Daiwa Securities

Daiwa's View

Root of ongoing crisis

➢ Probably close to LTCM crisis in 1998

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Daiwa Securities Co. Ltd.

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Markets were on the verge of collapse, but prices substantially rebounded on the weekend. The DJIA set a record one-day gain of $1,985, the US long-term interest rate rose by around 1%, the VIX index declined from 75 to 58, and the USD/JPY recovered to Y108 at one point. A notable point is the rebound of asset prices of superior credit. The iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD) bounced back from 117.9 to 123.05.

Markets appear to have favored full-fledged responses by major central banks/governments. On 13 March, the NY Fed started operations to purchase US Treasuries across the yield curve by implementing the contents of its release on 12 March. Due to this, the liquidity of US Treasuries, which had declined, appears to have recovered somewhat. A similar phenomenon can be observed for JGBs. On 13 March, the BOJ offered an unscheduled additional purchase operation for JGBs in the 5- to 10-year zone. This bolstered bond market's liquidity, which was remarkably low. Subsequently, the BOJ announced a release entitled *Market Operations toward the End of March* in which the central bank declared that it would continue to conduct additional outright purchases of JGBs as needed.

◆ BOJ: Financial Markets Department (13 Mar 2020)

Market Operations toward the End of March

Considering the recent unstable movements in global financial and capital markets, the Bank of Japan has decided to implement the following measures in order to ensure stability in financial markets toward the end of this March.

1. Provision of ample liquidity
Starting from the next week, the Bank will provide ample liquidity using market operations with long maturities such as Funds-supplying operations against pooled collateral and purchases of Japanese government securities (JGSs) with repurchase agreements that matures over the end of this March. Also, considering rapid decrease of liquidity in bond markets, the Bank conducted unscheduled outright purchase of Japanese government bonds (JGBs) today, which was not scheduled beforehand. The Bank will continue to conduct additional outright purchases of JGBs as needed, taking account of market conditions.

2. Measures to maintain stability of the repo market
In order to ensure stability in the market by easing excessive tightening in supply and demand of JGSs in the repo market toward the end of this March, the Bank will implement the following temporary measures.

(1) Increasing number of issues of JGSs offered in the Securities Lending Facility (SLF)
For the SLF to be offered between March 16 and April 3, in principle, the Bank will offer all available JGSs held by the Bank. Meanwhile, requests for issues of JGSs by counterparties in advance will be unnecessary.

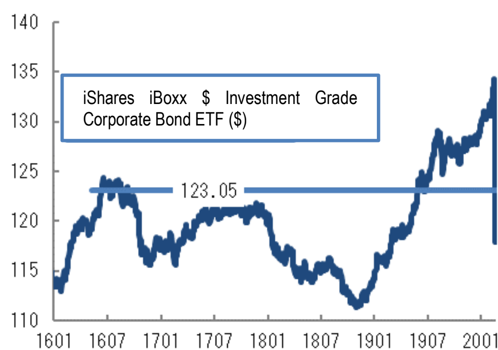
(2) Offers of sales of JGSs with repurchase agreements intended to provide the market with JGSs On March 25, the Bank will announce offers for sales of JGSs with repurchase agreements, with the exercise date as March 31 and the repurchase date as April 1. The Bank will announce additional offers for sales of JGSs with repurchase agreements, as needed.

Important disclosures, including any required research certifications, are provided on the last page(s) of this report.

Moreover, before the opening of the Tokyo market this morning, the US FOMC announced measures that can be called "all-in" ones—a 1 point emergency rate cut, forward guidance promising to offer low interest rates until the COVID-19 outbreak ends, the resumption of quantitative easing QE4 (incl. mortgages), and strengthening of the US dollar swap line arrangement among six central banks. In addition, its killer phrase "act as appropriate" is intact. In another release, the Fed encouraged banks to use their capital and liquidity buffers. Under the current situation, what is especially important is the latter two, which are presumed to support liquidity/credit. As these measures prove that the authorities recognize the worsening of problems under the current market (credit concerns → credit crisis → liquidity crisis), the market is likely to positively view these measures.

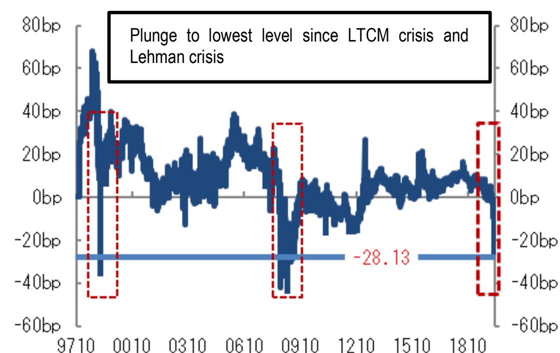
Currently, credit spread has been widening globally, which is creating the risk that bond issuance even at large companies will face trouble. Apparently, this is a credit crisis. However, the real reason behind this is probably a liquidity crisis. Once liquidity is depleted, risk assets are averted and normal prices are proposed only for superior assets. If a liquidity crisis occurs, selling would rush into high-yield bonds, followed by investment grade bonds, long-term government bonds, short-term government bonds, and gold. This would likely bring about a crash of superior asset prices and a collapse of the correlation among risk assets. Those who learned from history would know that this "collapse of the correlation" caused the bankruptcy of Long-Term Capital Management (LTCM) in 1998. At the moment, we have not yet seen mutual mistrust among financial institutions or the resultant cut in the swap line (credit suspension), unlike the case in the global financial crisis triggered by the Lehman Brothers' bankruptcy. The ongoing crisis is closer to the LTCM crisis in 1998, rather than the Lehman crisis.

