

Daiwa's View

Goodbye pessimism

- Market sentiment is already breaking free of pessimism

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Daiwa Securities Co. Ltd.

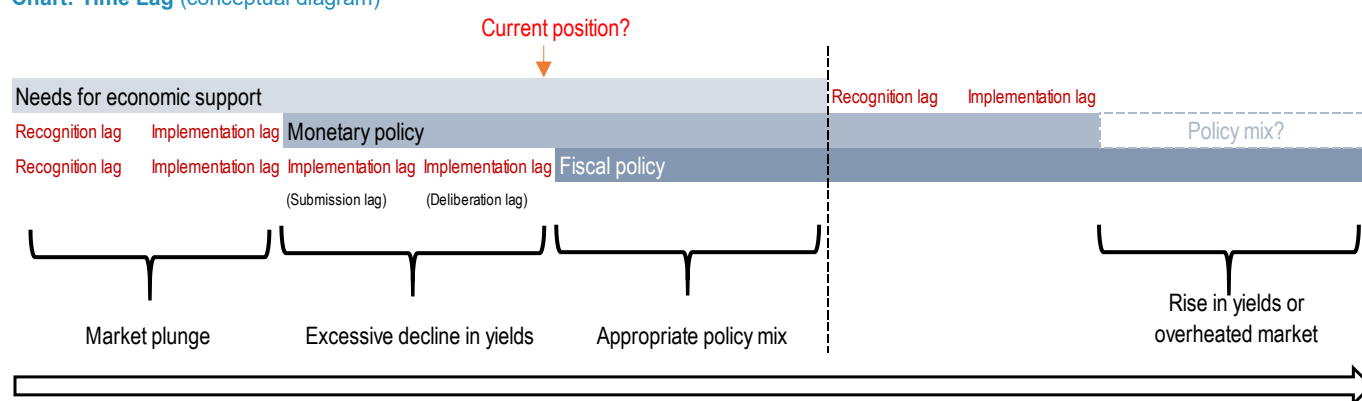
Market sentiment is already breaking free of pessimism

Goodbye pessimism

It appears that [the risk of waiting too long](#) was indeed high, as expected. Yesterday, stock prices in Japan, Europe, and the US surged again, and a series of other assets are also in the process of exceeding threshold levels. The DJIA, S&P 500, and Nikkei Stock Average recovered to around 25,000pt, 3,000pt, and 21,000pt, respectively. In the bond market, the 30-year German yield also surfaced to positive territory for the first time since 14 April. The 40-year JGB yield exceeded 0.5%, as well. The 5-year/30-year US yield spread posted bear steepening to 109.5bp, a level not seen since June 2017. The yield spread of 10-year Italian government bonds against German Bunds, a risk benchmark in Europe, also declined to 198bp, falling below the threshold level.

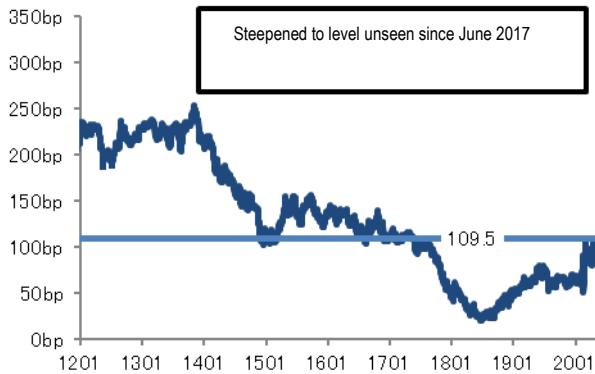
While economic indicators are showing signs of a major bottom, policy support has been further enhanced. Therefore, [a change in market trends](#) is clear. Yesterday, ECB chief economist Philip Lane stated that the eurozone economy likely hit a bottom in April, saying, "I think it's clear by the way that the absolute bottom was probably in April." Meanwhile, the supportive stance taken by authorities is solid, as shown by the high likelihood of additional easing—expansion of the Pandemic Emergency Purchase Programme (PEPP)—being decided at the ECB Governing Council meeting to be held on 4 June or in July. Since [the time lag between economic conditions and policy support](#) inevitably causes an overheated market, that is likely to happen during this crisis.

Chart: Time Lag (conceptual diagram)



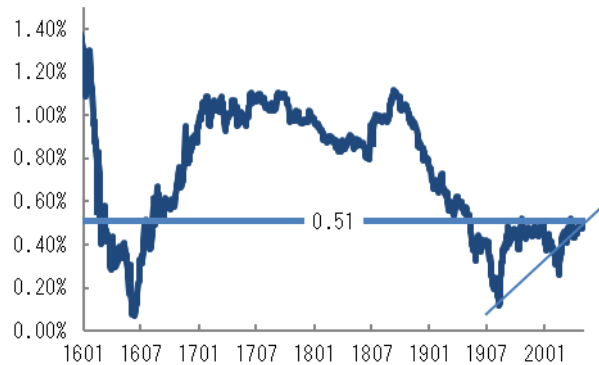
Source: Compiled by Daiwa Securities.

Chart: 5Y/30Y US Treasury Spread



Source: Bloomberg; compiled by Daiwa Securities.

