Daiwa Securities

Daiwa's View

Bracing for prolongation of demand shocks

- V-shaped recovery unlikely, given lockdowns and production adjustments

Fixed Income Research Section
FICC Research Dept.

Chief Market Economist
Mari Iwashita
(81) 3 5555-8852
mari.iwashita@daiwa.co.jp

Daiwa Securities Co. Ltd.

Bracing for prolongation of demand shocks

Spread of COVID-19 in Europe and US

Lockdowns have drastically changed global economic conditions

In Since the beginning of March, the COVID-19 virus has been rampant in Europe and the US. The sense of crisis in the Asian region is now being shared by the US and Europe, after a lag of several weeks. In late March, travel bans and restrictions on going out were tightened in various countries, and the lockdown of cities began. In order to prevent the spread of infection, the flow of people and goods has been stopped suddenly, so, even if it is temporary, sudden contraction of economic activity is unavoidable. The global economic landscape has changed drastically. Although we expected Jan-Mar negative growth in Asia centering in China, sluggish economic activity in Europe and the US has increased the possibility of global negative growth in Apr-Jun.

Due to combination of supply shocks and demand shocks, pace of recovery is likely to be moderate

Meanwhile, as the US and European nations have started to formulate full-blown economic measures, we can now see the direction of various measures. Since the details and size of the measures have been disclosed, we are now just waiting for them to be implemented. Many anticipate a V-shaped recovery in Jul-Sep after suspended operations in Apr-Jun, assuming the pandemic comes to an end at an early stage. However, we should recognize that the automobile industry already faced a slump due to a decline in global demand before the spread of COVID-19. Given the supply shocks caused by the supply chain disruption and the additional demand shocks, we should keep in mind that the pace of recovery is likely to be moderate in the US, as well.

IMF *World Economic Outlook* sees global economy shifting to recession scenario in 2020

Preventing spread of virus is vital; sense of crisis in Tokyo

On 23 March, IMF Managing Director Kristalina Georgieva expressed a sense of crisis, saying that the global economy in 2020 will enter a recession due to the new coronavirus pandemic, and that the first negative growth since 2009 (or in eleven years) since the global financial crisis (down 0.1%) would be inevitable. Her statement indicated a shift to a recession scenario in the *World Economic Outlook* to be announced in mid-April. However, the main scenario appears to be a recovery in 2021 due to early containment of the virus. If an end to the spread of the virus is delayed, the timing of the recovery will be delayed. Therefore, containing the spread of the virus is important. At an emergency meeting on 25 March in Japan, Tokyo Governor Yuriko Koike requested that people refrain from going outside this weekend for nonessential reasons, expressing a sense of crisis that Tokyo is in a "critical phase" in which it might see an "explosion" of cases. Until new medicines are developed, the spread of the virus will not stop without the cooperation of the public.

Japan will face downward pressure in Apr-Jun due to output adjustments, weak external demand, and a mood of self-restraint

I had already expected the weakness in Jan-Mar to linger to Apr-Jun. However, now, negative growth for the third consecutive quarter is almost certain because of suspended operations (output adjustments in line with weaker demand) at domestic auto plants (such as Toyota Motor) and weak external demand due to the impact of the aforementioned lockdowns in Europe and the US. Therefore, GDP in Apr-Jun is expected to fall more than in the Jan-Mar quarter. If the spread of the virus is not stopped and the mood of self-restraint is prolonged, downward pressure will increase.

Negative growth for third consecutive quarter expected; government removes "recovery" from wording in report

Since negative growth for the third consecutive quarter (since Oct-Dec 2019) is expected, the economy is now in a recession. In the Monthly Economic Report announced on 26 March, the Cabinet Office made a downward revision to its overall economic assessment and switched its wording from "recovering moderately" to in a "severe situation." This is the first time in six years and nine months that the wording "recovery" has been removed from the report.

