Daiwa Securities

Daiwa's View

Realization of tail risk

➢ Spreading correction in optimism

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Daiwa Securities Co. Ltd.

Realization of tail risk

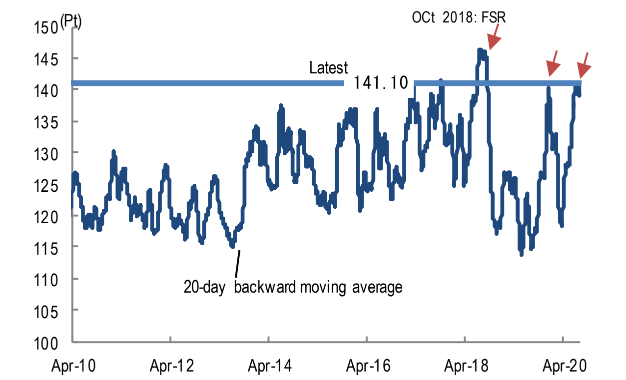
Spreading correction in optimism

Although US stocks had set record highs for consecutive days, the S&P 500 Index tumbled by around 3.5% last night driven by a sharp fall in high-tech issues. With dollar appreciation and flattening of the yield curve, we saw the unwinding of consensus trade in August. The plunge occurred in a bad timing immediately before the start of the blackout period of Fed officials ahead of the FOMC meeting in the week after next.

There were precursors. Risk-off moves have spread behind the stock rally, alongside a rise in tail risk indicator "SKEW Index," which is monitored by the BOJ. Since the beginning of this week, the VIX Index and CDS have continued to worsen, despite higher stock prices. It appears that there was a high possibility that some kind of event would trigger a widespread repricing of asset prices. In addition, Atlanta Fed president Raphael Bostic's remark that "we should be concerned about the risk of asset bubbles" in an interview may have cooled investor sentiment (although remark aired after plunge).

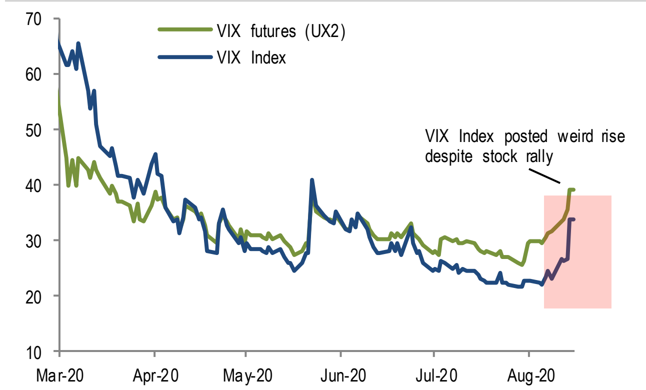
As Fed Governor Lael Brainard emphasized in her speech on 1 September, the Fed has shifted its focus from prolonged easing to financial stability. In order to avoid the "worst case," in which the Fed is forced to raise interest rates amid the shortfall of employment and inflation targets due to concerns about financial stability, the central bank is cautious about overly accommodative financial conditions. Due to the remark by the Atlanta Fed president, the pickoff to the market has intensified from "implied warnings" thus far. The Fed likely does not want further overheating, as we expected, while the US Financial Conditions Index has declined to 98.16, a level close to that at the time of the tech bubble around 2000.

US Tail Risk Indicator: SKEW*



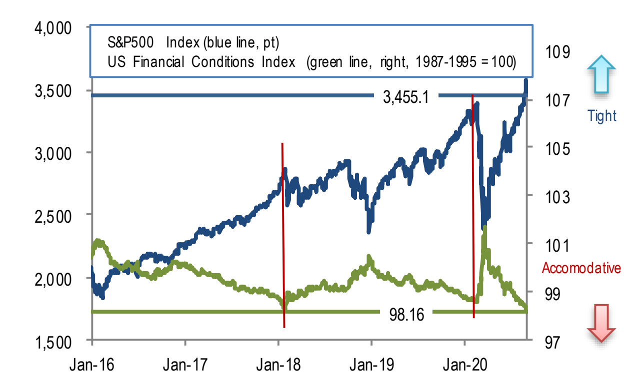
Source: Bloomberg; compiled by Daiwa Securities.
**Indexation of slope of curve shape of implied volatility of S&P 500 out-of-the-money options.*

