Daiwa Securities

Daiwa's View

Three specific factors with JGBs

- US Treasuries are flattening, but the right answer for JGBs would be a dip-buying stance

Signs of a fourth COVID wave bring early supplementary budget a step closer

- Over three months from end-December to end-March, Y4.5tn of COVID-19 discretionary reserves budgeted for in FY20 were used

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Three specific factors with JGBs (Tani)

US Treasuries are flattening, but the right answer for JGBs would be a dip-buying stance

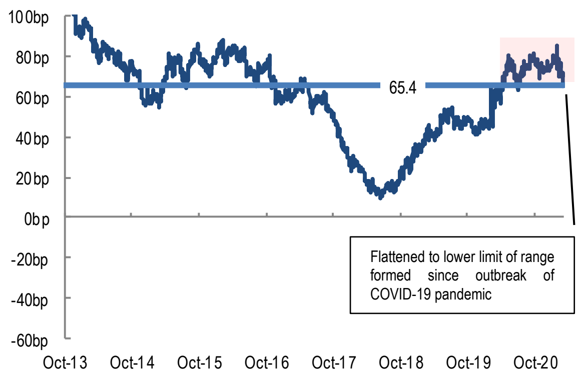
Yesterday, the 5-year, 10-year, and 30-year US Treasury yields closed at 0.90% (down 4bp), 1.67% (down 7bp), and 2.33% (down 8bp), respectively. While the S&P 500 Index set a record high, yesterday the yield curve flattened relatively sharply following flattening the day before yesterday. Due to this flattening for two consecutive days, the 10-year/30-year spread is about to break out from the lower limit of the range since the outbreak of the COVID-19 pandemic (65bp) (Chart below).

We can point out the following three factors behind this flattening: (1) superlong bonds being sold excessively, (2) the rise in yields now being led by the intermediate zone, and (3) the strong tone taken regarding tax hikes in the second round of fiscal plans. Although each factor is an important element, I focus on the first one.

For example, on 18 March, the 30-year yield temporarily exceeded 2.5% and superlong forward yields (e.g., 10-year forward 10-year yield) rose to around 3%, far above the longer-run projection of 2.5%. As this indicates that the market has almost fully factored in a rise in the longer-run projection, it is excessive at this point. There is probably also the possibility that market participants were again made aware of the excessive level of the longer-run projection after seeing the strong tone taken regarding tax hikes in yesterday's speech by President Joe Biden (the above-mentioned third factor).

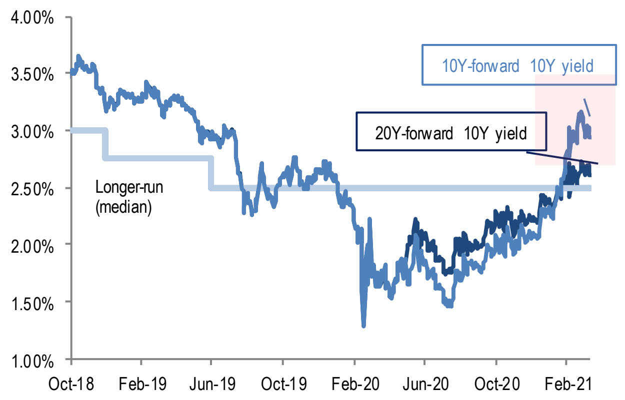
According to data from the CFTC, we can confirm rapid squeezing of short positions at leveraged funds since February from a record-high level (Chart on next page). This move appears to be reflecting the progress of correction in superlong Treasuries to a level where a winning rate of speculative short positions is low. Taking an overall view, the possibility appears high that the superlong zone of US Treasuries has reached a level where real money accounts are easy to buy.

US Treasury Yields (10Y/30Y spread)



Source: Bloomberg; compiled by Daiwa Securities.

US Treasury Yields (forward 10Y yields)



Source: Bloomberg; compiled by Daiwa Securities.

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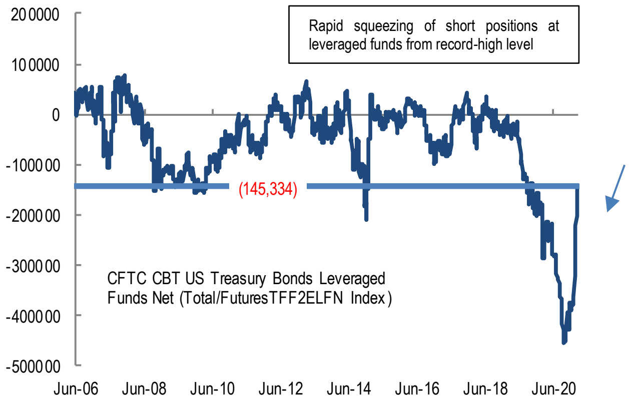
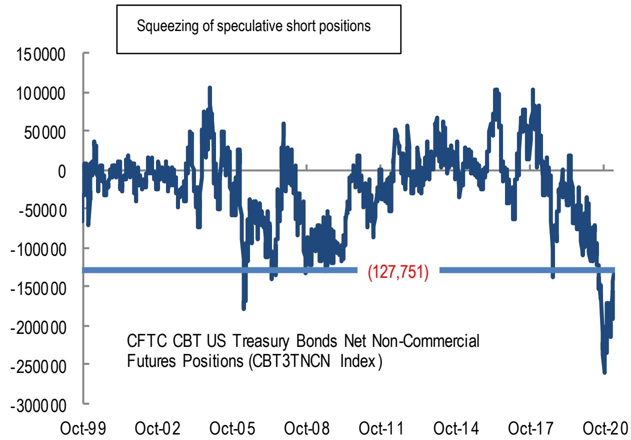
CFTC Short Positions at Leveraged Funds



Source: Bloomberg; compiled by Daiwa Securities.

