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Daiwa Securities

Daiwa's View

Rate-cut expectations aren't the only reason behind yield declines

➢ Downward shift of neutral interest rate also a factor

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.

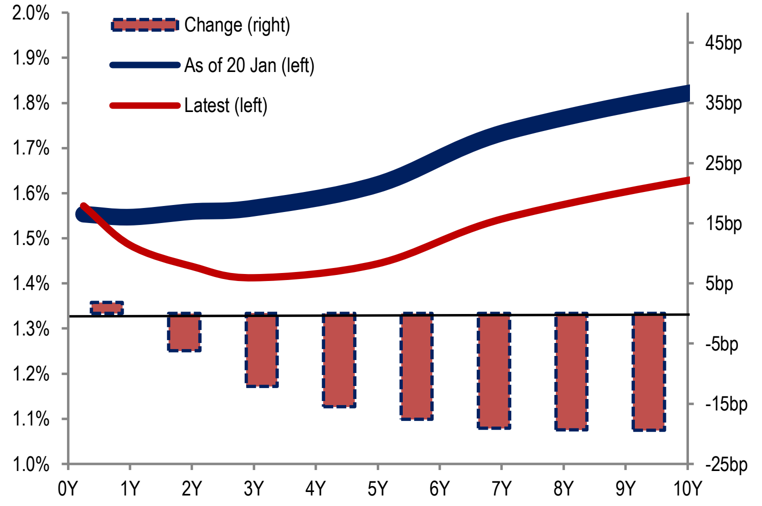
Rate-cut expectations aren't the only reason behind yield declines

Downward shift of neutral interest rate also a factor

Yesterday, all three major US stock indices set record highs again. With the German DAX hitting a fresh high, the Nikkei Stock Average Futures rose to Y23,940 and tested a recovery to Y24,000. The reported number of infections and death toll from the new coronavirus are still increasing, but the momentum has started to abate, leading to limited reactions in stock prices. Although it will take some time before the death toll peaks, the market has probably passed the worst stage.

In contrast to stock prices, interest rates have seen a weak recovery. Although the US long-term interest rate managed to recover to the 1.6% level, it is still 19bp below the level before the coronavirus outbreak. If yield declines were driven solely by rate-cut expectations, yields should have returned to the previous level in the absence of such expectations. However, this has not yet happened because, rather than being limited to simple expectations of rate cuts, the current yield downtrend appears to be reflecting the fact that the supply-side impact is putting downward pressure on the neutral interest rate via a decline in productivity and corporate margins.

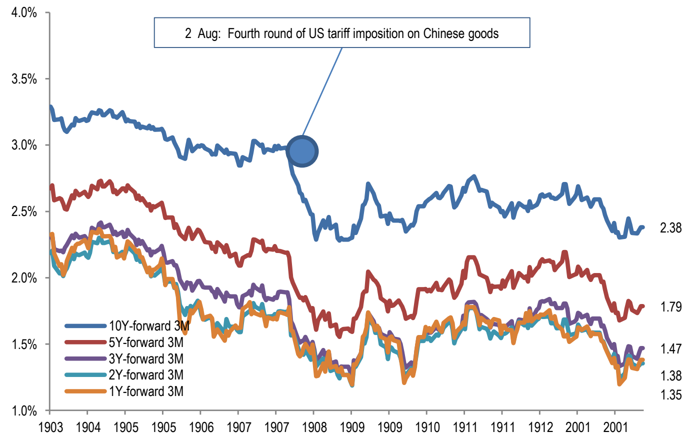
Chart: US Treasury Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

The trend in the 10-year forward 3-month US yield, which is recognized as one reference indicator for the neutral interest rate in the market, also implies that the weak recovery is not a temporary trend but a precursor of structural change. If so, the yield is unlikely to return to the same exact level as previously, even if the coronavirus confusion settles down. At most, the 10-year forward 3-month US yield is expected to recover to its downward trend line—around 2.50%. This corresponds to around 1.75% in terms of the US long-term interest rate, confirming a downward shift in the rate level.

Chart: US Forward Interest Rates (3M)



Source: Bloomberg; compiled by Daiwa Securities.

Meanwhile, if share prices continue to advance, the inversion in the short-term/intermediate zone of the US yield curve will likely gradually disappear.

At the moment, the short-term/intermediate zone of the US yield curve is inverted. (Note that short-term and long-term interest rates are no longer inverted.) Expectations of rate cuts are behind this partial yield curve inversion. However, as US stock prices have risen to such a high level, the Fed will probably hesitate to conduct additional rate cuts. All the more so considering the statement on 15 January by Dallas Fed President Robert Kaplan pointing out the possibility that monetary easing is “contributing to elevated risk-asset valuations.”

If rate-cut expectations diminish in line with higher stock prices alongside gradual reversion of the US yield curve to normal, the inversion of the JGB yield curve (which has occurred simultaneously with the US curve) will likely disappear. This is because aggressive purchases of intermediate JGBs by overseas investors may not continue, given their active stance thus far. Once overseas investors lose their momentum, the 5-year JGB yield may again rise toward –0.10%. We thus recommend profit taking in the intermediate zone.

On the other hand, outperformance of superlong JGBs is likely to continue, driven by the global correlation of the neutral interest rate. Of course, if the BOJ judges that superlong yields are excessively low, the offer amounts in Rinban operations will be reduced, putting a brake on a decline in JGB yields. However, the impact of the cut in purchase amounts in operations would be temporary, given the aforementioned primary movement (decline) in the US neutral interest rate. If superlong JGB yields rise due to trimming in BOJ purchase operations, this will provide a good dip-buying opportunity.

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[Standard & Poor's]

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[Moody's]

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[Fitch]

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May 2018

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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 Y10bn. 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 Y2bn 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.
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