Daiwa Securities

# Daiwa's View

## Turning point from liquidity crisis?

➢ Avoidance of "fallacy of composition"

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### Turning point from liquidity crisis?

Yesterday, four phenomena implied that the "liquidity crisis market" has reached a turning point. One is that the Fed has decided to support liquidity for creditworthiness of households/ companies by reopening a Commercial Paper Funding Facility (CPFF). As concerns about CP procurement lead to behavior to increase cash on hand, the liquidity market worsens. This is a good decision following the BOJ's move to increase the CP purchase amount on 16 March.

**Avoidance of "fallacy of composition"**

◆ **Federal Reserve Board announces establishment of a Commercial Paper Funding Facility (CPFF) to support the flow of credit to households and businesses (17 Mar 2020)**

The Federal Reserve Board announced today that it will establish a Commercial Paper Funding Facility (CPFF) to support the flow of credit to households and businesses. Commercial paper markets directly finance a wide range of economic activity, supplying credit and funding for auto loans and mortgages as well as liquidity to meet the operational needs of a range of companies. By ensuring the smooth functioning of this market, particularly in times of strain, the Federal Reserve is providing credit that will support families, businesses, and jobs across the economy. The CPFF will provide a liquidity backstop to U.S. issuers of commercial paper through a special purpose vehicle (SPV) that will purchase unsecured and asset-backed commercial paper rated A1/P1 (as of March 17, 2020) directly from eligible companies.

The CPFF program is established by the Federal Reserve under the authority of Section 13(3) of the Federal Reserve Act, with approval of the Treasury Secretary.

The commercial paper market has been under considerable strain in recent days as businesses and households face greater uncertainty in light of the coronavirus outbreak. By eliminating much of the risk that eligible issuers will not be able to repay investors by rolling over their maturing commercial paper obligations, this facility should encourage investors to once again engage in term lending in the commercial paper market. An improved commercial paper market will enhance the ability of businesses to maintain employment and investment as the nation deals with the coronavirus outbreak.

The Treasury will provide $10 billion of credit protection to the Federal Reserve in connection with the CPFF from the Treasury's Exchange Stabilization Fund (ESF). The Federal Reserve will then provide financing to the SPV under the CPFF. Its loans will be secured by all of the assets of the SPV.

A brief description of the program is attached. More detailed program terms and conditions and an operational calendar will be subsequently published.

The second is that eight major US banks announced that they would access the Fed's discount window. The FOMC formulated measures to supply ample liquidity at an emergency meeting. For example, the Fed substantially lowered the primary credit rate from 1.75% to an attractive level of 0.25% in the discount window (reflecting 100bp cut in FF rate and 50bp spread narrowing). However, private-sector financial institutions tend to avoid utilization of support programs by the government/authorities due to concerns about reputation risk (stigma issue). Therefore, it was uncertain whether they would actually use such programs in the current situation (similar mindset among Japanese banks, which tried to avoid "public fund injection" under financial crisis in 1998). In fact, the US authorities had encouraged accessing this discount window program since the surge in the repo rate from September 2019. However, the program was not utilized at that time.

Once financial institutions are trapped in this mindset, non-utilization of support programs by individual banks worsens the performance of the overall macro economy. This causes "fallacy of composition" via financial erosion at individual banks. In order to avoid this, key is how to lower the psychological hurdle for utilization. As mentioned above, eight major US banks announced that they would access the program, meeting the Fed's message (it encouraged depository institutions "to turn to the discount window"). This erased all the reasons behind hesitation in utilizing this program among all financial institutions. Due to the avoidance of "fallacy of composition," the discount window is now expected to function. We thus can say that the funding issue among US banks has reached a turning point. This is likely to support liquidity at US households/companies, combined with the first CPFF.

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

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.

The third is the announcement of bond issuance by several companies. Thus far, the primary market has been suspended, but some names, such as Verizon Communications and PepsiCo, decided to issue bonds. Although the average concession for new bonds appears to have been high at around 45bp, we positively view the resumption of funding.

