Daiwa Securities

Daiwa's View

Market not back to risk on

- Behind the scenes, caution proliferates

Time for analysis after completion of central bank events in Sep

- BOJ to examine financial/economic conditions in Oct

Fixed Income Research Section
FICC Research Dept.

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

Chief Market Economist
Mari Iwashita
(81) 3 5555-8852
mari.iwashita@daiwa.co.jp
Daiwa Securities Co. Ltd.

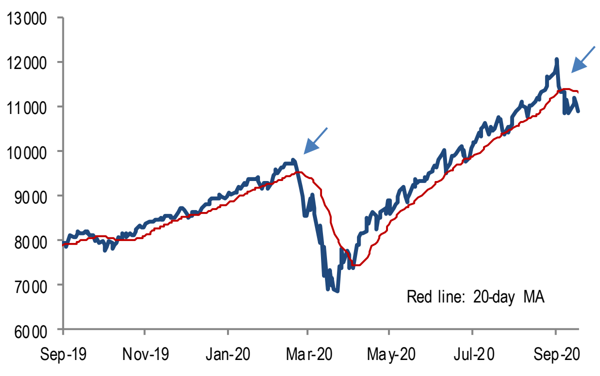
Market not back to risk on (Tani)

Behind the scenes, caution proliferates

With the central-bank events of September winding down, US high-tech stocks continued softening yesterday. Despite the Fed unveiling a dot chart showing the fed funds rate staying put until end-2023, NASDAQ dropped 140 points to 10,910, continuing the market modulation that started in early September. Markit's North American Investment Grade CDS Index (5-year) rose back above 70bp for the first time since July the other day.

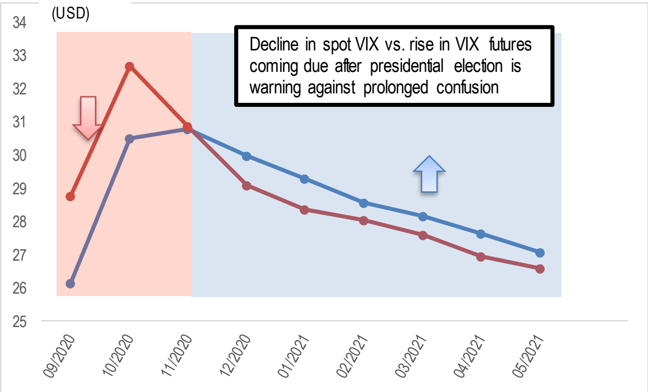
One interesting aspect here is that the term structure of VIX futures is behaving differently than it usually does. While the spot VIX has been declining recently, VIX futures coming due after the presidential election rose (see the lower-right chart). This implies a widening of concerns over the possibility that turmoil surrounding the US presidential election will continue past the election. Normally, a decline in the spot VIX is associated with a decline in risk and increase in share prices, but given this recent change in term structure, the kind of rally normally seen when VIX is declining has become less likely.

US NASDAQ Index



Source: Bloomberg; compiled by Daiwa Securities.

Change in Term Structure of VIX Index Futures (w/w)



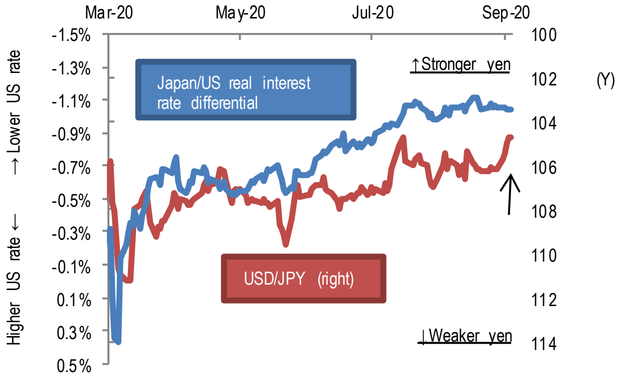
Source: Bloomberg; compiled by Daiwa Securities.

