Daiwa Securities

Daiwa's View

Short-term steepening pressure, long-term flattening pressure

- ➢ Situation would change when consideration about "stage after increased JGB issuance" deepens

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Daiwa Securities Co. Ltd.

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Situation would change when consideration about "stage after increased JGB issuance" deepens

Last Friday, I had the honor of making a speech at a seminar held by the Securities Analysts Association of Japan. I sincerely thank the participants and investors who recommended me.

Through this seminar, I recognized the strength of structural factors behind yield declines. As the Fed pointed out, the yield declines over recent decades became a trend due to a notable decline in the "equilibrium real interest rates." A series of central bank actions such as negative interest rates are just the results of passive actions in reaction to the decline in the equilibrium real interest rates.

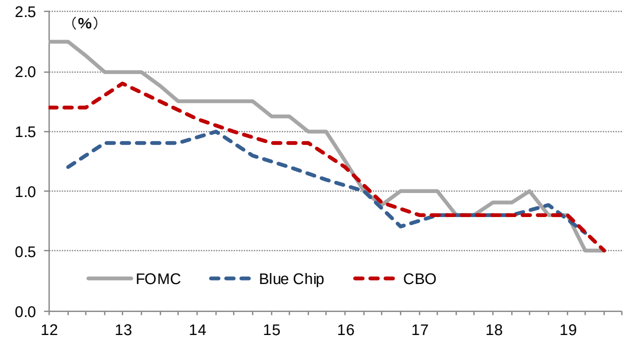
◆ **Minutes of FOMC meeting on 29-30 Oct 2019** (20 Nov 2019)

- With estimates of equilibrium real interest rates having declined notably over recent decades, policymakers saw less room to reduce the federal funds rate to support the economy in the event of a downturn.

Even in such a situation, global yields are currently rising. In particular, the bear steepening of the JGB yield curve stands out (right-hand chart below). Will this trend continue?

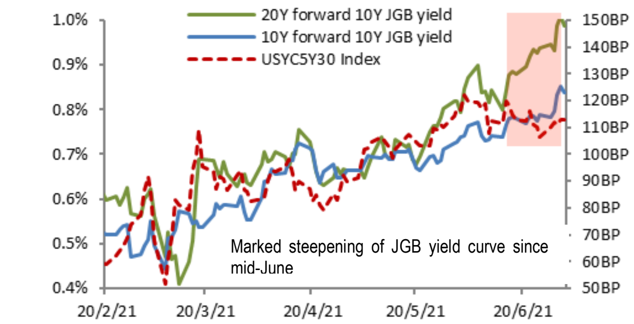
If we first state the conclusion, the factors that caused the decline in the equilibrium real interest rates have eased, while such easing is a temporary phenomenon amid responses to the COVID-19 crisis. Now, market participants are paying full attention to "increased JGB issuance and the BOJ's stance on operations," but the situation surrounding the yield curve is likely to change when consideration about the market deepens after the increased issuance. Market participants need to recognize the existence of the two forces of "short-term steepening pressure" and "long-term flattening pressure."

Chart: Natural Rate of Interest in US



Source: Fed, CBO, Blue Chip; compiled by Daiwa Securities.

Chart: Steepening of JGB Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

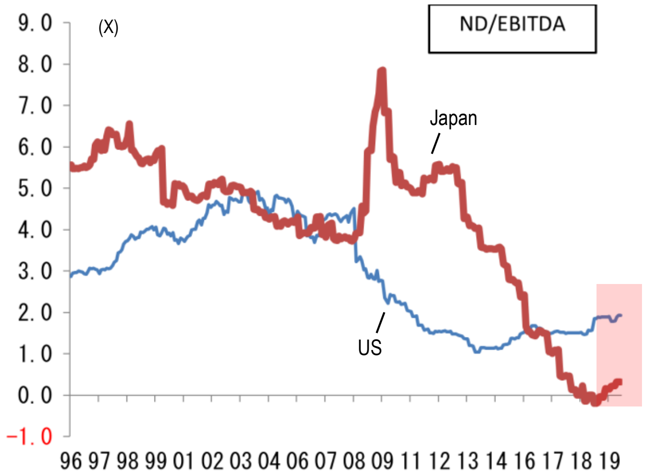
We have explained major factors behind the global decline in the equilibrium real interest rates (natural rate of interest) thus far. In this report, we examine whether four factors—(1) demographics, (2) a decline in debt-financed investment, (3) a change in income distribution, and (4) excessive supply of funds—will lead to changes.