Fourth is US dollar fund-supplying operations by the BOJ, where financial institutions placed bids and successful bids amounted to $32.325bn (about Y3.4tn). This was conducted in line with the BOJ's decision to supply ample funds at an emergency meeting on 16 March. In addition, this operation included the first three-month operation, reflecting the decision.

**Chart: US Dollar Funds-Supplying Operations by BOJ (17 Mar)**

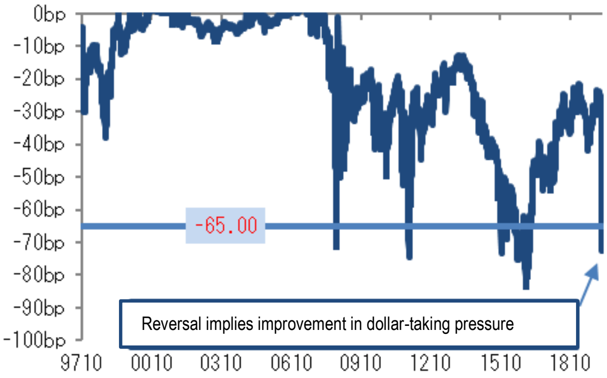
| Period | Loan rate | Amount of successful bids ($bn) |
|---|---|---|
| 2 weeks | 0.37% | 2.053 |
| 3 months | 0.41% | 30.272 |

*Source: Bloomberg; compiled by Daiwa Securities.*

The loan rate in the BOJ's operations reflected the conditions agreed on the provision of US dollar liquidity among six major central banks (incl. Fed). It was very attractive at 0.37% for three-month ops and at 0.41% for one-week ops. There were no reasons to avoid using this scheme, but financial intuitions had tended to refrain from using it for fear of a bad reputation on the "lack of dollar-funding capacity," resulting in no bids or a limited amount. However, this time, private-sector financial institutions met the BOJ's intention to supply "ample funds," and a sufficient amount was accepted via usage of the scheme. The avoidance of "fallacy of composition" has also been confirmed here. Thanks to support by major central banks in Japan, the US, UK, Europe, Switzerland, and Canada, the dollar-funding issue was resolved at related financial institutions. Due to this, the liquidity issue has reached a turning point.

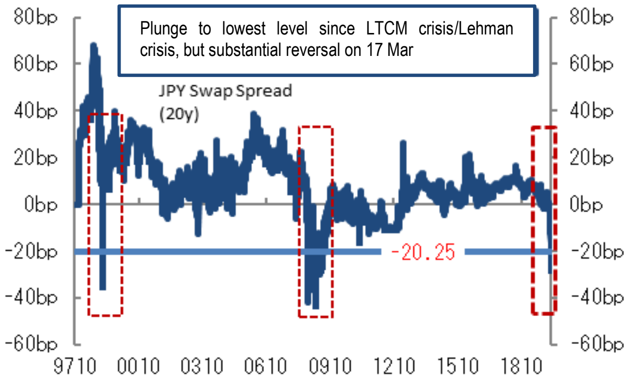
Once position adjustments end on the selling side, this liquidity crisis is likely to normalize. I recognize that yesterday was a turning point.

**Chart: USD/JPY Currency Basis**




*Source: Bloomberg; compiled by Daiwa Securities.*

**Chart: Yen Swap Spread (20Y)**




*Source: Bloomberg; compiled by Daiwa Securities.*

Of course, the liquidity issue is not the only problem surrounding the current market amid the COVID-19 outbreak. However, <u>the depletion of liquidity is probably the cause of the critical confusion of the current market.</u> Securing of the liquidity is the premise for market normalization. Once we confirm improvement in this respect, we can shift focus to the government's economic measures. Yesterday, the media reported that US President Donald Trump was considering an economic package worth around Y129tn. This is the background of the rise in long-term interest rates. Also in Japan, Prime Minister Shinzo Abe announced the intention to formulate "drastic and powerful economic policy," aiming for a V-shaped recovery. Valuation on the size of expenditures depends on the timing of the end of the COVID-19 outbreak, in addition to the content of the expenditures. We wait expeditious deliberations on the budget at the Diet with a focus on national benefits.

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**■ Credit Rating Agencies**

**[Standard & Poor's]**

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**[Moody's]**

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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 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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- 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.
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