Another concerning development is that the yen hit a 7-week high against the dollar, breaking below a USD/JPY of 105. Because the ECB, which abhors deflationary pressures from currency appreciation, expressed concern after its September policy meeting and the BOE has begun considering how it may implement negative interest rates, there is now concern over the possibility that the specter of competitive monetary easing is back to haunt the market. This has drawn attention to the BOJ, which of the major central banks seems to be making the most backward-looking statements about additional easing, and thus created some concern over the possibility of yen appreciation pressures.

Important disclosures, including any required research certifications, are provided on the last page(s) of this report.

It is of course true that exchange rates are a relative concept and thus directly affected by the actions of other countries and other central banks. It appears that the Fed is moving in the direction of strengthening forward guidance and expanding QE rather than introducing negative interest rates, but that aside, the reality is that a return of competitive easing would put broad downward pressures on global interest rates.

USD/JPY, Japan/US 10Y Real Interest Rate Differential

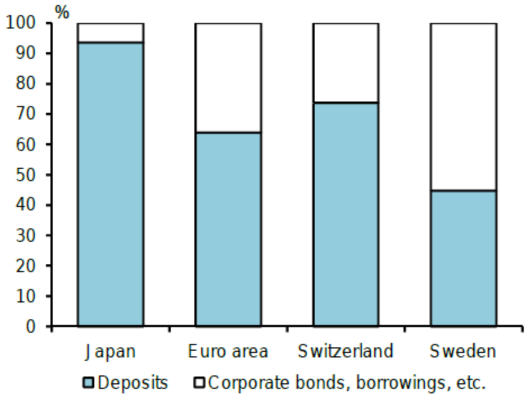


Source: Bloomberg; compiled by Daiwa Securities.

The ECB may have the advantage over the BOJ in any competition to drive negative interest rates lower

Furthermore, although it has been a while since this has been a topic, if this does devolve into a competitive deepening of negative interest rates, the ECB likely has a competitive advantage over the BOJ. Because the liability structures of most of Europe's financial institutions are characterized by insufficient deposits relative to loans, the ECB's supply of funding at negative interest rates that are lower than the policy rate makes it easier to deal with any side effects on lenders. The liability structure of Japan's financial institutions is weighted toward deposits (i.e., they have deposit surpluses, and these have been exacerbated by the pandemic), such that even if the BOJ were to further lower negative interest rates in conjunction with expanding its supply of funding at negative rates (or pay interest on reserves, which would have the same effect), it would create an even bigger challenge for Japanese banks struggling to invest the deposits that they have attracted with positive interest rates.

Breakdown of Financial Liabilities at Financial Institutions



Source: Extracted from BOJ Financial System Report *(Apr 2019).*

Safe assets that still pay a positive yield are the easy choice for investing deposits that were attracted with positive yields. Consequently, if the competitive easing described above becomes a reality, 20-year JGBs, the yield on which has risen to around 0.4%, will likely become a perfect place to park funds. Of course, a full-fledged easing competition has yet to begin and is nothing more than a mental exercise at this stage, but the truth is that we have moved a step closer to the point where such a mental exercise is necessary.

Time for analysis after completion of central bank events in Sep (Iwashita)

Sep BOJ MPM uneventful; economic assessment revised up

Assessment on capex lowered, services consumption also sluggish

Growth rate projections to be lowered, vs. upgrades in US, Europe

At its Monetary Policy Meeting (MPM) on 16-17 September, the BOJ decided to maintain the status quo by majority vote as (1) data for Jun-Aug released since the last meeting on 14-15 July confirmed recovery trends after reopening the economy and (2) the financial market is stable. The economic assessment on the current status of Japan's economy was revised upward to "has started to pick up with economic activity resuming gradually, although it remains in a severe situation." By item, the assessment on overseas economies, exports, and industrial production was upped, while that on business fixed investment was lowered (chart on next page). In Japan, economic activities have started to soften more than expected due to weak capex and sluggish services consumption (people remained cautious in summer due to resurgence of infections since Jul). This is different from the upward revisions to growth projections in the US and Europe. In compiling the next October *Outlook for Economic Activity and Prices* report (*Outlook Report* to be released 29 Oct), board members are expected to discuss revisions to their projections for growth rates. Amid uncertainty about the pandemic, we should continue to be aware of downside risks.

