

Daiwa's View

Differential between US short-term and long-term rates disappears

- Market once again demanding rate cuts?

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Daiwa Securities Co. Ltd.

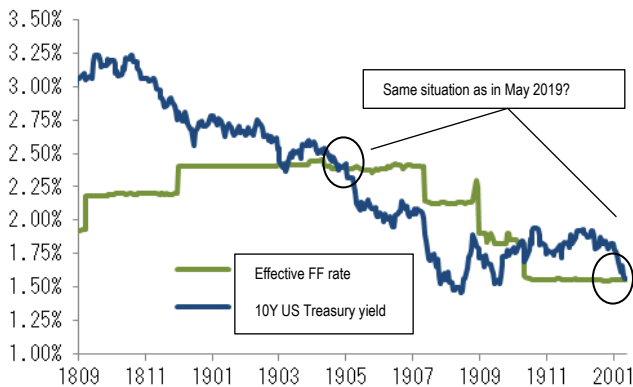
Market once again demanding rate cuts?

Differential between US short-term and long-term rates disappears

Yesterday, the WHO declared the coronavirus outbreak a global health emergency, and the first case of person-to-person coronavirus transmission was confirmed in the US. In the midst of these developments, the US long-term interest rate declined to 1.59%, close to the 3-month rate. The differential between the US short-term and long-term rates has thus virtually disappeared.

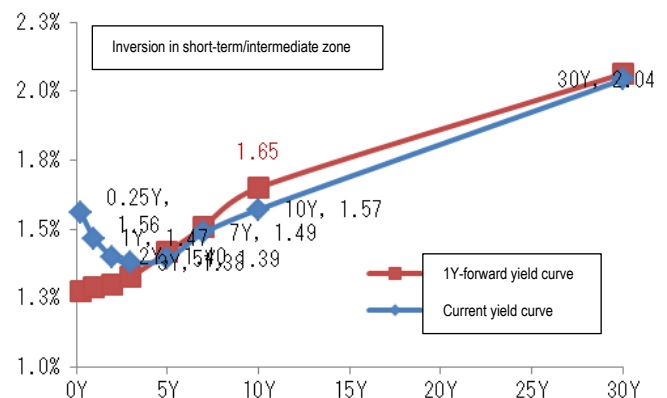
As previously reported, [our estimated range for the 10-year US yield in 2020 is from 1.60% to 2.00%](#), assuming that the US yield curve does not invert in 2020 as the global/US economic fundamentals are bottoming out. However, the differential between US short-term and long-term interest rates is now on the verge of becoming negative. As shown by the 1.5-year forward 3-month US rate being 20bp below the 3-month rate, partial inversion is observed in the short-term/intermediate zone of the yield curve. This implies that the market is once again demanding rate cuts.

Chart: US Long-term Interest Rate and Effective FF Rate



Source: Bloomberg; compiled by Daiwa Securities.

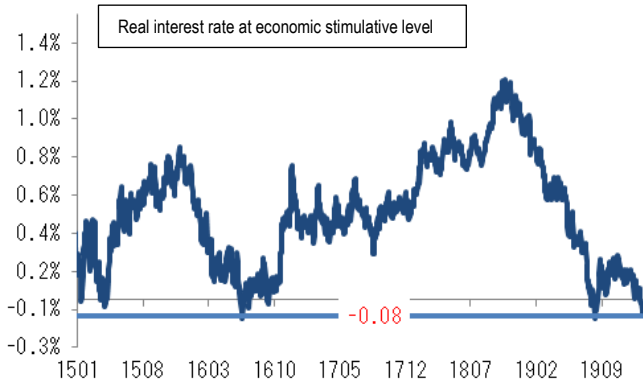
Chart: US Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

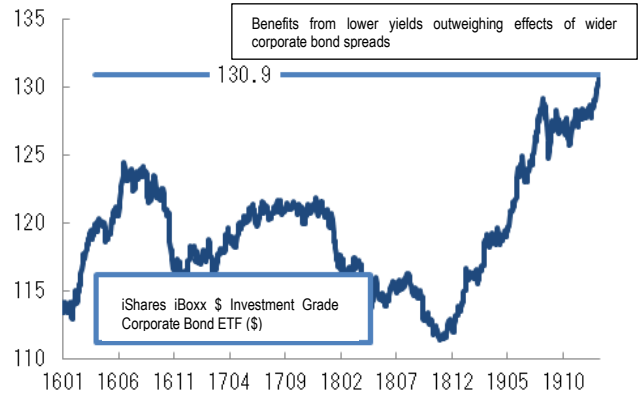
Are concerns about a US recession growing rapidly? Some indicators that are highly correlated with the economy appear to indicate that this is not the case (charts on next page). For example, the 10-year US real interest rate declined to around -10bp, close to the five-year bottom it hit in July 2016 and May 2019. US corporate bond prices have risen to a five-year high of 130.9, suggesting that the benefits from lower yields are outweighing the effects of the widening of corporate bond spreads. These figures imply that the current yield declines may be a product of "flight to quality" in response to the unknown coronavirus risk, rather than reactions to recession concerns.

Chart: 10Y US Real Interest Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart: iShares iBoxx \$ Investment Grade Corporate Bond ETF

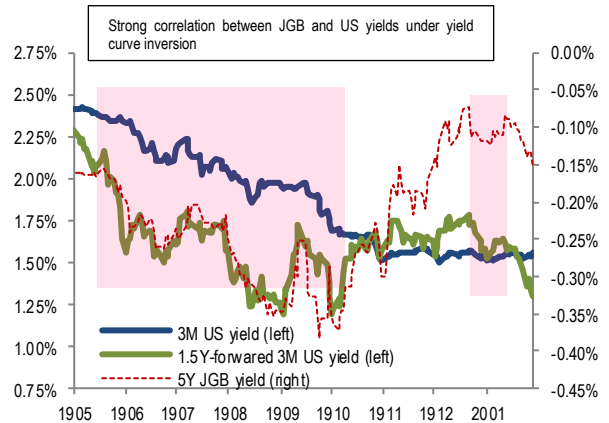


Source: Bloomberg; compiled by Daiwa Securities.

Of course, we cannot neglect hedging against unknown fears. It is possible that market sentiment, which has cooled from “Optimism” at the beginning of the year to “Neutral,” could suddenly plunge to “Fear.” Meanwhile, it is true that “flight to quality” rapidly unwinds in many cases once tail risks disappear. A little more time is needed in order to discern whether the 10-year US yield will stay below 1.6%.

Another focus of attention is the recovery of the correlation between Japanese and US yields. Since November 2019, the correlation between the 1.5-year forward 3-month US yield and the 5-year JGB yield had tended to be weak. However, it has now clearly recovered. Looking back at the trend, the correlation tended to strengthen during the period of US yield curve inversion (chart below). This is probably a reflection of the fact that there is a higher return from JGBs (on dollar converted basis) in maturity zones where the US yield curve is inverted. With dollar-denominated JGBs, attention tends to be on hedging cost (incl. currency basis). However, the most influential factor for the JGB yield level is inversion of the US Treasury yield curve, which serves as a benchmark.

Chart: 3M US Yields and 5Y JGB Yield



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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- 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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