◆ Examination regarding situation of yield decline factors

(1) Long explanations about the demographics are unnecessary. Even before or after the pandemic, downward yield pressure caused by the megatrend of the aging population is unchanged.

(2) Since the global financial crisis, corporate debt financing sharply declined. Recently, the trend has turned around. That said, the increase is mainly caused by temporary financing activities to cope with the funding crisis in line with lower sales due to lockdowns, meaning the lack of the aspect of "investment" to drive economic growth. Even if downward yield pressure eases in terms of this point, it would only be a temporary phenomenon.

Chart: Net Debt/EBITDA Ratio in Japan and US (index constituent companies)



Source: Bloomberg; compiled by Daiwa Securities.

(3) Due to fiscal measures and cash handouts in the face of the COVID-19 pandemic, income redistribution has been reinforced in major advanced nations. This may have temporarily eased the issue of income distribution, which has long put downward pressure on yields. On the other hand, it has become apparent that the pandemic caused the greatest damage to the most vulnerable populations. Once temporary redistribution in line with the pandemic is suspended, the issue of income distribution would worsen. Unless a program of full-scale income redistribution, such as basic income, is adopted, we are likely to face downward yield pressure again after the crisis ends.

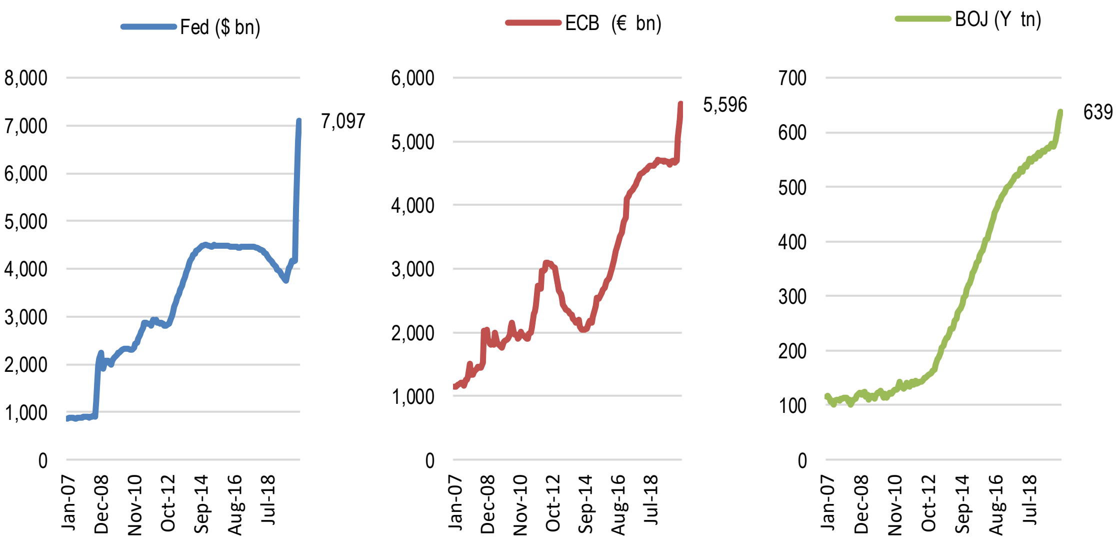
◆ Chicago Fed president Charles Evans (24 Jun 2020)

・While the economic impact has been catastrophic for an extraordinarily large number of people and businesses, sadly, the cost has fallen most heavily on some of our most vulnerable populations. …Like you, I am outraged and horrified by injustices toward the black community. Racism has no place in our society, and each of us has a responsibility to combat it.

