

Daiwa's View

Diminishing inflation expectations

- Which is correct—JGBs or swaps?

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Daiwa Securities Co. Ltd.

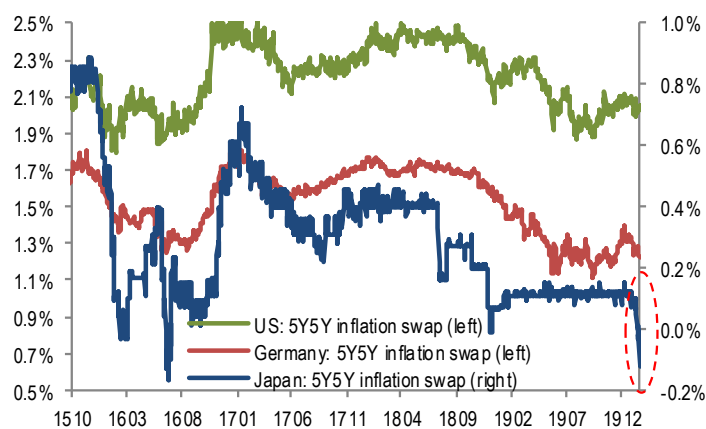
Which is correct—JGBs or swaps?

Diminishing inflation expectations

One week has passed since the 5-year forward 5-year inflation swap rate fell into negative territory. When this figure fell below zero on 27 December 2018, it recovered to positive territory in two business days. If it remains negative for more than a week, that will be the first time that happened since July 2016, when the rate returned to positive territory after eight business days. Therefore, if the figure remains negative for more than two weeks, that will be the first time since October 2012 (the beginning of Abenomics).

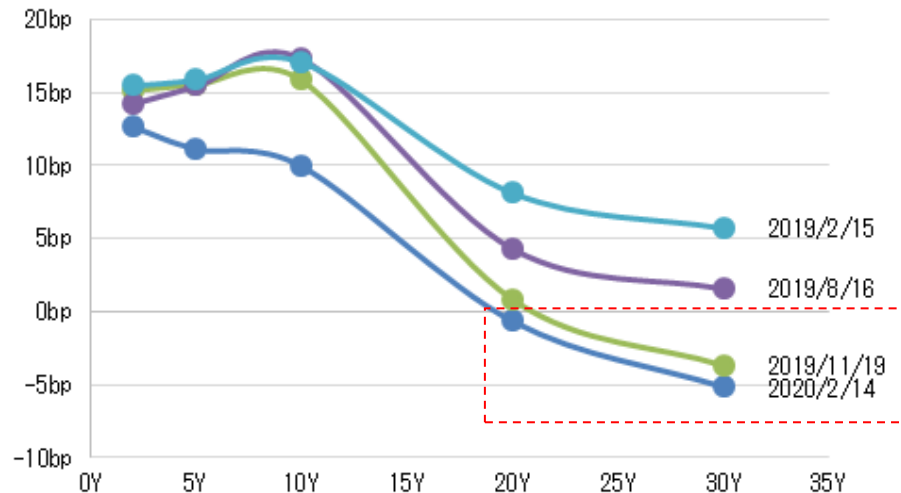
Although the 10-year JGB breakeven inflation rate is positive at 0.08%, the absolute level is the lowest since the start of Abenomics. The signs are different (one is positive, the other is negative), but both indicators imply that market-based inflation expectations are very weak.

Chart: 5Y-forward 5Y Inflation Swap in Japan, US, and Europe



Source: Bloomberg; compiled by Daiwa Securities.

Chart: JPY Swap Spread



Source: Bloomberg; compiled by Daiwa Securities.

Also, in Japan, swap spreads (yield spreads between JGBs and swaps) in some maturity zones have been taking hold in negative territory recently.

By definition, the yen swap rate is an aggregate of 6-month yen LIBOR, supporting the “6-month yen LIBOR > JGB yields” relationship. Accordingly, the current situation in which swap rates are lower than JGB yields is illogical. The negative swap spreads mean that either JGB yields are too high or swap rates are too low.

Previously, we were able to assert that JGBs are correct in light of high liquidity. However, the BOJ has been intervening directly in the JGB market since the introduction of the yield curve control policy in September 2016, keeping us from being able to assert that JGBs are correct. Although it may just be a coincidence, the swap spread in the superlong zone appears to have remained in negative territory since September 2019 when BOJ governor Haruhiko Kuroda warned against an excessive decline in superlong yields.

If swap rates reflect fundamentals more accurately than JGB yields, we can say that negative swap spreads partially contain the attractive features of superlong JGBs (roughly equivalent to risk premium against the risk of market intervention by the BOJ, such as a cut in offer amounts in JGB purchase operations). We thus recommend stances of “leveling” purchases and dip-buying for superlong JGBs.

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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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- 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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- 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.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

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