Daiwa's View

Seems like the usual risk-on at first glance, but...

- Latest rebound differs from previous post-pandemic rebounds in some respects

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Daiwa Securities Co. Ltd.

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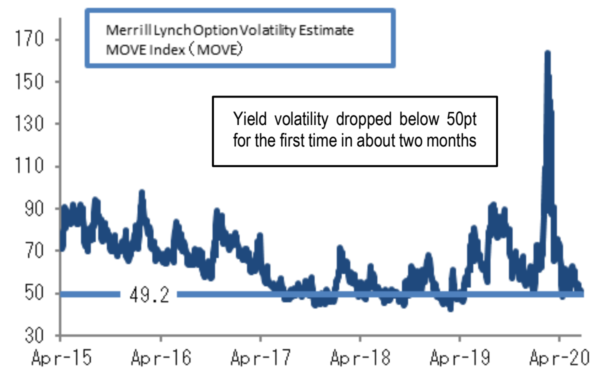
Latest rebound differs from previous post-pandemic rebounds in some respects

On Friday, the DJIA rose 369 points and NASDAQ was up 69 points and posted a third straight day of record highs. With concerns about a second wave of the virus having depressed risk sentiment, the market appeared to react favorably to clinical trials showing that US-based Gilead's *Remdesivir* greatly reduced mortality rates in covid-19 patients. The risk-on weakening of the dollar pulled the dollar index down to 96.66.

Although this looks like the typical risk-on move at first glance, this latest rebound may be different in several respects. The first point to note is the change (decline) in volatility. MOVE, an index measuring the volatility of US Treasury yields, dropped below 50 points for the first time in about two months. The VIX index of US stock volatility also fell, to 27.29 points.

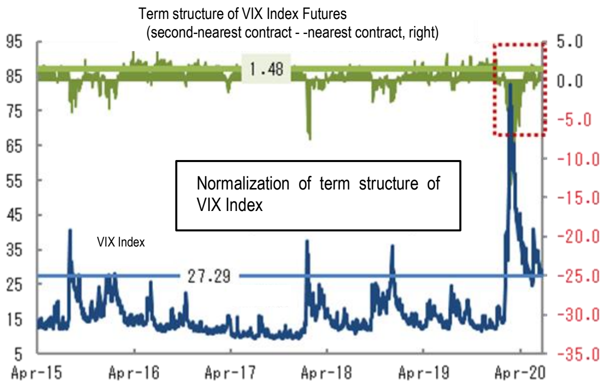
That said, we are focusing on the improvement in volatility quality, rather than that in volatility levels. The spread between the in-close (July) VIX futures contract and the 1-month out (August) contract rose to +1.48ppt. This return to an upward-sloping VIX futures curve indicates market sentiment has improved. There was also a decline in the SKEW index, a measure of tail risk calculated from the smile curve of US stock volatility, down to 135.68 points from 148 points at end-June, suggesting fewer purchases of out of the money (OTM) options. Both the term and depth of volatility are declining, suggesting that the risk avoidance of previously pessimistic institutional investors may have hit bottom.

Chart: Volatility Index for US Treasuries



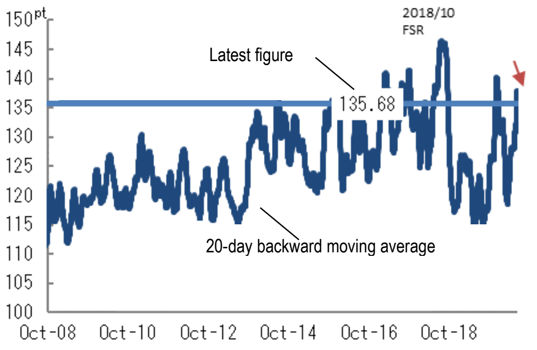
Source: Bloomberg; compiled by Daiwa Securities.

Chart: Volatility Index for US Stocks (VIX and VIX Futures)



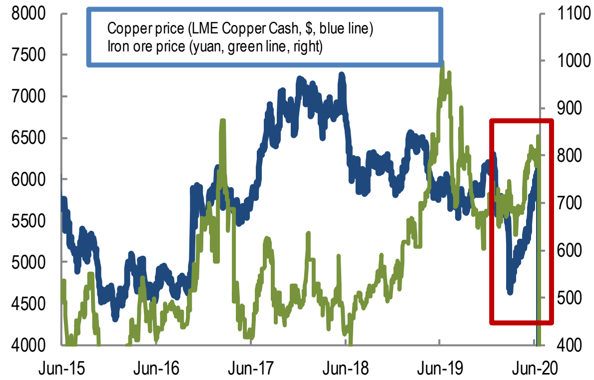
Source: Bloomberg; compiled by Daiwa Securities.

Chart: Tail Risk Indicator for US Stocks (SKEW)



Source: Bloomberg; compiled by Daiwa Securities.

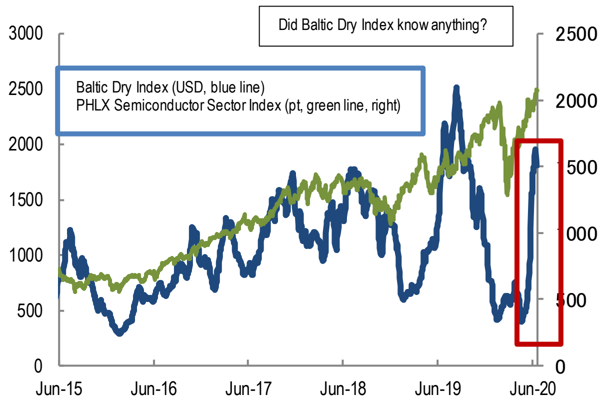
Chart: Commodity Prices



Source: Bloomberg; compiled by Daiwa Securities.