Chart: 40Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

We have started to see moves that could enable us to avoid this fate. Regarding capital keys, which have made the ECB's QE rigid, Governor of the French central bank François Villeroy de Galhau said yesterday that the ECB's PEPP "shouldn't be bound to capital keys." This is noteworthy as a controversial remark because capital keys are a subtle and unavoidable issue for deepening the integration of the EU in the future, together with the French-German agreement on the euro recovery fund the other day. Of course, it would be premature to assume that long-cherished hopes since the establishment of the ECB will be realized in one stroke. Regarding the response to the coronavirus crisis, however, it is true that we have begun to observe positive aspects. (As the saying goes, "A broken bone is the stronger when it is well set.") Since we have begun to notice aspects of the crisis that have brought about progress, rather than setbacks, this is likely to boost market sentiment, which had worsened profoundly.

Market sentiment is already breaking free of pessimism. CNN's Fear & Greed Index showed extreme optimism [at the beginning of the year](#), and then extreme pessimism in March. The index has now recovered to 50, a normal level. The put/call ratio and relative return of stocks and bonds have already entered the "Greed" zone. Once we confirm a recovery of the junk bond spread and stock market momentum, both of which are rapidly improving, the pessimistic sentiment will have finally run its course¹.

Chart: Investor Sentiment Index (CNN's Fear&Greed Index)



Source: Extracted from CNN.

¹ Defaults in parts of the junk bond market are a phenomenon already factored in the widening in March. It is highly likely that such defaults will lead to tighter spreads as a sign of the "playing-out of negative factors."

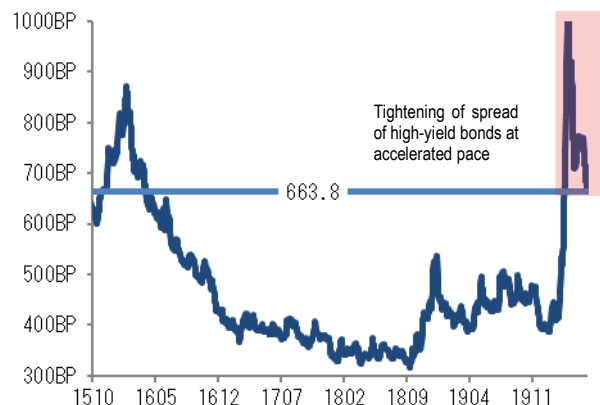
Under these circumstances, yesterday the online *Nikkei* newspaper reported that easing of requirements for public fund injections will prevent dysfunction at regional financial institutions. The article states that authorities will make it easier for financial institutions to receive public funds by removing stipulations regarding earnings targets and clarification of management responsibility, and do away with repayment deadlines, in order to prevent the impact of the COVID-19 pandemic from increasing concerns about the financial system.

This is a very good step in the right direction. In Japan, which mainly relies on indirect financing, a capital shortage at financial institutions always causes a financial crisis. In the current coronavirus crisis, since the economy is facing a heavy burden, a response to regional financial institutions is being called for as part of national policy. If the government makes strong demands for self-responsibility at financial institutions when their capital erodes as a result of aggressive loan provision in order to meet national requests, the optimal approach for financial institutions would be to take self-defensive action. This would result in the fallacy of composition, and prevent the objectives of national policy from being achieved.

Meanwhile, the preparation of public funds at an early stage, as reported yesterday, and the reduction of penalties on usage are likely to mitigate the issue of stigma and enable financial institutions to perform their duties with confidence. This is a good move towards eventually lowering the need for the injection of public funds by pre-empting a stall in the macro economy and reining in an increase in bad loans. A situation will be easily created that resembles what US President Trump described on 21 May when he said that the US has “unlimited ammunition if we need it, but we won’t need it.” As a result of preparation of backstops, the US commercial paper market has already become independent of support, which is an example of success (see chart below).

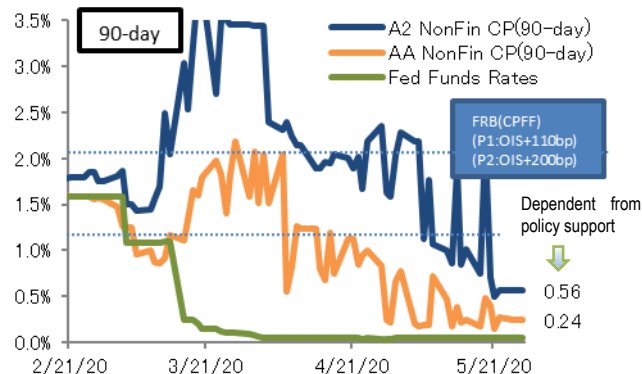
As we have stated previously, the authorities’ policy response to the coronavirus crisis has been expeditious and well-directed. Although we must remain careful and not allow our vigilance to slacken, a financial crisis derived from policy mistakes is unlikely to occur this time since authorities are giving the situation their full attention. Now is the time to break free of excessive pessimism, in our view.

Chart: US High-yield Corporate Bond Spread (cash bonds)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: US Non-financials Commercial Paper (3M)



Source: Bloomberg; compiled by Daiwa Securities.

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[Standard & Poor's]

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[Moody's]

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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 ¥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%.

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- 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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