

Daiwa's View

After the storm comes a calm?

- Agreement on EU recovery fund may be a game changer

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp



Daiwa Securities Co. Ltd.

Agreement on EU recovery fund may be a game changer

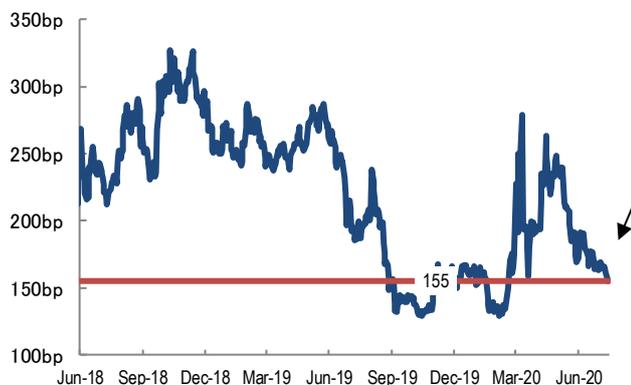
After the storm comes a calm?

Yesterday, EU leaders reached an agreement on the recovery fund after five-day discussions. While the ratio of grants was lowered in comparison with the initial plan, the ratio of loans was increased¹. However, nations that had been strongly concerned about the fiscal burden, such as the Netherlands and Austria, also agreed to the recovery fund, which has a historical meaning. As this European solidarity is a positive result brought about by the COVID-19 pandemic, the saying “after the storm comes a calm” is very appropriate here.

There is no room to argue the point that the nations that will benefit the most from this agreement are in southern Europe, especially Italy. It is expected that a large amount of grants will be distributed to Italy, which was hit hardest by the pandemic among European nations. The yield spread of 10-year Italian government bonds vs. German Bunds has thus declined to 155bp.

That said, the impact of this historic agreement is likely to spread broadly over the long term, not limited to benefits to Italy. This is symbolized by the movements of the euro currency. As the EUR/USD rate rose to 1.15, the trend over the past several years has decisively turned around. It was deemed that the block cannot eliminate the structure of “Northern Europe vs. Southern Europe” as there were protracted struggles among member nations due to the European debt crisis in 2011-12. However, concerns about the political dysfunction of the EU have now eased, which is an important point, but the background of the trend shift in the euro is the outlook that joint procurement, which is virtually joint euro bonds, will be an ideal investment target in reserving the euro, and this will raise the position of the euro as a “reserve currency.”

Yield Spread of 10-Year Italian Government Bonds vs. German Bund

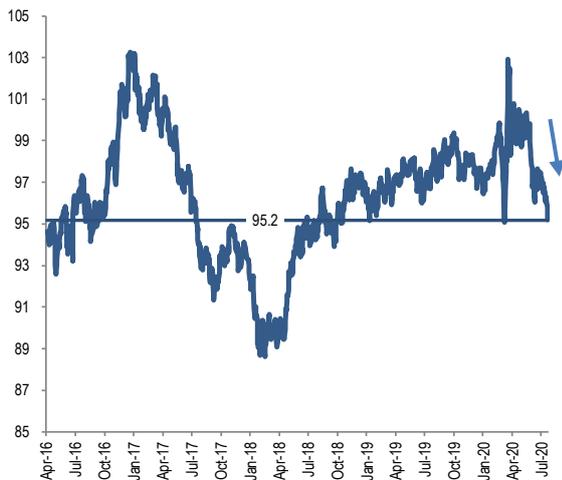


Euro (EUR/USD)



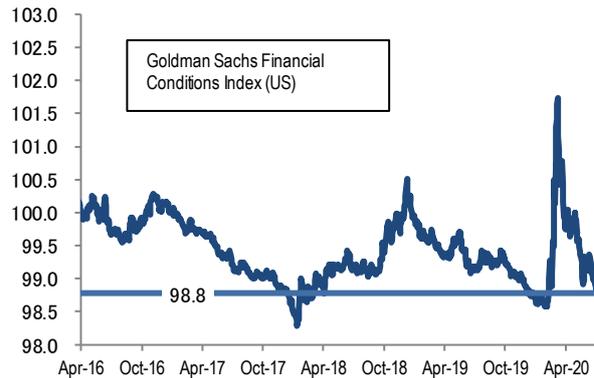
¹ Of economic recovery package totaling €750bn (Y92tn), €390bn will be distributed as grants (no need to repay) and remaining €360bn will be provided as low-interest loans.