Cooperation between gov't and BOJ to continue

Suga's interest in monetary policy not as strong as Abe's

At the post-meeting regular press conference by BOJ governor Haruhiko Kuroda, he was asked about the future policy stance at the start of the new Suga Cabinet. There were also many questions on the opinion on the Fed's new strategy (introduction of average inflation target of 2%) and the recognition of exchange rates/stock prices. He replied that close coordination with the government would continue and policy operations would be conducted. He also said "the government and the BOJ will implement necessary policies in line with the joint statement, and the statement played a major role … there is absolutely no need to change our 2% inflation target." He hopes for regular biannual meetings with Prime Minister Yoshihide Suga as with Mr. Abe. Although Mr. Suga is passionate about micro policies, such as regulatory reforms and conquering of the vertically segmented administrative system, we have the impression that his interest in monetary policy is not as strong as Mr. Abe's. As long as the market is stable, we will not see Mr. Suga making requests of the BOJ.

Fed projects inflation to not exceed 2% until 2023; policy rate maintained at zero

In Kuroda's term of office, momentum to review current framework will not grow

Next, we look at measures by the central banks in the US and Europe. At the FOMC meeting on 15-16 September, forward guidance was revised in line with the new strategy of the average inflation target of 2%. Under the cautious forecasts that inflation will not exceed 2% until 2023, the dot chart showed a stance of not raising interest rates until 2023. In the near term, the Fed is poised to ascertain the economic conditions by strongly implying the prolongation of low interest rates. Regarding the Fed's average inflation target of 2%, Gov. Kuroda stated that "as we have already adopted an overshooting-type commitment, we have been aiming to achieve inflation of 2% on average since previously. The Fed's view is in line with ours … 2% is not a ceiling." Meanwhile, given his intention to fulfil his term of office (Apr 2023), we do not think that momentum to review the current framework will grow during his term of office.

Stance of carefully monitoring exchange rate level

Market interest to shift to US fiscal discussions, presidential election

In a question on forex trends, an example of the ECB was cited (President Christine Lagarde replied that ECB discussed euro trend but would "carefully monitor" exchange rate going forward). Mr. Kuroda made a neutral reply—"it is desirable that exchange rates will move stably, reflecting fundamentals" and "our stance of carefully monitoring the exchange rate level is unchanged." The USD/JPY rate is currently at the Y104 level, pointing to slight appreciation of the yen. However, Mr. Kuroda does not appear to assume rapid appreciation of the yen under the current condition that all major central banks are set off to prolong easing. With the completion of central bank events in Japan, the US, and Europe in September, the near-term focal point is the fiscal discussion impasse in the US. Market interest is likely to shift to the US presidential election on 3 November.

Regarding the stock price trends, Mr. Kuroda recognized that "stock prices are not extraordinary high, given indicators such as the P/E," saying that "we are flexibly buying ETFs to avoid an excessive rise in the risk premium." He appears to think that the stock price level in Japan has not reached a level that would cause concern about the financial imbalance.

During crisis responses, priority at BOJ to stabilize financial system

Oct time to examine financial/economic conditions

Due to the aforementioned factors, the BOJ is likely to focus on measures to support corporate financing and put top priority on stabilization of the financial system during the phase of crisis responses. While the statement says that the BOJ "will not hesitate to take additional easing measures if necessary," the central bank would deem that additional easing will be necessary only in the case of major downward revisions to the economic outlook and/or appreciation of the USD/JPY rate staying below Y100. That said, the branch managers' meeting (online, 8th) and the *Financial System Report* and *Outlook Report* are scheduled for release in October. The time to analyze the recent financial/economic conditions is near.