Both manufacturers and non-manufacturers worsened to double-digit negative readings in March Reuters Tankan

DIs among large manufacturers to fall into negative territory in BOJ's March Tankan; start of economic recession

Japan's economic data for Feb-Mar is now available, and it shows a marked slump in sentiment. In the March Reuters Tankan released on 17 March (242 firms responded out of a universe of 400 firms during the survey period of 2-12 Mar), the sentiment index worsened to –20 among manufacturers and –10 among non-manufacturers (charts 1 and 2). In the former, the reading plunged by 15 points m/m, posting the biggest decline since April 2011 immediately after the Great East Japan Earthquake. The readings fell into negative territory in all sectors. In particular, deterioration was drastic in steel/nonferrous metals (down 28 points) and foods (down 27 points). The survey included comments that the situation is like the one immediately after the Lehman crisis mainly in steel-related and construction fields, and that capex plans have been partially postponed or cancelled. The sentiment index is projected to fall by another 25 points, suggesting that the negative impact of disrupted supply chains will be prolonged mainly in the auto sector. The business condition DIs among large manufacturers are also expected to fall into negative territory in the BOJ's March Tankan to be released on 1 April. This is likely to reconfirm the start of an economic recession.

COVID-19 pandemic has caused collapse of high-level DIs among non-manufacturers, which were foundation of Japan's soundness

Impact of fewer inbound tourists to be confirmed by *Sakura* Report

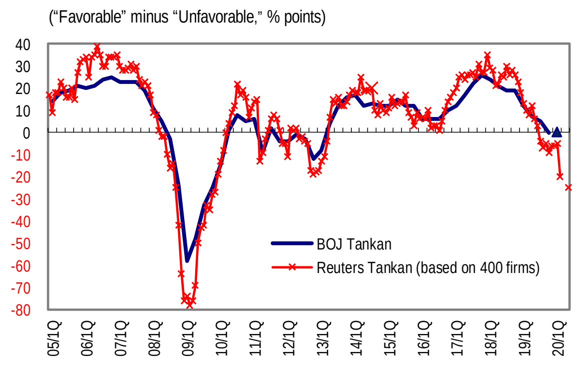
The sentiment index among non-manufacturers posted the largest-ever decline (down 25 points m/m). The COVID-19 outbreak caused a collapse of DIs among non-manufacturers, which had been maintaining the soundness of Japan's economy. The plunge was substantial especially in transport/utility (down 46 points) and wholesalers (down 39 points). People involved pointed to a decline in the container cargo volume and the marked influence of a reduction in inbound tourists. Although the sentiment index is projected to remain unchanged at –10, a downtrend is likely to continue if signs of an end to the virus outbreak are not confirmed. More concrete conditions will become apparent in the interview survey of the BOJ's Regional Economic Report (*Sakura* Report) to be released on 9 April.

Government considering emergency economic package, given the severe economic conditions

With GDP expected to contract by around 10%, Y50tn-plus package appears reasonable

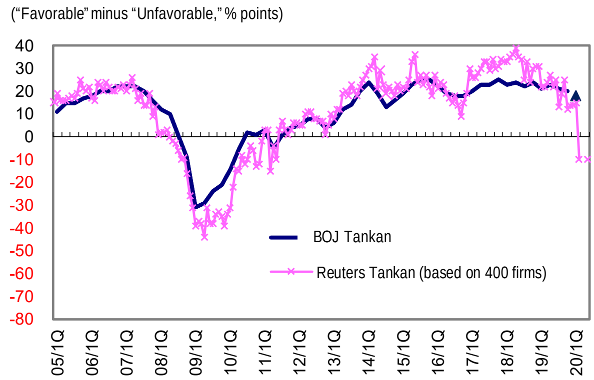
Given the severe outlook, the government is moving to formulate an emergency economic package to cope with the COVID-19 pandemic that will accompany the compilation of the FY20 supplementary budget for approval by early/mid-April. At the end of 2019, large-scale economic measures (Y26tn on all-projects basis) were formulated to avoid an economic slowdown after the Tokyo 2020 Olympic Games. With the decision to postpone the Olympic Games, such economic measures seem to be somewhat incomplete. It would be effective to combine these two packages by reviewing, in so far as possible, how they will be used so that they can be made to be in line with recent developments. The April economic package is anticipated to be of a similar size to the one during the global financial crisis (around Y56.8tn), which appears reasonable, considering that I now estimate that the COVID-19 pandemic will reduce GDP by about 10%. In addition, its effects will be maximized if beneficiaries are limited to people/companies in need of help (income compensation and corporate support). Moreover, it would be good to establish a flexible framework that can implement additional measures to maintain employment and avoid corporate bankruptcies when the entire extent of the damage has been confirmed.

Chart 1: Business Conditions DI Among Large Manufacturers



Source: BOJ, Reuters; compiled by Daiwa Securities.
Note: Symbols away from lines indicate forecasts.

