Daiwa's View

Steepening pressure is building

➢ 15-year/20-year steepener attractive

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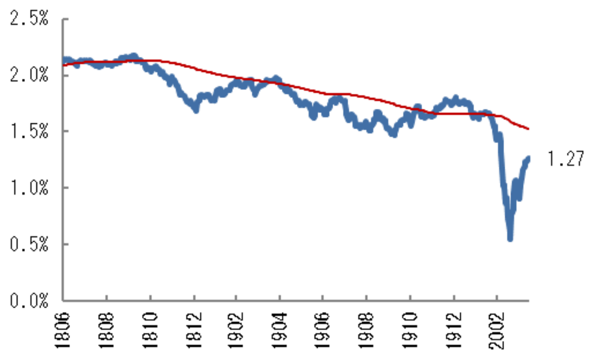
Upward pressure on long-term and superlong yields (steepening) has been observed. The 10-year/20-year JGB yield spread, which is garnering strong attention, has risen from 18bp on 20 March to around 30bp, while the 2-year/10-year US Treasury spread (described as "US long-term/short-term yield spread" hereafter in this report) has also risen from 12bp on 21 February to 52bp.

Currently, one of the factors driving the expansion of the US long-term/short-term yield spread is a recovery of inflation expectations. Yesterday, the 10-year US breakeven inflation rate (BEI) rose to 1.27% after hitting a bottom at 0.55% on 19 March. A slight rebound from the level in the midst of the liquidity crisis is natural. However, we think that further upside potential remains for the BEI, given its trendline over the past several years and the divergence with the Fed's inflation target. If we assume a recovery to the trendline, the 10-year BEI may return to around 1.50%.

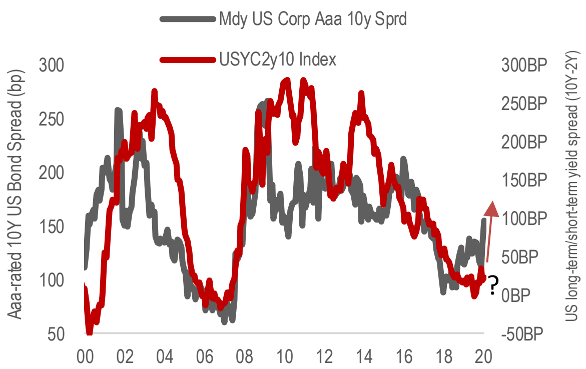
The correlation between the corporate bond spread and yield curve also appears to imply further steepening of the long-term/short-term yield spread. Looking at the current pattern, steepening of the yield curve is observed after the US credit spread widened due to economic concerns triggered by the COVID-19 pandemic. In past patterns, steepening of the yield curve was driven by the Fed's substantial rate cuts to cope with economic downturns (approximately equal to widening of corporate bond yield spread). However, this time around, expectations for a very large amount of fiscal spending, rather than rate cuts, are boosting long-term interest rates, while the policy interest rate was lowered to the ELB.

Chart: 10Y US Breakeven Inflation Rate



Source: Bloomberg; compiled by Daiwa Securities.

Chart: US Long-term/short-term Yield Spread and Aaa-rated 10Y Bond Spread



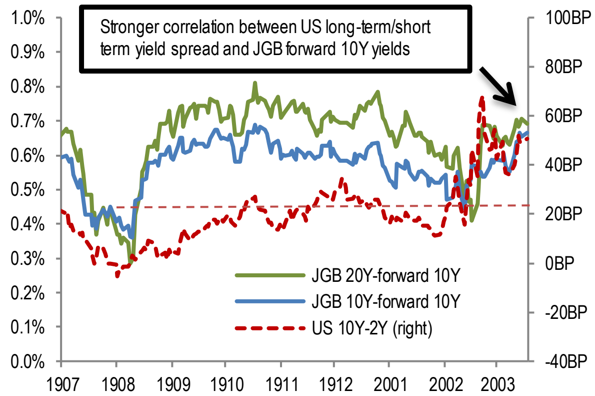
Source: Bloomberg; compiled by Daiwa Securities.

Is the above-mentioned view a blue-sky theory? I believe the structure that the yield curve is steepened by the combination of (1) "an increase in the issuance of government bonds" to address powerful downward economic pressure and (2) "monetary policy" to suppress the short-end of the yield curve is highly convincing. In addition, the correlation between the US long-term/short-term yield spread and JGB forward 10-year yields (component specific to superlong zone) has recently been increasing. Therefore, if US yields steepen, it is highly possible that steepening pressure will also be put on JGB yields.

If we assume that the US BEI's recurrence to its trendline is fully reflected in the US long-term/short-term yield spread (= real interest rate assumed at fixed level), the US long-term/short-term yield spread is estimated to rise to around 75bp. This corresponds to a rise in the JGB forward rate to around 0.8%, given the recent correlation between US and Japanese yields (chart below). In this case, if we assume that the 10-year JGB yield is 0%, the 20-year JGB yield would reach 0.40% and the 30-year JGB yield is calculated at above 0.5%.

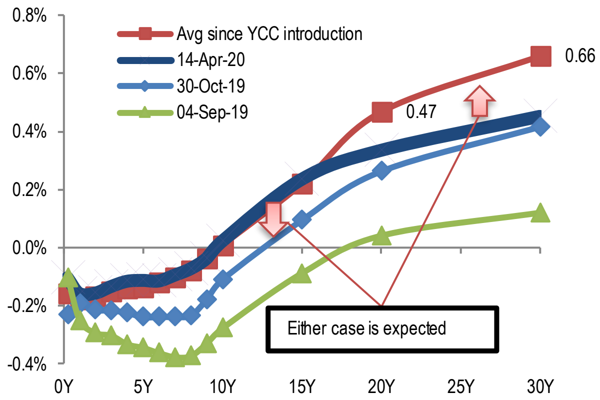
While yields of JGBs with residual maturity up to 15 years are in line with the average since the introduction of the YCC policy, the 20-year and 30-year JGB yields are close to the level seen at the end of October 2019. We think that 15-year/20-year steepener is attractive even in the case that superlong yields rise toward the average since the introduction of the YCC in the aforementioned scenario (= bear steepening) or the case that the market will return to a Goldilocks market owing to a rapid end to the COVID-19 outbreak (= bull flattening).

Chart: US Long-term/short-term Yield Spread



Source: Bloomberg; compiled by Daiwa Securities.

Chart: JGB Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

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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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February 2020

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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), Daiwa Securities Living Investment Corporation (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%.

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