Daiwa's View

Outperforming 20-year sector

➢ Bond vigilantes vs. yield hunt

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Daiwa Securities Co. Ltd.

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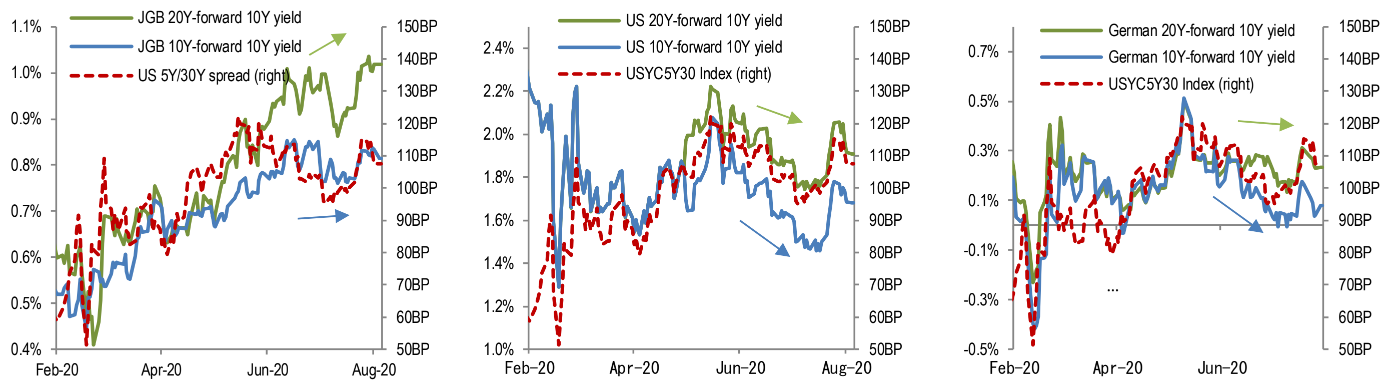
Global comparison of 10-year forward yields since the COVID-19 pandemic shows a common point of a wider spread between 10-year forward 10-year yield and 20-year forward 10-year yield. Both have tended to be roughly at the same level thus far. However, since May 2020, the former has been clearly outperforming the latter (see charts below).

As one reason behind the outperformance of 20-year JGBs vs. 30-year JGBs, we pointed out the possibility of an impact from increased excess funds at depository institutions in our previous report. Although we think that this is still effective, what should be pointed out at the same time is that such outperformance of the 20-year sector was not necessarily a Japan-specific phenomenon. In the following paragraphs, we will simply examine the backgrounds behind the global outperformance of the 20-year sector by referring to (1) the pure expectation hypothesis and (2) the existence of a fiscal risk premium.

10Y-forward Yield in Japan, US, Europe: Outperformance of 10Y-forward 10Y Yield is Globally Common Phenomenon



Source: Bloomberg; compiled by Daiwa Securities.

If we assume the pure expectation hypothesis—i.e., the yield level purely consists of only an expected path of policy interest rates with no existence of risk premium on public finance and others, the aforementioned gap in the performance is interpreted as follows: "more people have the view that central banks will be in the process of normalization of policy interest rates even in ten years' time[1]." Of course, we can partially agree with this, but the impact of the second fiscal risk premium appears to be more realistic if we base it on perception in the market.

[1] Once rate-hike process completed, 10-year forward 10-year yield and 20-year forward 10-year yield converge to same level.

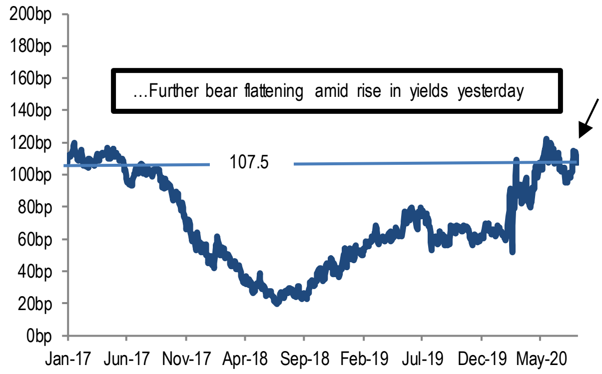
In the case that the fiscal risk premium is perceived, the widening of the risk premium boosts the level of superlong yields. On the other hand, investors' yield hunt gradually pushes down the risk premium from the short end of the curve. The conflict of these two vectors created the difference in the performance between 20-year bonds with relatively short maturity and 30-year bonds with long maturity, which was probably what was actually happened. In other words, this is the structure of a wave of the yield hunt coming up against the alarm for the issuance of additional government bonds by "bond vigilantes." This is the most natural interpretation, in our view.

Looking at Japan's experiences in the past, yield uptrends that reflected the fiscal risk premium were just temporary and eventually provided good buying opportunities. Of course, we are unable to underestimate the size of fiscal spending caused by the pandemic. However, if we assume that the trend of "Japanification of US interest rates" exists, we need to consider whether we should continue to join the "bond vigilantes."

In addition, we can read a recovery of the correlation between JGBs and global yields from the chart on the previous page. The tendency is marked especially in the 10-year forward 10-year yield (main component of 20-year rate). Now, the aspect of JGB-specific supply/demand conditions appears to have diminished. Probably, the impact of investors' yield hunt, instead of the fiscal risk premium, has become dominant. Either way, if JGBs recover the correlation with global yields, the US yield trends should be more of an indispensable factor than before.

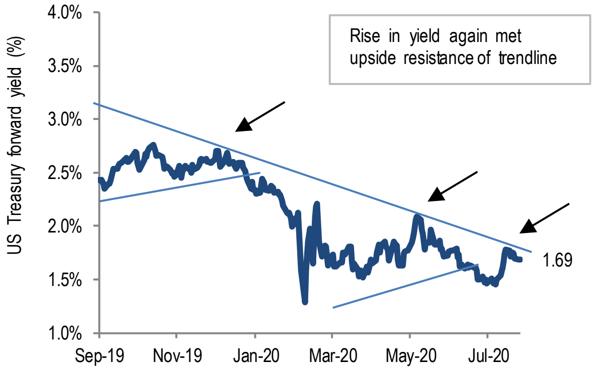
Regarding US yields, yesterday we saw the relative outperformance of superlong yields amid a rise in yields, creating bear flattening of the 5-year/30-year curve. As shown in the right-hand chart below, the short-term uptrend of the 10-year forward 3-month yield (led by supply/demand factor) was again constrained by the longer-term trend (decline in neutral interest rate). We think that this trend of US yields is providing supportive factors when Japanese investors consider investment in superlong JGBs.

US 5Y//30Y Spread



Source: Bloomberg; compiled by Daiwa Securities.

US 10Y forward 3M Yield



Source: Bloomberg; compiled by Daiwa Securities.

Daiwa Securities

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[Standard & Poor's]

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February 2020

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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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* 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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