

# Daiwa's View

## Things to watch for in 2020: Part 3

- How far risk-on will increase = how far capital market line will flatten

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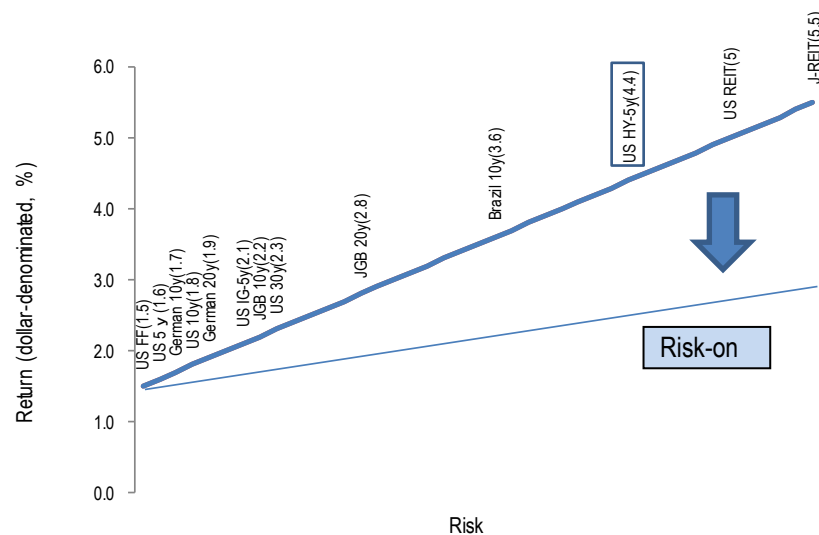
**How far risk-on will increase = how far capital market line will flatten**

### Things to watch for in 2020: Part 3

Although the words risk-on/off are often used, their definition is vague in many cases. In this report, when we use the word of risk-on, it shows the phenomenon of flattening of the capital market line. This means a wide range of decline in an expected/required rate of return against additional risk taking.

The CAPM is an equilibrium pricing theory regarding risk assets that was established by William Sharpe (1964) and John Lintner (1965) based on Harry Markowitz's (1959) portfolio selection theory. Generally, it is well known that a higher return is required for higher risk assets. Their major achievement is precise pricing of assets via theoretical derivation of one line that shows the risk/return relationship. Of course, the derivation of an accurate capital market line necessitates rigorous assumptions. As shown in the chart below, however, we are able to roughly picture the capital market line by plotting the expected/required rate of return by product.

Chart: Capital Market Line (conceptual diagram)



Source: Bloomberg; compiled by Daiwa Securities.

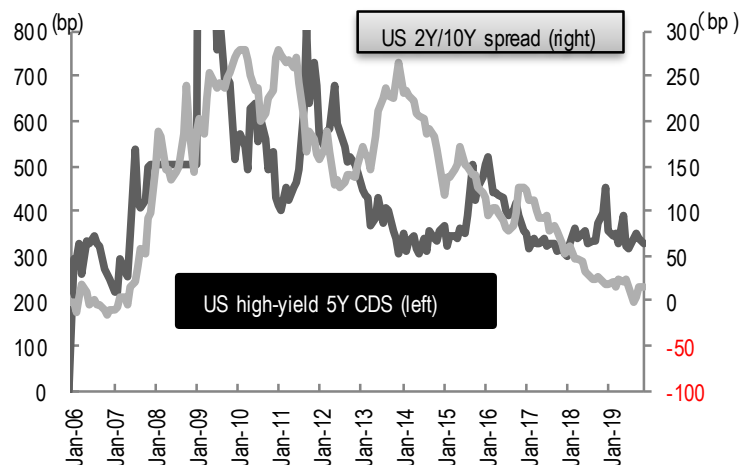
In picturing the slope of the capital market line, we need to pay attention to high-yield bonds. While rating agencies' major faults were the over-assignment of high ratings to securitized products without adequate grounds, and the global financial crisis in 2009, their major achievement would be the creation of the high-yield bond market. Unlike investment-grade bonds, high-yield bonds are deemed to have a relatively high probability of default in a specific period of time. The change in the additional spread of high-yield bonds, "which never reassure investors," is very useful in observing the expected/required rate of return against market risk (one reason that high-yield bonds are called "canary in a coal mine").

When the spread of high-yield bonds is tight, the expected/required rate of return on risk assets is low. If we say for confirmation, all risk assets are essentially plotted on one capital market line. Therefore, the differential between short-term and long-term interest rates, which shows an expected rate of return on duration risk, is no exception. In other words, risk-on (flattening of capital market line) implies flattening of the yield curve.

Looking at the 5-year CDS level of US high-yield bonds, we found that it has declined to around 280bp, the lowest level since the global financial crisis. We thus can think that the capital market line is at the flattest condition since the global financial crisis. For reference, the pre-global financial crisis bottom was 180bp.

We have to avoid implicitly deciding that the pre-global financial crisis bottom is an unsurpassable limit. At that time, then Fed chair Alan Greenspan was raising interest rates, but at least rate hikes by the Fed are not currently expected. We can never eliminate the possibility that the capital market line will flatten beyond the pre-global financial crisis level. How far risk-on will increase in 2020 is an important concern also for interest rates.

**Chart: US High-Yield Bond Spread, Differential Between Short-term and Long-term Interest Rates**



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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The information is posted under "Unregistered Rating Information" (<http://www.standardandpoors.co.jp/unregistered>) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (<http://www.standardandpoors.co.jp>)

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#### [Moody's]

##### The Name of the Credit Rating Agencies Group, etc

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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website ([https://www.moody.com/pages/default\\_ja.aspx](https://www.moody.com/pages/default_ja.aspx)))

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#### [Fitch]

##### The Name of the Credit Rating Agencies group, etc

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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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- 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.**

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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