Weaker Dollar Behind Stronger Euro



Source: Bloomberg; compiled by Daiwa Securities.

US Financial Conditions Index Approaching Pre-pandemic Level



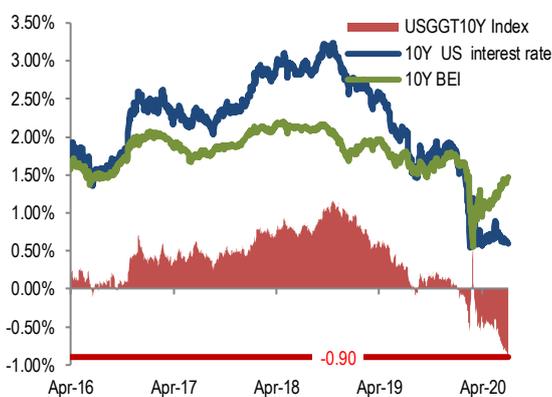
Source: Bloomberg; compiled by Daiwa Securities.

In short, the agreement on the EU recovery fund is a game changer, implying that appreciation of the euro may be prolonged. The resultant strength of the euro causes a weaker dollar (flip side of the coin), which is likely to ease the financial environment in the US. In fact, the Dollar Index (DXY) has declined to 95.15, the lowest level since the beginning of 2019.² The US Financial Conditions Index also improved to 98.8, close to the lowest level for the past four years.

The symbolic move under the circumstances is a further decline in US yields, despite the weaker dollar and a surge in asset prices. This implies that the market may have started to factor in the possibility that it will take a very long time before the Fed hikes the rate. In addition, the combination of a rise in inflation expectations and suppressed nominal interest rate causes a decline in the real interest rate. Yesterday, the 10-year US real interest rate fell to -0.9% , indicating that the effects of the Fed's monetary easing are increasing day by day.

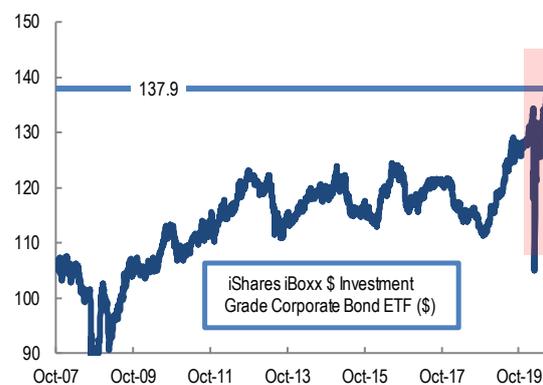
The S&P 500 Index again advanced yesterday, with the price of US investment grade corporate bond ETF setting a record high. I wonder whether the Fed wants to take preemptive measures for overheated asset prices caused by easing, or favors a series of movements actually leading to a rise in inflation expectations. How the Fed will express its recognition on overheated asset prices at next week's FOMC meeting appears to be becoming an important point in forecasting the market trends.

10Y US Real Interest Rate Fell to -0.9%



Source: Bloomberg; compiled by Daiwa Securities.

US Investment Grade Corporate Bond ETF Setting Record Highs for Consecutive Days



Source: Bloomberg; compiled by Daiwa Securities.

² Excl. level (95.07) logged at time of liquidity crisis amid coronavirus crisis in Mar 2020.

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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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- 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%.
- 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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- 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.

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Corporate Name: Daiwa Securities Co. Ltd.

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