Change in Descriptions of BOJ's Economic Assessment

	Jul 2020		Sep 2020	Chg
Current condition				
Japan's economy	"has been in an extremely severe situation with the impact of COVID-19 remaining at home and abroad, although economic activity has resumed gradually"	⇒	"Japan's economy has started to pick up with economic activity resuming gradually, although it has remained in a severe situation due to the impact of the novel coronavirus at home and abroad"	↗
Overseas economies	"have been depressed significantly, reflecting the impact of the COVID-19 pandemic, although they have shown signs of heading toward a pick-up"	⇒	" have started to pick up from a state of significant depression"	↗
Exports	"have declined substantially"	⇒	"have turned to a pick-up"	↗
Capex	"has been more or less flat"	⇒	"corporate profits and business sentiment have deteriorated, and business fixed investment has been on a declining trend"	↘
Private consumption	"has decreased significantly, mainly in services such as eating and drinking as well as accommodations, it has shown signs of a pick-up recently"		"has picked up gradually on the whole, although consumption of services, such as eating and drinking as well as accommodations, has remained at a low level"	→
Public investment	"has increased moderately"		"has continued to increase moderately"	→
Housing investment	"has declined moderately"		"has declined moderately"	→
Industrial production	"have declined substantially"	⇒	"have turned to a pick-up"	↗
Financial conditions	"have been accommodative on the whole but those for corporate financing have remained less so, as seen in deterioration in firms' financial positions"		"have been accommodative on the whole but those for corporate financing have remained less so, as seen in weakness in firms' financial positions"	→
Prices	"The y/y change in the CPI (all items less fresh food) is at around 0%, mainly affected by the decline in crude oil prices. Inflation expectations have weakened somewhat."		"The y/y change in CPI (all items less fresh food) is at around 0%, mainly affected by the past decline in crude oil prices"	→
Outlook				
Japan's economy	"with economic activity resuming, is likely to improve gradually from the second half of this year through the materialization of pent-up demand and supported by accommodative financial conditions and the government's economic measures"		" with economic activity resuming, is likely to follow an improving trend through the materialization of pent-up demand and supported by accommodative financial conditions and the government's economic measures"	→
Prices	"Downward pressure on prices is projected to wane gradually along with economic improvement.…The y/y change in the CPI is expected to turn positive and then increase gradually"		"The y/y change in CPI (all items less fresh food) is likely to be negative for the time being, mainly affected by COVID-19 and the past decline in crude oil prices. Hereafter, it is expected to turn positive and then increase gradually, as downward pressure on prices is projected to wane gradually. "	→

Source: BOJ; compiled by Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

■ The Significance of Registration

Registered Credit Rating Agencies are subject to the following regulations:
1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of March 7th, 2017, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings are Moody's Investors Service's ("MIS") current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. MIS defines credit risk as the risk that an entity may not meet its contractual, financial obligations as they come due and any estimated financial loss in the event of default. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk, or price volatility. Credit ratings do not constitute investment or financial advice, and credit ratings are not recommendations to purchase, sell, or hold particular securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information, is given or made by MIS in any form or manner whatsoever.

Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of April 16th, 2018, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Moody's Japan K.K. (https://www.moodys.com/pages/default_ja.aspx)

[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.com/site/japan)

Assumptions, Significance and Limitations of Credit Ratings

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

For the details of assumption, purpose and restriction of credit ratings, please refer to "Definitions of ratings and other forms of opinion" on the website of Fitch Rating Japan Limited.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of September 27th, 2019, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Fitch Rating Japan Limited (https://www.fitchratings.com/site/japan)

February 2020

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Conflicts of Interest: Daiwa Securities Co. Ltd. may currently provide or may intend to provide investment banking services or other services to the company referred to in this report. In such cases, said services could give rise to conflicts of interest for Daiwa Securities Co. Ltd.

Daiwa Securities Co. Ltd. and Daiwa Securities Group Inc.: Daiwa Securities Co. Ltd. is a subsidiary of Daiwa Securities Group Inc.

Other Disclosures Concerning Individual Issues:
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).

6) NEC (6701): NOTICE REGARDING U.S. PERSONS: This report is not intended for distribution to or use by any person in the United States. Securities issued by NEC Corporation have been suspended from registration in the U.S. and are subject to an order of the U.S. Securities and Exchange Commission dated June 17, 2008, pursuant to Section 12(j) of the Securities Exchange Act of 1934. This document is not a recommendation or inducement of any purchase or sale of such securities by any person or entity located in the U.S. Daiwa Securities Co. Ltd. disclaims any responsibility to any such person with respect to the content of this document. Any U.S. person receiving a copy of this report should disregard it.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- 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.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association