Daiwa's View

Unexpected surprises

➢ We expect volatility to be high

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Daiwa Securities Co. Ltd.

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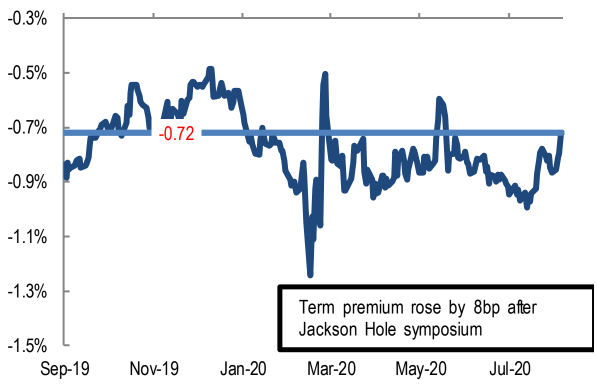
US stocks posted new record highs last Friday as US interest rates turned from a rising to declining trend. Japan had a surprise when Prime Minister Abe announced his resignation.

Because at this stage share prices and interest rates are unlikely to continue rising at the same time, if the strong upward move in interest rates sparked by the Jackson Hole symposium were to continue, it would increase the likelihood of the tail risk scenario of risk asset prices correcting sharply on a snapback in interest rates. The potential for such a scenario has not disappeared. However, the term premium, after a sharp 8bp increase following Jackson Hole, declined around 6bp last Friday, reviving the prospects of the snapback scenario. The 10-year UST yield, which had momentarily climbed to 0.78% during Tokyo trading hours, fell to 0.72%, while the JGB futures price, which had weakened by 0.30 in response to Mr. Abe's resignation and Jackson Hole, rebounded 0.19 during after-hours trading.

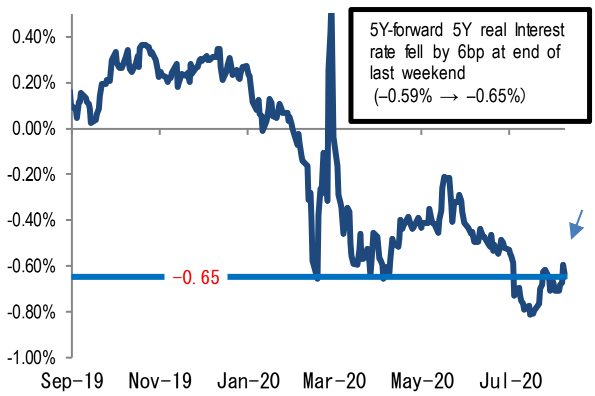
With the blackout period prior to the September FOMC meeting approaching, speeches by key Fed officials are scheduled every day this week[1]. The speeches are clearly aimed at strengthening communications during the interim between Jackson Hole and the September policy meeting. Although it is doubtful the Fed wants to see a rapid rise in interest rates that would weaken the economy, it may be concerned over a stock market that continues setting new record highs and is focused on shaping market expectations ahead of its September meeting.

Term Premium of 10Y US Treasury Bonds



Source: Bloomberg; compiled by Daiwa Securities.
Note: Last Thursday's data (on the day of Jackson Hole symposium) used as latest.

5Y-forward 5Y US Real Interest Rate



Source: Bloomberg; compiled by Daiwa Securities.

[1] Fed Vice Chair Richard Clarida on 31 Aug, Fed Governor Lael Brainard on 1 Sep, New York Fed President John Williams and Cleveland Fed president Loretta Mester on 2 Sep, and Chicago Fed President Charles Evans on 3 Sep.

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Prime Minister Abe's resignation was truly a surprise. This has been a year of surprises, including the covid-19 pandemic and the Prime Minister's shocking resignation.

Although the tendency is to believe that nothing will change with a change in administration, it is worth reflecting upon whether that is because of status quo bias. Humans are known to have a psychological and emotional bias toward thinking that there will not be any major change from the status quo. In fact, unexpected changes are constantly occurring, and because observing them creates psychological anxiety there is an emotional bias toward concluding that there will not be further change. Although the status quo bias is reassuring, it is in some respects like the frog placed in slowly boiling water.

In a snap poll taken over the weekend by the Nikkei and TV Tokyo, the favorite among survey respondents for the next prime minister was former LDP secretary-general Shigeru Ishiba (Chief Cabinet Secretary Yoshihide Suga, deemed most likely to carry on with Abenomics, came in fourth). Mr. Ishiba actually came in first ahead of No. 2 Abe in the 2012 LDP presidential election, but in the runoff (when only sitting Diet members can vote) Mr. Abe came back to beat him by a small margin. Although Mr. Ishiba does not have much support in the Diet, he has strong support among regional voters and is clearly a viable candidate. His chances tend to be dismissed because of status quo bias, but if Mr. Ishiba, who has been somewhat dismissive of Abenomics, were to become the next prime minister, it would be another surprise for the market.

Regardless of who is chosen as the next prime minister, what will likely count the most will be their stance on fiscal policy and foreign diplomacy. The market consensus is that there will be continued fiscal expansion to deal with the pandemic, but the next administration, which will face a lower house election in October 2021, must think seriously about how it will deal with government debt and the primary balance, both of which have worsened significantly as a result of the fiscal policies pursued thus far. Although we doubt the new administration would immediately move toward fiscal reconstruction (tax hikes), there is clearly some uncertainty over whether it would continue with the lavish pork-barrel policies that have been in place, as well as over negotiations with bureaucrats. The resignation of Prime Minister Abe, who succeeded in building a special relationship with President Trump, is also a shock on the diplomatic front. With the US-China confrontation intensifying, if the relationship between Japan's next prime minister and President Trump (or the next US president) sours, it will create new risks to national security.

Monetary policy is currently geared toward coping with the pandemic and we do not expect it to change significantly because of Mr. Abe's resignation. Nevertheless, the market may take a renewed interest in monetary policy following a period in which it has been mostly under the radar. For example, the 5-year JGB yield rose to a range of -0.07% to -0.065% on Friday, putting it within 3bp of the -0.04% level targeted by the BOJ in its November 2016 fixed-rate purchase operations. It is possible that the BOJ's decision, announced on Friday, not to change its September JGB purchase amounts despite yields having hit this level will trigger needless speculation that the BOJ, ignoring the destabilization of the T-bill market that is already becoming a flashpoint, wants yield increases to spread to the short-term to intermediate zones, to the point where the market pressures the BOJ to act. We expect JPY bonds, which are now facing two variables, the FOMC and political developments, to be volatile for a while.

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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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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%.

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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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