Daiwa Securities

Daiwa's View

Things to watch for in 2021: Part 1

➢ Will "rampant coronavirus = risk on" continue?

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Daiwa Securities Co. Ltd.

Happy New Year! Your continued support is greatly appreciated.

Things to watch for in 2021: Part 1

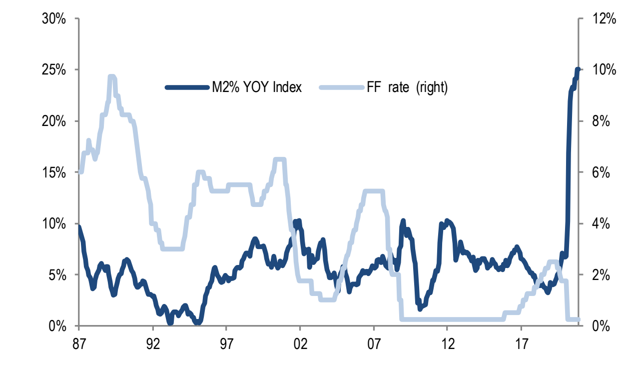
Will "rampant coronavirus = risk on" continue?

When we look back at last year, an unpleasant fact is that the COVID-19 pandemic served as an event that led to stock rallies. The driving power for the Nikkei Stock Average topping 24,500 points and hitting its 30-year high was "wartime" fiscal spending to cope with the pandemic crisis and monetary easing that funded such spending, instead of an improved outlook for corporate earnings.

Unfortunately, the pandemic is still rampant at this time. In Japan, the situation has worsened and four governors in the greater Tokyo metropolitan area (incl. Tokyo governor Yuriko Koike) called on the central government to consider declaring another state of emergency. If we regard the current situation as in line with last year's moves, we can conclude that risk-on moves will strengthen due to fiscal spending and monetary easing.

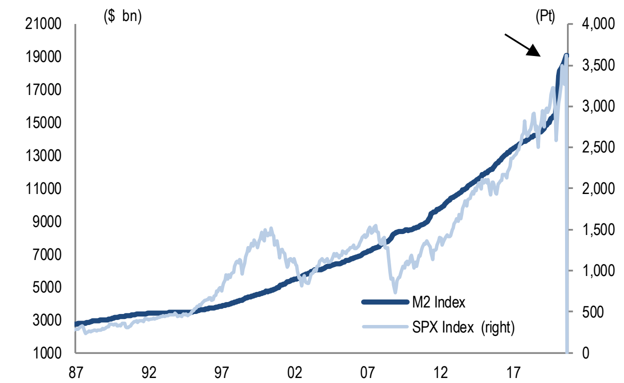
What we should note in leading to this conclusion, which is against our intuitions, would be money stock (M2) and the stock price level. Between the two factors, there is a long-term correlation. Since the outbreak of the pandemic last year, there has been a structure in which money stock has surged at several tens of percentage points on an annualized basis, and the stock price has caught up (chart below). Many people point out that higher stock prices were caused by lower interest rates. In terms of data, however, the correlation with money stock is more marked than that with interest rates. In this light, the stock price may be a "monetary phenomenon," instead of inflation.

US Money Stock (M2, y/y), FF Rate



Source: Bloomberg; compiled by Daiwa Securities.

US Money Stock (M2, amount), S&P 500 Index



Source: Bloomberg; compiled by Daiwa Securities.

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That said, is it appropriate to continuously assume “rampant coronavirus = risk on” in 2021?[1]

We state the conclusion first. The answer is “yes,” under the current main scenario that “we see some light at the end of the tunnel” at some point in the middle of this year. However, if the diffusion of vaccines and acquisition of herd immunity do not proceed steadily, the relationship of “rampant coronavirus = risk on” may reverse at some point, in our view.

This is because risk-on moves seen last year were products of governments' “wartime” fiscal spending and monetary easing, as mentioned above. However, the COVID-19 pandemic is an event that worsens fiscal conditions. As fiscal leeway in major developed nations has declined due to last year's expenditures, there are concerns that additional large-scale fiscal measures would strengthen downward pressure on ratings[2].

In addition, the current distorted structure in which assets held by the wealthy are increasing rapidly while many people are facing difficulties entails risk of destabilizing the political situation (more so if deterioration in fiscal condition creates malignant inflation). As President-elect Joe Biden called for an increase in taxes on capital gains in the first place, he insists that the top rate (39.6%) should be applied for long-term capital gains in the wealthy class whose annual income is at least $1mn. Given the current condition that only asset prices have been rising strikingly, we think that the grounds to raise capital gains may be increasing more than before the presidential election.

In short, whether the state of “rampant coronavirus = risk on” will continue depends on governments' "willingness" and "ability" to continue with the same amount of fiscal spending as last year. If such spending is prolonged, the impact on “ability” would strengthen.

What is generally said as a consequence of fiscal deterioration is the risk of a surge in interest rates. However, concerns about a continued surge in interest rates do not appear to be so strong in advanced nations, which mainly issue local currency-denominated government bonds (central banks can contain such risk). On the contrary, we may need to pay attention to the possibilities that (1) downgrading of the sovereign rating will widen credit spreads in the private sector (→ risk off) and (2) concerns about the downgrading of sovereign rating will increase the momentum of fiscal reconstruction (tax hikes) and cut inflation in the bud.

Governments got through 2020 by using reserves accumulated thus far. In 2021, however, “fiscal condition” may become a theme in various meanings. We intend to monitor it without prejudgment.

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[1] In examining whether estimated correlation between two factors has universality, general effective method is to imagine “limits.” In current case, we can automatically see answer by imagining what will happen in case of long-term fatal COVID-19 pandemic.

[2] In Oct 2020, S&P Global's top sovereign analyst Roberto Sifon-Arevalo raised alarm, saying that “The main point to see here is where do we see the trajectory going forward. If we see the trajectory as establishing more of a different structural pattern, then you are going to see some (rating) movements there.”

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2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, 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

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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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[Fitch]

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IMPORTANT

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).

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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.

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