Daiwa's View

Temporary brake

➢ Rise in interest rates will face a higher hurdle from now on

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Daiwa Securities Co. Ltd.

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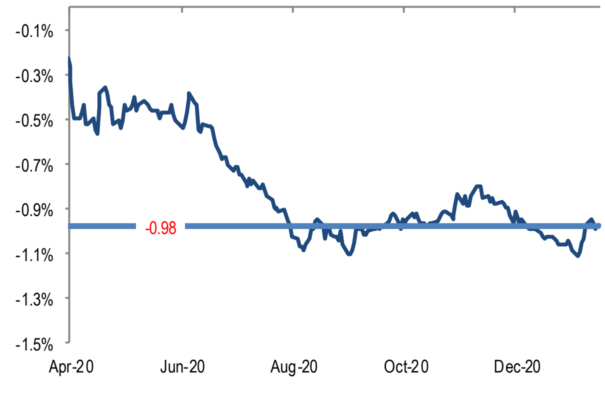
Rise in interest rates will face a higher hurdle from now on

The US long-term interest rate rose to1.18% in the first half of the week, and then declined to 1.08% in the middle of the week. Currently, it is at their midpoint of 1.13%. Based on a number of factors, we think that the US long-term interest rate has temporarily reached a point where it is easier to meet upside resistance. We explain them in the following sections.

First is the stance of Fed officials. Through last Thursday, several Fed officials showed an aggressive stance toward the start of tapering by the end of the year. Since last Friday, however, many officials have made firefighting remarks. Fed officials weakened signals regarding the exit when it became easier for the real interest rate to rise due to the jump in the long-term interest rate. This can serve as a reason for slowdown in the pace of the rise in interest rates[1].

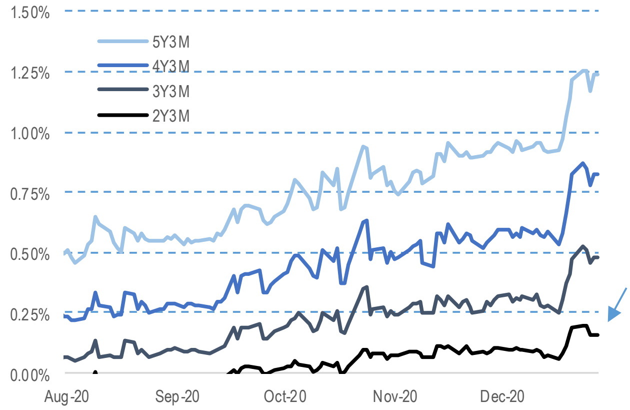
Second is the market response to rate hikes. When the long-term interest rate rose to 1.18%, the market fully factored in a rate hike in mid-2023 and even a hike in the first half of 2023 was factored in (right-hand chart below). However, as reported, the schedule of tapering constrains the schedule for rate hikes. As there have been a series of remarks that tapering would be unlikely to start at least within this year, such remarks eventually restrained speculation about an earlier rate hike.

10Y US Real Interest Rate



Source: Bloomberg; compiled by Daiwa Securities.

Market Responses to Rate Hikes



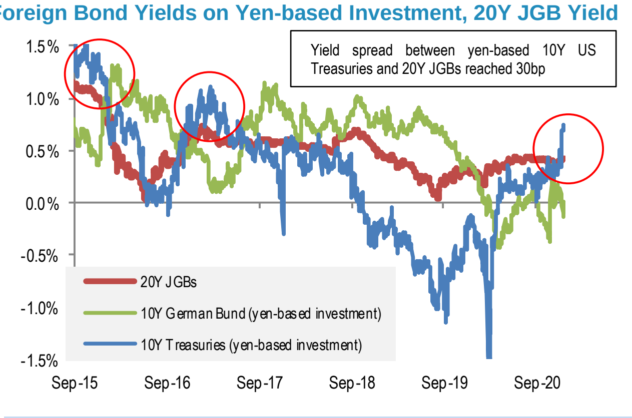
Source: Bloomberg; compiled by Daiwa Securities.

[1] Atlanta Fed Raphael Bostic, who made a hawkish remark on 7 Jan, also said that "policymakers should be concerned about asset bubbles" in Sep 2020. In the Sep 2020 FOMC meeting, Dallas Fed president Robert Kaplan also voted against the action due to caution about a bubble. Amid the continued rally in risk asset prices, their hawkish remarks are within expectations (otherwise, who will play a role in restraining risk assets?).

Third is the comparison with foreign bonds. As a result of striking rise/steepening of US yields among major advanced nations, the yield of 10-year US Treasuries on a yen-based investment exceeded that of 20-year JGBs by around 30bp. In the past, the yield spread between these two products peaked out at the lower 30bp level. Therefore, the spread may have reached the level where it is easier for the inflow of funds from outside the US to increase.

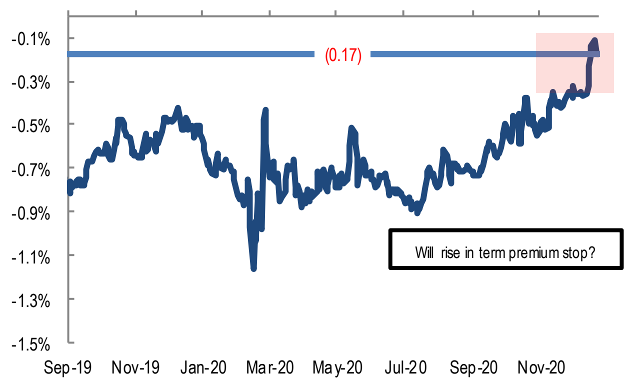
Describing this situation from a different viewpoint, we can say that this may stop the rise in the term premium, which has continued since last August. In the past, the term premium has had a close correlation with the inflow of funds from overseas. If the relative differences with Japanese and European interest rates widen further, the inflow of international funds would increase, which is likely to put a brake on the rise in the US long-term interest rate.

Foreign Bond Yields on Yen-based Investment, 20Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Term Premium on 10Y US Treasuries



Source: Bloomberg; compiled by Daiwa Securities.

Finally, we look at this chart. Graphing the US long-term interest rate on a log scale, the rate peaks out at around 1.2%. The chart alone would not be sufficiently convincing, but in combination with the aforementioned three factors, it implies that, compared to the hurdle faced thus far, the rise in interest rates will face a higher hurdle from now on.

US Long-term Interest Rate (on log scale)

Source: Bloomberg; compiled by Daiwa Securities.

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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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February 2020

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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%.

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.

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