Chart: Dollar-denominated Corporate Bond ETF Price



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Yen Swap Spread (20Y)



Source: Bloomberg; compiled by Daiwa Securities.

Why has the liquidity been depleted to such a level? One reason is the fact that very large financial institutions have been under the control of strict/multi-layered regulations by Basel III, in our view. Due to these financial regulations to prevent a recurrence of a crisis like the Lehman crisis, financial crises have been obviated. However, we can point out one aspect that liquidity (that should be provided as market makers) has been constrained.

If so, (1) reduction of the countercyclical capital buffer rate, decided at an emergency meeting by the BOE on 11 March, (2) easing of capital regulations by the ECB on 12 March, and (3) the utilization of bank capital and liquidity buffers encouraged by the Fed on 15 March can be called excellent moves that could (1) ease burdens at financial institutions under the severe regulations and (2) prop up the currently declining market liquidity. Similarly, expansion of CP/corporate bond operations at the BOJ, which was reported by *Nikkei* flash news on 13 March is also an excellent move. As reported, these moves are expected to help market liquidity recover, while reducing burdens at market makers (if realized). These moves by central banks are likely to recover a part of market intermediation functions at financial institutions, which have been strictly constrained since the promulgation of Basel III, in addition to provision of the effects of economic stimulus and

credit support. Central banks appear to be prescribing proper measures, discerning the problems. I repeat that the current necessary moves in the market are support for liquidity and corporate credit, unlike the deepening of negative rates, which entails the risk of worsening these problems.

Is it possible to change the current situation to an investment opportunity? In fact, purchases of real superior assets at a low price are available only at time of liquidity crisis. If the current crisis is an LTCM-type one and not a Lehman crisis type, appropriate measures may lead to an early market recovery similar to the LTCM crisis. However, even if the liquidity crisis is contained, we cannot completely deny the possibility that the market will again worsen toward a credit collapse. We thus have to be aware of the possibility that market volatility will remain high. Under the circumstances, we recommend hunting out "superior assets" that have been sold at distressed prices, without aiming to get rich quick. Representative assets whose prices tend to recover quickly relative to others are asset swap spread (between gov't bond yields and swap rates) and credit of ultra-blue-chip issues.

◆ **BOJ: Financial Markets Department (13 Mar 2020)**

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◆ **FOMC Statement (15 Mar 2020)**

The coronavirus outbreak has harmed communities and disrupted economic activity in many countries, including the United States. Global financial conditions have also been significantly affected. Available economic data show that the U.S. economy came into this challenging period on a strong footing. Information received since the Federal Open Market Committee met in January indicates that the labor market remained strong through February and economic activity rose at a moderate rate. Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although household spending rose at a moderate pace, business fixed investment and exports remained weak. More recently, the energy sector has come under stress. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. Market-based measures of inflation compensation have declined; survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The effects of the coronavirus will weigh on economic activity in the near term and pose risks to the economic outlook. In light of these developments, the Committee decided to lower the target range for the federal funds rate to 0 to 1/4 percent. The Committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals. This action will help support economic activity, strong labor market conditions, and inflation returning to the Committee's symmetric 2 percent objective.

The Committee will continue to monitor the implications of incoming information for the economic outlook, including information related to public health, as well as global developments and muted inflation pressures, and will use its tools and act as appropriate to support the economy. In determining the timing and size of future adjustments to the stance of monetary policy, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

The Federal Reserve is prepared to use its full range of tools to support the flow of credit to households and businesses and thereby promote its maximum employment and price stability goals. To support the smooth functioning of markets for Treasury securities and agency mortgage-backed securities that are central to the flow of credit to households and businesses, over coming months the Committee will increase its holdings of Treasury securities by at least $500 billion and its holdings of agency mortgage-backed securities by at least $200 billion. The Committee will also reinvest all principal payments from the Federal Reserve's holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. In addition, the Open Market Desk has recently expanded its overnight and term repurchase agreement operations. The Committee will continue to closely monitor market conditions and is prepared to adjust its plans as appropriate.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Patrick Harker; Robert S. Kaplan; Neel Kashkari; and Randal K. Quarles. Voting against this action was Loretta J. Mester, who was fully supportive of all of the actions taken to promote the smooth functioning of markets and the flow of credit to households and businesses but preferred to reduce the target range for the federal funds rate to 1/2 to 3/4 percent at this meeting.

In a related set of actions to support the credit needs of households and businesses, the Federal Reserve announced measures related to the discount window, intraday credit, bank capital and liquidity buffers, reserve requirements, and—in coordination with other central banks—the U.S. dollar liquidity swap line arrangements. More information can be found on the Federal Reserve Board's website.

