

Daiwa's View

Dollar depreciation” and “currency basis,” both of which could cause weaker correlation between US and Japanese yields

- Incentive to buy JGBs

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Daiwa Securities Co. Ltd.

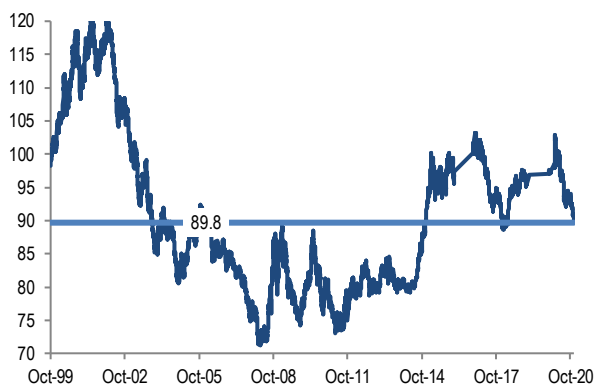
“Dollar depreciation” and “currency basis,” both of which could cause weaker correlation between US and Japanese yields

Incentive to buy JGBs

◆ Overwhelming depreciation of the dollar

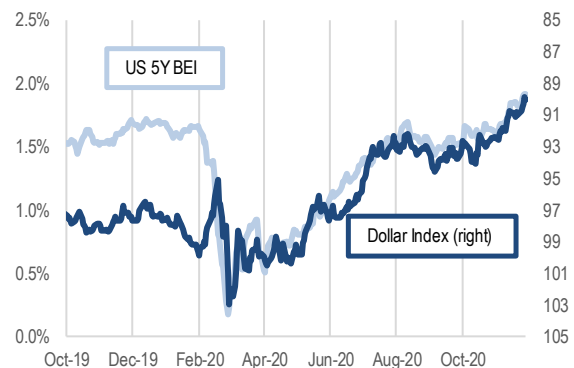
What should be noted yesterday is sharp “depreciation of the dollar.” The Dollar Index finally declined to a level below 90 for the first time since April 2018. The yen also strengthened to the Y102 level against the dollar at one point. Although I leave detailed explanations of currency fluctuations to FX analysts, I attribute this trend partly to the Fed’s dovish stance announced at yesterday’s December FOMC meeting. As currency exchange rates move based on “zero-sum” thinking, this depreciation of the dollar raises the breakeven inflation rate in the US. Meanwhile, this raises deflation pressure in counterparty nations such as Japan, Europe, and China. Accordingly, from the viewpoint of US and Japanese yields, dollar depreciation under the zero-sum game could cause a negative correlation (weaker correlation), instead of a positive correlation.

Long-term Trend of Dollar Index



Source: Bloomberg; compiled by Daiwa Securities.

Dollar Index, US 5Y Breakeven Inflation Rate

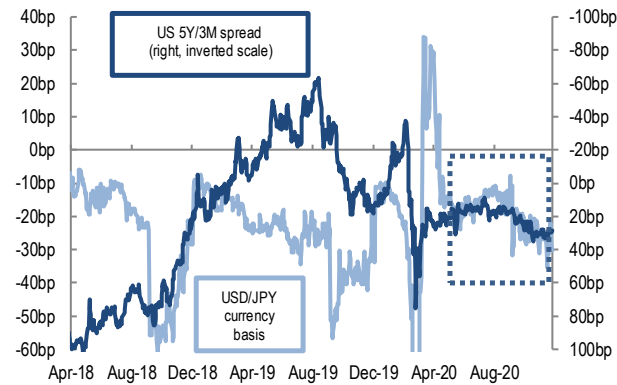


Source: Bloomberg; compiled by Daiwa Securities.

◆ Gradual deterioration of currency basis

It does not mean that yesterday’s level exceeded a threshold, but another focus of attention regarding currency exchange rates is the gradually worsening currency basis swap. Yesterday, the 3-month USD/JPY currency basis fell to -28.5bp in negative territory. Of course, this is not deeply negative from a historical viewpoint. However, it surfaced to positive territory at one point, while the Fed has actively increased supply of the dollar since the outbreak of the COVID-19 pandemic. It has since moved in historically shallow negative territory of the -10bp level, and now appears to be gradually returning to a normal level.

US 5Y/3M Spread, 3M USD/JPY Currency Basis



Source: Bloomberg; compiled by Daiwa Securities.

Of course, the currency basis has a wide range of variable factors. However, there is a correlation between the basis and the degree of steepening of US Treasuries, which I have been watching as a characteristic of price movements since April 2020 (chart above). Currently, only the US is posting a marked steepening among the three major bond markets (Japan, US, Europe). Therefore, it is becoming easier for the US to attract overseas investment funds, from the viewpoint of monetization from the long-term/short-term yield spread,

◆ Impact on JGBs

We need to carefully watch the impact of these movements on the JGB market. This is because the USD/JPY currency basis may worsen further (or improve less) next year as a certain degree of upward pressure is expected for the US 5-year yield if the above-mentioned correlation continues. As is widely known, JGB investment is more attractive for overseas investors when the currency basis deepens in negative territory. If funds of overseas investors flow into the JGB short/intermediate zone next year in line with a bear steepening of US Treasuries, the zone may deepen in negative territory compared to this year.

If a decline in yields of the short-term zone has an influence on the intermediate zone and then the long-term zone mainly via roll-down return improvement, the 10-year yield could fall below zero again from the current level of slightly above 0%.

If so, investment money, which avoids negative yields, is likely to flow into the superlong zone of more than ten years. This year's data shows that the average for the 10-year/20-year spread when the 10-year yield is below zero is around 29bp, around 5bp lower than the spread when the 10-year yield is above zero. Accordingly, if the 10-year yield settles in negative territory, the 20-year yield level may shift from the current 0.35-0.40% level to the 0.30-0.35% level.

This is just a simple examination regarding the complicated product of the currency basis under the assumption that it has a correlation with the shape of the US Treasury yield curve. Current and expected moves of currencies and the currency basis may cause a negative correlation between the US and Japanese yields (or weaker correlation) although they usually have a positive correlation. This serves as an incentive to buy JGBs.

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- 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.
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■ Credit Rating Agencies

[Standard & Poor's]

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[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)

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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.moody.com/pages/default_ja.aspx))

Assumptions, Significance and Limitations of Credit Ratings

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[Fitch]

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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 ¥10bn. 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).

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

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- 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

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