Daiwa's View

Should 20-year JGB yield follow US yields?

➢ Should follow global macro trend

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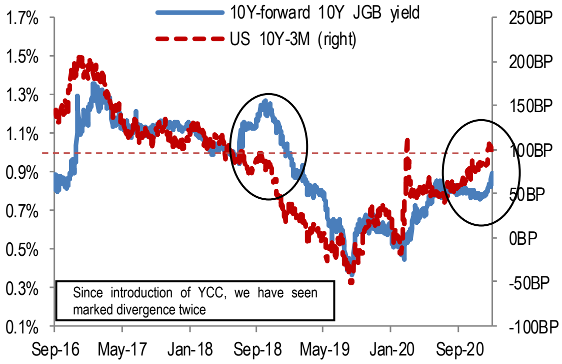
On 20 January, Joe Biden was sworn in as the 46th US president. A change of US president, who is regarded as a world leader, has a large impact on other nations as well. In Japan, the BOJ's monetary policy meeting is slated for today. From the viewpoint of ascertaining economic activity, prices, and financial conditions, we again think it was difficult for the BOJ to choose the option of announcing the "assessment" results at the January meeting. The contents of the additional policy package (combination of several measures) and near-term operations depend on the fiscal stance under the Biden administration and the Fed's stance as well as developments regarding COVID-19 and vaccines from now on.

Since Jiji Press delivered a report about a widening of the trading band of the 10-year JGB yield, the 20-year sector has been softening. Confirming the "10-year forward 10-year yield," corresponding to the latter half of the 20-year yield (excl. first half 10-year yield fixed at around 0%), we can find a close correlation with the US long-term/short-term yield spread (10-year/3-month spread). Under this major trend, we have seen a marked divergence twice since the introduction of the yield curve control (YCC) policy. The first divergence happened after the BOJ decided on more flexible operations in July 2018, and the second happened in August 2020 when the US yield curve started to steepen.

US Long-term/short-term Yield Spread, 10Y-forward 10Y JGB Yield



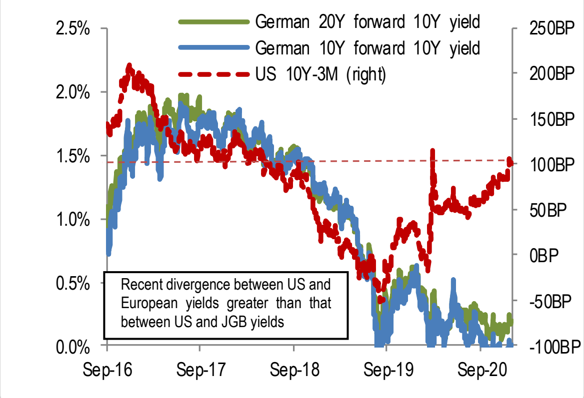
Source: Bloomberg; compiled by Daiwa Securities.

In this impressive chart, there are two points to note. The first one is the fact that since the decision on more flexible operations in July 2018, the BOJ had steepened the yield curve by distorting supply/demand conditions for JGBs (via reduction in offer amounts in purchase operations), but the curve has returned to the level based on fundamentals/global balance as time passed. In the latter half of 2018, the Fed was in the rate-hike stage, while the US Treasury yield curve posted bear flattening at the same time. As a result, the good performance from the attempt to steepen the curve was short-lived. JGBs also flattened in line with the global trend.

The experience in July 2018 tells us that unreasonable transactions based on only short-term supply/demand factors cannot continue for long (note: there may be stock effects). It would be a good idea to wait for tailwinds from fundamentals by setting up a framework that can "accept" steepening.

Next, from this viewpoint, making a decision for more flexible asset purchases in the current condition amid the growing tendency of steeper US yields would be more appropriate than that in July 2018. In particular, as there is now a divergence between the US long-term/short-term yield spread and the 10-year forward 10-year JGB yield, we could expect the latter to follow the former. That said, it is premature to conclude this from the comparison with US alone. Confirming the conditions in Europe, the other giant economy, we find that the European yields were strongly correlated with the US long-term/short-term yield spread until around October 2019, but since then the yield trends have diverged.

US Long-term/short-term Yield Spread, European Forward 10Y Yields



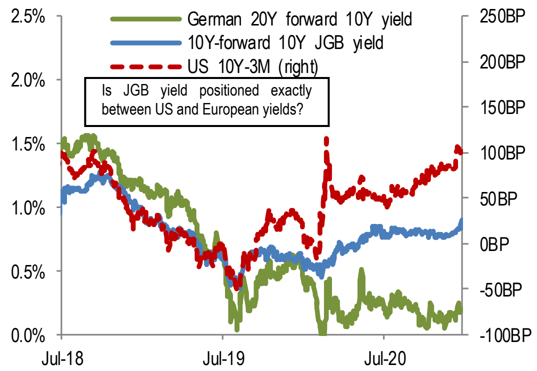
Source: Bloomberg; compiled by Daiwa Securities.

In short, the flattening until 2019 was a movement under the common trends in advanced nations across the board, while it is highly likely that the current steepening of US yields cannot be necessarily called a global trend (possibility that US yields will lead global trend). Of course, the currency is not the only factor to see yields, but one aspect is the structure in which the US is enjoying a weaker dollar, while Europe is suffering from a stronger euro. When we think of Japan's position vs. the US and Europe, it is closer to Europe. The current condition is not "Japan/US vs. Europe." In terms of exchange rates as well, the situation in July 2018 differs from the current one.

If so, it may be not necessarily appropriate to expect JGB superlong yields to follow the US long-term/short-term yield spread alone. The 10-year forward 10-year JGB yield appears to be currently positioned exactly between the US and European yield trends (chart on next page).JGBs are likely reflecting fundamentals to some extent.

At a post-meeting press conference in December 2020, BOJ governor Haruhiko Kuroda stated that "With the resurgence of COVID-19 cases now battering the economy, it has become critical to maintain stability in the bond market and keep the entire yield curve low and stable." The "entire yield curve" includes the superlong sector. Needless to say, we need to pay close attention to the January meeting and *Outlook for Economic Activity and Prices* report. However, if the 20-year yield level rises further due to concerns about a near-term reduction in offer amounts in operations and deterioration of supply/demand conditions in anticipation of such a reduction, it would become more attractive in comparison with investment in other assets. In the longer term, we would see moves in line with fundamentals in the global market, including Europe and, of course, Japan. In short, this means the question of whether Japan's neutral interest rate (inflation expectations, natural rate of interest) will rise amid a recovery.

US Long-term/short-term Yield Spread, European/JGB Forward 10Y Yields



Source: Bloomberg; compiled by Daiwa Securities.

◆ **Press Conference by BOJ Governor Haruhiko Kuroda** (18 Dec 2020)

- With the resurgence of covid-19 cases now battering the economy, it has become critical to maintain stability in the bond market and keep the entire yield curve low and stable.

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[Standard & Poor's]

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[Moody's]

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February 2020

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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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- 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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