VIX Index



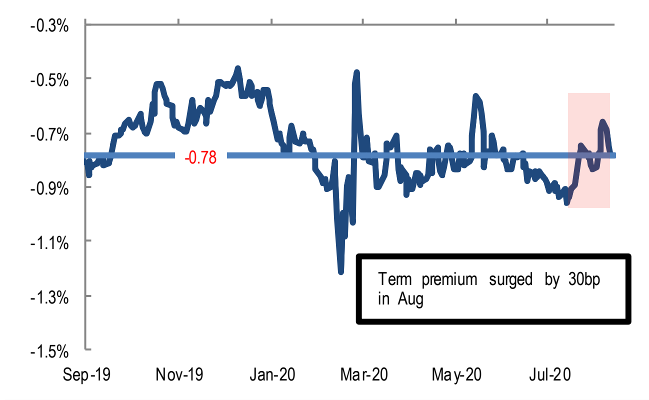
Source: Bloomberg; compiled by Daiwa Securities.

US Stock Price, Financial Conditions Index



Source: Bloomberg; compiled by Daiwa Securities.

Term Premium of 10Y Treasury Bonds



Source: Bloomberg; compiled by Daiwa Securities.

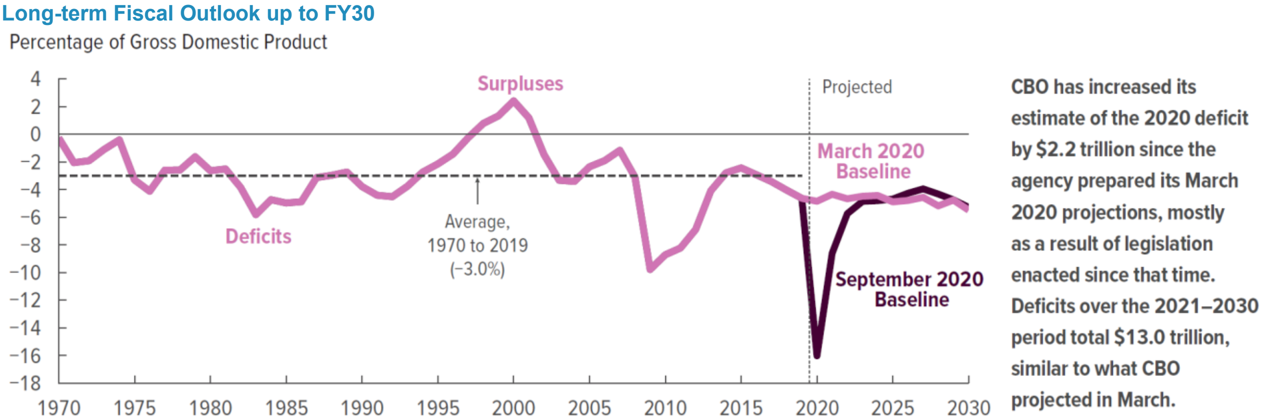
While US stocks set record highs in August, the term premium of 10-year Treasury bonds surged by as much as 30bp (–0.96% on 4 Aug → –0.66% on 28 Aug, right-hand chart above). This appears to have been caused by deterioration in bond supply/demand conditions in line with large-scale issuance of Treasury and corporate bonds, coupled with reflation trade backed by an excessively optimistic outlook for an economic recovery and inflation. If a "correction in optimism" spreads from this point, most of the 30bp rise in the term premium in August may be unwound.

In terms of fiscal policy as well, new information has appeared that could change the existing story of "increased issuance of government bonds = widening of term premium."

The day before yesterday, the US Congressional Budget Office announced its long-term fiscal outlook up to FY30. It is notable that the CBO projects an improvement in the fiscal deficit over the 2021-30 period in comparison with the projection as of March, despite an increase in national debt due to the increased issuance of government bonds (chart below).

