg; compiled by Daiwa Securities.

Chart: German Bund Yield Curve (%)


Source: Bloomberg; compiled by Daiwa Securities.

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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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- 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 ¥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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- 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.

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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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