(4) As economist Lawrence Summers has pointed out, one background factor behind the globally falling neutral interest rate is excess demand for safe assets. Needless to say, one reason is QE introduced by major central banks since the global financial crisis. Regarding this point as well, the problem has temporarily eased due to the massive amount of fiscal spending to address the pandemic by each government (although major central banks absorbing most of increased issuance of government bonds via large-scale asset purchase programs, pressure due to increased issuance prevailing).

Pandemic-related fiscal spending is very extensive, but this is just a temporary factor. On the other hand, QE is expected to be implemented over the longer term. In the case of continued low inflation, QE would also be prolonged, and the easing effects of supply/demand conditions due to increased issuance of government bonds would likely be absorbed as time passes. Rather, it is highly likely that central banks will fret about ways to rein in excessive flattening under this structure, while continuing with QE.

Chart: Balance Sheets at Major Central Banks to Continue to Expand amid Low Inflation, ELB Restriction



Source: Bloomberg; compiled by Daiwa Securities.

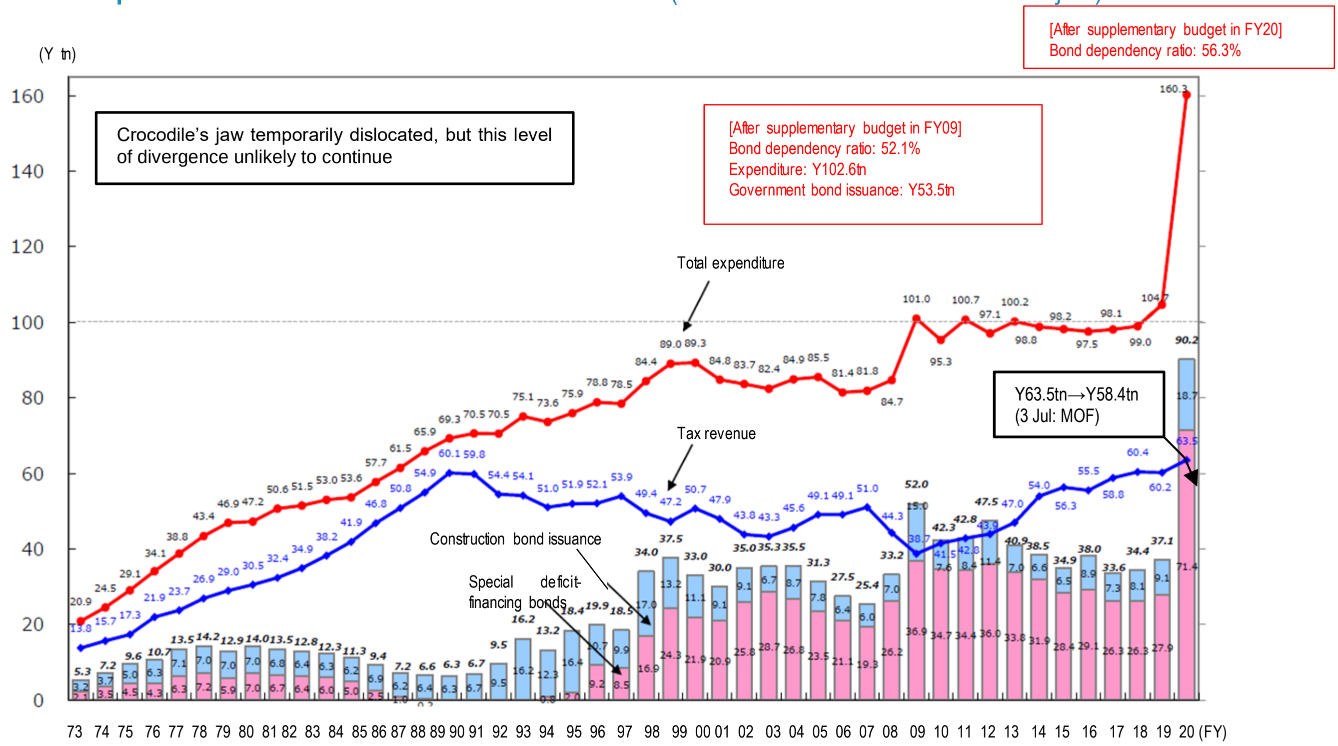
The aforementioned sections are examinations regarding factors behind yield declines. In closing this report, I explain the point that the Japanese yield curve has markedly steepened in global comparison.