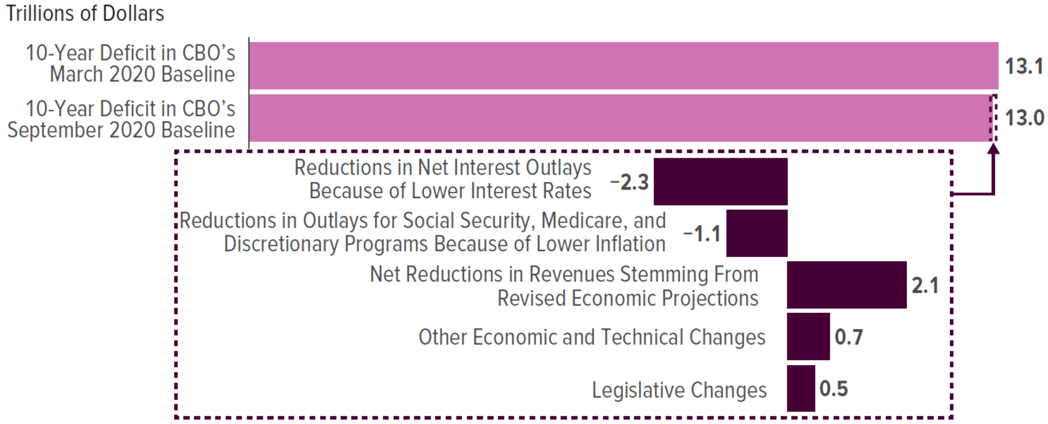
In the CBO's updated outlook, cumulative interest outlays over the ten years have substantially reduced (by around $2.3tn) due to lower interest rates since the COVID-19 pandemic, which is expected to substantially contribute to fiscal improvement. Regarding the debt/GDP ratio, which garners a lot of interest in terms of ratings, the figure is expected to worsen due to measures to cope with the pandemic, but it is expected to remain roughly flat after that. Of course, this partially depends on developments of the pandemic, a risk among some market participants—"increased issuance of government bonds = rise in term premium ⇒ fiscal risk premium"—could turn out to be too quick of a story if the fiscal risk does not heighten to the level of concern. Combined with the aforementioned correction in optimism, we have the impression that it has become easier to buy bonds than in August.

Long-term Fiscal Outlook up to FY30



Source: Extracted from US Congressional Budget Office materials.

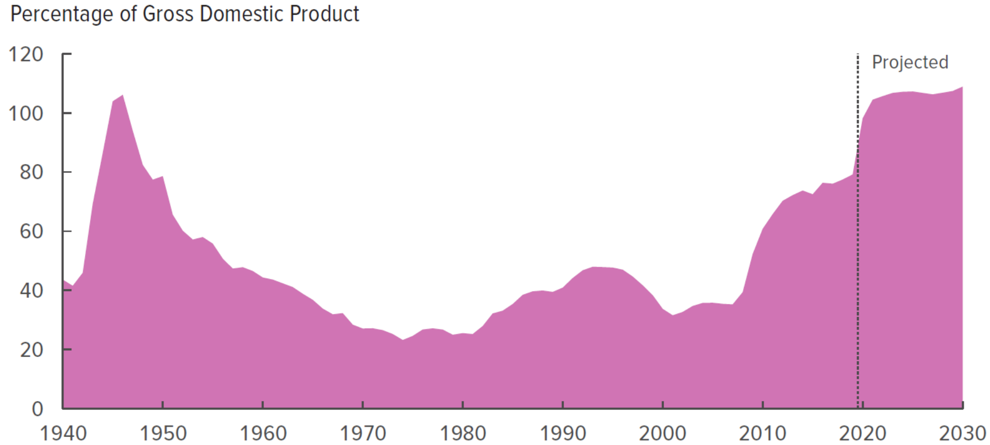
Long-term Fiscal Outlook up to FY30



Over the 2021–2030 period, the effects of changes in CBO's economic forecast, the estimated effects of legislation, and other changes largely offset. On net, projected deficits over the 10-year period are $0.1 trillion smaller than CBO projected in March 2020.

Source: Extracted from US Congressional Budget Office materials.

Debt/GDP ratio up to FY30



Federal debt in 2030 would equal 109 percent of GDP, nearly 30 percentage points higher than it was at the end of 2019. At the end of 2030, debt is projected to be more than two and a half times its average over the past 50 years.

Source: Extracted from US Congressional Budget Office materials.

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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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- 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.
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- 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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