Daiwa Securities

Daiwa's View

Monetary policy converging to direction of "soft YCC" as we expected?

➢ Odds turning against short positions

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Daiwa Securities Co. Ltd.

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Odds turning against short positions

Before turning to the ECB Governing Council meeting, we confirm the Bank of Canada's (BOC) Governing Council held on 9 December, where the status quo was decided for monetary policy. Of note is the addition of the new phrase "keep interest rates low across the yield curve" in the statement. This reconfirmed that the BOC is aware of soft yield curve control (YCC)[1].

Turning to the ECB Governing Council meeting, which garnered attention, in line with expectations, the council decided on an expansion of the period and size of a wide range of measures. These included an increase in the envelope of the pandemic emergency purchase programme (PEPP) and an extension of the period of purchases/the reinvestment under the PEPP, as well as an extension of the period over which a preferential interest rate will apply in the TLTRO. Meanwhile, noteworthy points from the market viewpoint are: (1) at her press conference, President Christine Lagarde emphasized a flexible stance, saying that "the envelope need not be used in full (if favourable financing conditions can be maintained)" and (2) the initial reaction of selling pressure on bonds stopped quickly and then bonds were bought back (e.g., 10-year German Bund to –0.60%).

◆ Press conference by ECB President Christine Lagard (10 Dec 2020)

We will conduct our purchases under the PEPP to preserve favourable financing conditions over this extended period. **We will purchase flexibly according to market conditions** and with a view to preventing a tightening of financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation. In addition, the flexibility of purchases over time, across asset classes and among jurisdictions will continue to support the smooth transmission of monetary policy. If favourable financing conditions can be maintained with asset purchase flows that do not exhaust the envelope over the net purchase horizon of the PEPP, **the envelope need not be used in full**. Equally, the envelope can be recalibrated if required to maintain favourable financing conditions to help counter the negative pandemic shock to the path of inflation.

Regarding the flexibility of asset purchases, this would include the aspects of (1) consideration in order to avoid fragmentation within the ECB Governing Council and (2) responses to cope with uncertainty about the recovery pace after the distribution of COVID-19 vaccines. However, a slightly deeper interpretation of the "flexibility" may be possible. The wording reminds us of the fact that executive board member Isabel Schnabel stated on 1 December that "the ECB should focus on keeping financial conditions at current levels through the crisis rather than announcing a blockbuster stimulus package that beats market expectations," and executive board member Philip Lane said on 26 November that "it is essential that the macroeconomic recovery is not derailed by a premature steepening of the yield curve," ahead of yesterday's decision.

The common message from the two executive board members is the "stance of supporting a recovery from the pandemic crisis via persistent continuation of accommodative monetary environment," rather than easily strengthening easing.

[1] Minutes of Nov FOMC meeting touched on BOC's decision on 28 Oct, which virtually means that effectiveness of this soft YCC was discussed.

In addition, the method of changing the asset purchase amount according to the financial environment, which was newly adopted by the ECB this time, is a characteristic method under the YCC framework. Given the change in the aforementioned BOC statement and the minutes of the November FOMC meeting, which referred to the decision by the BOC on 28 October, we are sharpening our recognition that central banks' monetary policy is converging to the direction of "soft YCC."

As a reason behind the fact that upward pressure on yields, seen as an initial reaction of the ECB announcement, stopped quickly, we think that the market became aware of the aforementioned YCC aspect—continuation of persistent easing, in addition to the difficulty in Brexit negotiations. If central banks' monetary policy has a soft YCC aspect, the probability of an emergence/continuation of a surge in yields, like tail risk, would decline, compared to other cases. In other words, risk of loss in long positions is likely to be more limited than previously, while the odds (and degree of gains) of short positions by speculative investors would decline.

Under the soft YCC, a rise in yields in line with the fundamentals (= reflection of neutral interest rate) is, of course, accepted to some extent, and the policy does not necessarily mean promotion of an excessive flattening. However, it is highly likely that a premature steepening of the yield curve, which is inconsistent with fundamentals and central banks' policy guidance, will be contained by QE adjustments. The odds appear to be turning against short positions.

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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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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%.

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- 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.
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