◆ Federal Reserve Actions to Support the Flow of Credit to Households and Businesses (15 Mar 2020)

The Federal Reserve is carefully monitoring credit markets and is prepared to use its full range of tools to support the flow of credit to households and businesses and thereby promote its maximum employment and price stability goals. In addition to actions taken by the Federal Open Market Committee, including actions taken in coordination with other central banks, the Federal Reserve Board announced a series of actions in support of these goals. These actions are summarized below.

Discount Window
Federal Reserve lending to depository institutions (the "discount window") plays an important role in supporting the liquidity and stability of the banking system and the effective implementation of monetary policy. By providing ready access to funding, the discount window helps depository institutions manage their liquidity risks efficiently and avoid actions that have negative consequences for their customers, such as withdrawing credit during times of market stress. Thus, the discount window supports the smooth flow of credit to households and businesses. Providing liquidity in this way is one of the original purposes of the Federal Reserve System and other central banks around the world.

The Federal Reserve encourages depository institutions to turn to the discount window to help meet demands for credit from households and businesses at this time. In support of this goal, the Board today announced that it will lower the primary credit rate by 150 basis points to 0.25 percent, effective March 16, 2020. This reduction in the primary credit rate reflects both the 100 basis point reduction in the target range for the federal funds rate and a 50 basis point narrowing in the primary credit rate relative to the top of the target range. Narrowing the spread of the primary credit rate relative to the general level of overnight interest rates should help encourage more active use of the window by depository institutions to meet unexpected funding needs. To further enhance the role of the discount window as a tool for banks in addressing potential funding pressures, the Board also today announced that depository institutions may borrow from the discount window for periods as long as 90 days, prepayable and renewable by the borrower on a daily basis. The Federal Reserve continues to accept the same broad range of collateral for discount window loans.

Intraday Credit
The availability of intraday credit from the Federal Reserve supports the smooth functioning of payment systems and the settlement and clearing of transactions across a range of credit markets. The Federal Reserve encourages depository institutions to utilize intraday credit extended by Reserve Banks, on both a collateralized and uncollateralized basis, to support the provision of liquidity to households and businesses and the general smooth functioning of payment systems.

Bank Capital and Liquidity Buffers
The Federal Reserve is encouraging banks to use their capital and liquidity buffers as they lend to households and businesses who are affected by the coronavirus.

Since the global financial crisis of 2007-2008, U.S. bank holding companies have built up substantial levels of capital and liquidity in excess of regulatory minimums and buffers. The largest firms have $1.3 trillion in common equity and hold $2.9 trillion in high quality liquid assets. The U.S. banking agencies have also significantly increased capital and liquidity requirements, including improving the quality of regulatory capital, raising minimum capital requirements, establishing capital and liquidity buffers, and implementing annual capital stress tests.

These capital and liquidity buffers are designed to support the economy in adverse situations and allow banks to continue to serve households and businesses. The Federal Reserve supports firms that choose to use their capital and liquidity buffers to lend and undertake other supportive actions in a safe and sound manner.

Reserve Requirements
For many years, reserve requirements played a central role in the implementation of monetary policy by creating a stable demand for reserves. In January 2019, the FOMC announced its intention to implement monetary policy in an ample reserves regime. Reserve requirements do not play a significant role in this operating framework.

In light of the shift to an ample reserves regime, the Board has reduced reserve requirement ratios to zero percent effective on March 26, the beginning of the next reserve maintenance period. This action eliminates reserve requirements for thousands of depository institutions and will help to support lending to households and businesses.

◆ Coordinated Central Bank Action to Enhance the Provision of U.S. Dollar Liquidity (15 Mar 2020)

The Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, and the Swiss National Bank are today announcing a coordinated action to enhance the provision of liquidity via the standing U.S. dollar liquidity swap line arrangements.

These central banks have agreed to lower the pricing on the standing U.S. dollar liquidity swap arrangements by 25 basis points, so that the new rate will be the U.S. dollar overnight index swap (OIS) rate plus 25 basis points. To increase the swap lines' effectiveness in providing term liquidity, the foreign central banks with regular U.S. dollar liquidity operations have also agreed to begin offering U.S. dollars weekly in each jurisdiction with an 84-day maturity, in addition to the 1-week maturity operations currently offered. These changes will take effect with the next scheduled operations during the week of March 16.1 The new pricing and maturity offerings will remain in place as long as appropriate to support the smooth functioning of U.S. dollar funding markets.

The swap lines are available standing facilities and serve as an important liquidity backstop to ease strains in global funding markets, thereby helping to mitigate the effects of such strains on the supply of credit to households and businesses, both domestically and abroad.

Daiwa Securities

Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

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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.
4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

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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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[Fitch]

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February 2020

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Other Disclosures Concerning Individual Issues:
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 Inc. and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group Inc. is to acquire up to 5.01% of Credit Saison's total common shares outstanding (excl. treasury shares; as of 31 Jul 2019).

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(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- 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.

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