Chart 2: Business Conditions DI Among Large Non-manufacturers



Source: BOJ, Reuters; compiled by Daiwa Securities.
Note: Symbols away from lines indicate forecasts.

Instability of financial markets still requires caution as Japan heads towards end of fiscal year / Central banks should provide support to maintain flow of money

As we approach the end of March, the final month of Japan's fiscal year, the instability of financial markets still requires caution. With regard to the shortage of dollar liquidity, however, six major central banks agreed to enhance provision of dollar liquidity on 20 March. The Fed also resumed CP purchases on 17 March, followed by the introduction of a credit support program on 23 March, in addition to its decision to buy unlimited amounts of US Treasuries and MBS. The BOJ also increased ETF purchases to reduce the risk premium. As such, a series of necessary moves were taken by central banks. Their role is to provide support to maintain the flow of money, even if the flow of people and goods stops.

Central banks pressured by market to take further action, like during Lehman crisis

If demand shocks are prolonged, central banks may need to consider next move

The virus outbreak brings to mind the wise words of former BOJ governor Masaaki Shirakawa who said that crises always come in different forms. Some have said the coronavirus shock is similar to Black Monday (Oct 1987) in terms of heightened uncertainties about the future, fear that no end is in sight, and market restlessness. On the other hand, current conditions are also similar to the September 2008 Lehman shock in terms of central banks being pressured to take further action if a rapid succession of new easing steps fail to stop markets from falling. However, the current crisis clearly differs in many ways. First, the epicenter of the crisis is China, not the US. Second, this crisis was caused by the spread of an infectious disease and not the collapse of a financial bubble. That said, if concerns about a credit crunch ultimately spread, supply shocks persist, and demand shocks are prolonged, the current emergency steps will be insufficient and measures to address a recession will probably eventually become necessary.

Until end of pandemic comes into view, international cooperation and collaboration with government will be important

In the near-term, the government will play an important role. However, it's safe to say that the central bank should also be giving thought to its next move if it wants to be prepared for a protracted struggle. In the Summary of Opinions at the BOJ Monetary Policy Meeting on 16 March (released 25 Mar), several members assume the slump will be prolonged and insist that it is necessary to maintain a strong cooperative framework with the government. Until an end of the pandemic comes into view, international cooperation and collaboration with the government will be important.

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.

■ The Significance of Registration

Registered Credit Rating Agencies are subject to the following regulations:
1) Duty of good faith.
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

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of March 7th, 2017, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings are Moody's Investors Service's ("MIS") current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. MIS defines credit risk as the risk that an entity may not meet its contractual, financial obligations as they come due and any estimated financial loss in the event of default. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk, or price volatility. Credit ratings do not constitute investment or financial advice, and credit ratings are not recommendations to purchase, sell, or hold particular securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information, is given or made by MIS in any form or manner whatsoever.

Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of April 16th, 2018, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Moody's Japan K.K. (https://www.moodys.com/pages/default_ja.aspx)

[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.com/site/japan)

Assumptions, Significance and Limitations of Credit Ratings

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

For the details of assumption, purpose and restriction of credit ratings, please refer to "Definitions of ratings and other forms of opinion" on the website of Fitch Rating Japan Limited.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of September 27th, 2019, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Fitch Rating Japan Limited (https://www.fitchratings.com/site/japan)

February 2020

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Conflicts of Interest: Daiwa Securities Co. Ltd. may currently provide or may intend to provide investment banking services or other services to the company referred to in this report. In such cases, said services could give rise to conflicts of interest for Daiwa Securities Co. Ltd.

Daiwa Securities Co. Ltd. and Daiwa Securities Group Inc.: Daiwa Securities Co. Ltd. is a subsidiary of Daiwa Securities Group Inc.

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).

6) NEC (6701): NOTICE REGARDING U.S. PERSONS: This report is not intended for distribution to or use by any person in the United States. Securities issued by NEC Corporation have been suspended from registration in the U.S. and are subject to an order of the U.S. Securities and Exchange Commission dated June 17, 2008, pursuant to Section 12(j) of the Securities Exchange Act of 1934. This document is not a recommendation or inducement of any purchase or sale of such securities by any person or entity located in the U.S. Daiwa Securities Co. Ltd. disclaims any responsibility to any such person with respect to the content of this document. Any U.S. person receiving a copy of this report should disregard it.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(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.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association