This change can also be felt in other respects: the rebounds in the Chinese yuan and commodity prices. There has been a puzzling sharp rise in Chinese stock markets since the start of July. The limited interviews we have conducted indicate that mainland China's institutional investors were caught flat-footed by this sharp rise. Copper and iron ore prices have continued climbing higher and the Baltic Dry Index is also high. The Chinese Yuan strengthening to a USD/CNY below 7 for the first time in four months during all of this can be attributed to several factors. One reason may be that the market has started to realize that China's fundamentals are overpowering US-China frictions (or that those frictions are easing). It is at least true that commodity prices have recovered sharply and the yuan has rebounded. This stronger yuan has led to risk-on moves fueled by a weaker dollar.

Chart: Baltic Dry Index and SOX Index



Source: Bloomberg; compiled by Daiwa Securities.

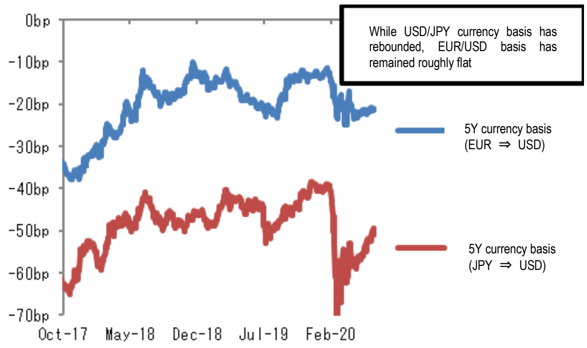
Chart: Yuan (CNH)

Source: Bloomberg; compiled by Daiwa Securities.

There are new developments in the pressures to hold the dollar. Specifically, while the EUR/USD currency basis swap spread (EURUSD XCCY, or EUBS) has not moved much, the USD/JPY currency basis swap spread (USD/JPY XCCY, or JYBS) has quickly become much less negative, suggesting a change from what had been one-sided demand for dollars (left side chart on next page). Because the dollar's price moves vs. the euro differ from those vs. the yen, the explanation must be specific to the USD/JPY currency pair rather than dollar-driven moves caused by the pressure to hold dollars. This suggests the possibility that there was a change in outward investment from Japan and/or inward investment from overseas.

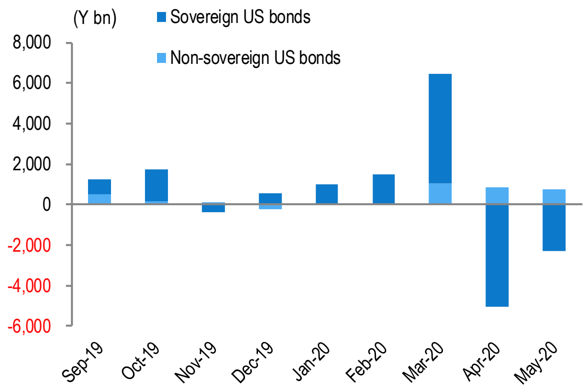
One characteristic of Japan's investment in foreign bonds since March has been increased investment in non-sovereign bonds. We attribute this to smart money taking advantage of the excessive widening of corporate bond spreads caused by the pandemic. Such investments have generated large profits over only a few months' time. The data confirms that this trend of investing in non-sovereign US bonds continued at least through May, but corporate bond prices started hitting new highs in June, and with the JGB yield curve steepening more than the yield curves for other sovereign debt, foreign bonds have become less attractive. It would not be surprising if this resulted in fewer purchases of non-sovereign bonds. We think those investments in non-sovereign bonds offering a spread are fully hedged against currency risk using currency basis swaps with a matching term (i.e., longer than three months). The recent narrowing of negative spreads on USD/JPY currency basis in the 5-year and longer dated zones may reflect a lessening of outward investments by Japanese investors.

Chart: Currency Basis Spread (5Y)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Investment in US Securities by Japanese Investors



Source: Bloomberg; compiled by Daiwa Securities.

It is also possible that nonresident investors have started investing in JGBs again. Based on the Fed's forward guidance, US Treasury yields are expected to remain extremely low out to the 5-year zone, further deepening the dearth of yield in the short-term to intermediate zones. With funds in search of yield flowing into corporate bonds offering spreads and pushing US corporate bond ETFs to new record highs, JGB spreads vs. Treasurys may be gradually starting to look more attractive to dollar-based investors. The absolute yield on the 5-year JGB in USD terms is currently around 0.9%, which equates to a spread over Treasurys of 60bp. This 60bp spread did not look like much after the massive widening of corporate bond spreads early in the pandemic, but the rapid narrowing of US corporate bond spreads may have drawn more attention to the attractiveness of JGB relative spreads.

Last week, the market was focused on the 30-year JGB auction to gauge the sustainability of this steepening trend, but when also looking at US corporate bond spreads and the trend in the USD/JPY currency basis, of more importance may be the better-than-expected results of the 5-year JGB auction. We will be watching this week's data on outward/inward investment, scheduled for release on Thursday, to see if there was an increase of inward investment in intermediate to long-term bonds. If the data confirms a significant increase of inward investment, it may bring a new development in the JGB market: declining yields in the short-term and intermediate zones. If it does, it will indicate a broadening of the search for yield and may also signal the return of across-the-board buying.

Daiwa Securities

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[Standard & Poor's]

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[Moody's]

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February 2020

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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), 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%.

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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* 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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