Although some often attribute the steepening to increased JGB issuance, the true reason is probably the change in the BOJ's stance on operations. If the BOJ increases the purchase amount in its operations by the same amount as the increased issuance, it is possible to neutralize the impact on the yield curve (sterilization). However, the BOJ did not dare do so, and it kept the offer amounts in the superlong zone unchanged, which is key this time. The yield curve can steepen only because of the YCC policy, which is the reason for the markedly steepened Japanese yield curve in global comparison.

Due to the change in the BOJ's stance, it has become definitive that the JGB yield curve will temporarily steepen in the stage of increased issuance. Meanwhile, what will happen when the "crocodile's mouth" normalizes and the JGB issuance amount is reduced? In such a case, the BOJ is likely to reduce the purchase amount by the same amount as the decreased issuance in the short-term/intermediate zone, where its purchase amount was upped in line with the increased issuance. On the other hand, the scope to reduce the offer amounts in the superlong zone is limited as the BOJ did not raise the purchase amount when the issuance was increased. Accordingly, it is highly possible that the decreased issuance amount will directly lower yields in the superlong zone.

In Japan, short-term pressure to increase JGB issuance is strong. That said, the amount is determined by the degree of the "crocodile's mouth," —i.e., the difference between revenues and tax income. As we reported before, the crocodile's mouth in FY20 is large, as its jaw is dislocated (chart on next page), reflecting the fact that the COVID-19 crisis has triggered one the worst recessions in history. Given that the pandemic is one of the shortest in history, the crocodile's mouth in the future is unlikely to remain the same size as that in FY20. The Fiscal System Council remained silent, recognizing that we are facing difficulty on a national scale. However, it has started to warn against the loosening of fiscal discipline,[1] endorsing the fact that the crocodile's mouth will become smaller going forward.

Chart: Expenditures and Revenues in General Account (crocodile's mouth with dislocated jaw)



Source: MOF; compiled by Daiwa Securities.

Due to the aforementioned considerations, we can forecast the path of Japan's superlong yields. In the near term, "short-term steepening pressure" is likely to remain. However, when the number of investors who are aware of the market after increased JGB issuance becomes the majority, "long-term flattening pressure" would prevail (continuation of low-level yields) and yields are expected to decline to a level that reflects the neutral interest rate[2].

Based on this outlook, our near-term recommendations are a steepener trade for short-term investors and a "leveling purchase stance plus something extra" for long-term investors. In particular, now is an important time for long-term investors, and they should build positions as much as possible before market participants start to consider the stage of decreased JGB issuance. During the current period of increased issuance, there is no need to chase high prices in the secondary market. However, meaningful purchases are recommended at superlong JGB auctions in this fiscal year.

[1] On 2 July, Sadayuki Sakakibara, former chairman of the Japan Business Federation, stated that "I have no doubt that we should prioritize measures to protect public health, lives, and life amid this national difficulty." He also said that "we are positioned to say 'please do not forget fiscal discipline.' "
[2] If we assume 10-year yield of around 0%, points of reference for 20-year and 30-year yields are around 0.3% and 0.5%.

Daiwa Securities

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[Standard & Poor's]

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February 2020

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* 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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