US Short Positions Among Speculative Investors



Source: Bloomberg; compiled by Daiwa Securities.

◆ Three specific factors with JGBs

Regarding yesterday's JGB yields, meanwhile, the 10-year JGB auction ended with a favorable result, but bear steepening proceeded relatively substantially due to a specific factor with JGBs involving cuts in the offer amount in *Rinban* operations. The 20-year JGB yield has risen to around 0.5%. As this is a specific factor with JGBs, JGB yields do not necessarily fully follow the flattening of US Treasury yields seen for the past two days. Meanwhile, another specific factor with JGBs is the 10-year JGB yield target of around 0%, and, therefore, we need to watch the balance with this factor.

Given the relationship with the 10-year JGB yield target of around 0%, we estimate that the upward pace of the 10-year JGB yield will slow when the yield reaches 0.15%, and the rise will almost stop at 0.2%.

If so, and if we assume that the 20-year JGB yield will move in parallel with the 10-year yield (the 10-year/20-year spread will be constant) based on the starting point of the current level of the 10-year yield of 0.12%, it is calculated that the upward pace of the 20-year JGB yield will slow when the yield reaches 0.53%, and the rise will almost cease at 0.58%.

In addition, the five-year ahead general price outlook at large non-manufacturers in the BOJ's Tankan (JPINGLN5 Curncy, released yesterday) remained flat at 0.6%. (I refer to this data in gauging the true value of JGB yields.) This also provides no reason to change our opinion that we would go all-in at a 20-year JGB yield of 0.6%, which was derived based on the true value. It is effective to buy on dips at a level of above 0.5%.

Meanwhile, the emergence of signs of a fourth wave in the COVID-19 pandemic should be noted. Yesterday, the government decided to impose strict measures for Osaka, Hyogo and Miyagi prefectures to prevent the spread of the infectious disease. On the fiscal front, discretionary reserves are about to run out, despite the fact that there should have been around Y5tn left. If we face a fourth wave of COVID-19 cases following the hurried lifting of the state of emergency in the Tokyo metropolitan area, further deterioration in fiscal conditions will be undeniable (further issuance of JGBs; see next page for details). We would like to keep in mind that, in addition to *Rinban* operations and the 10-year yield target of around 0%, a delay in vaccine distribution is another specific factor in Japan. Although US Treasuries are flattening after the overshoot, the right answer for JGBs would be a dip-buying stance.

Signs of a fourth COVID wave bring early supplementary budget a step closer (Hamada)

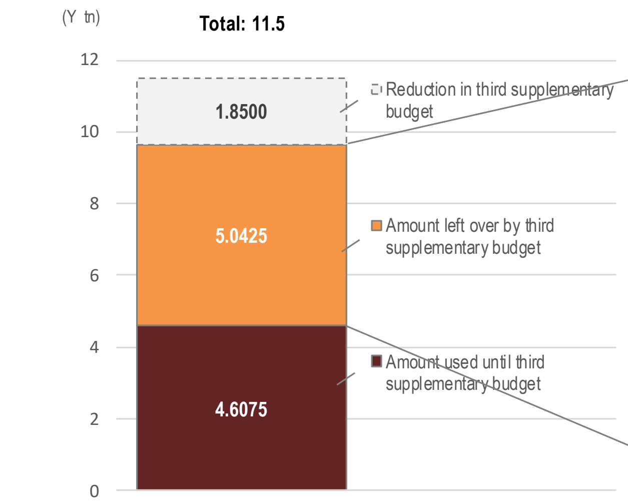
Over three months from end-December to end-March, Y4.5tn of COVID-19 discretionary reserves budgeted for in FY20 were used

The recent resurgence of infections, which may be indications of a fourth wave, prompted the government on 1 April to initiate pre-emergency measures aimed at stopping the pandemic's spread. The tighter restrictions will last for a month, from 5 April until 5 May, and cover three prefectures, Osaka, Hyogo, and Miyagi. An extension of these measures to other regions would increase the subsidy amounts paid to eating and drinking establishments operating under shortened hours. The FY21 budget includes Y5tn of discretionary reserves for COVID-19. In FY20, Y4.5tn was used over the three-month period from end-December to end-March, when Japan's second state of emergency was in effect. If the FY21 discretionary reserves are spent at the same pace, they would nearly run out by the end of the Apr-Jun quarter, and likely require replenishment, to cover at least the period from summer to fall, by way of a first supplementary budget drafted during the regular session of the Diet.

In FY20, the first and second supplementary budgets established COVID-19 discretionary reserves totaling Y11.5tn, Y4.6075tn of which was used until the third supplementary budget, after which Y1.85tn was reduced, leaving Y5.425tn available (left panel in the chart below).

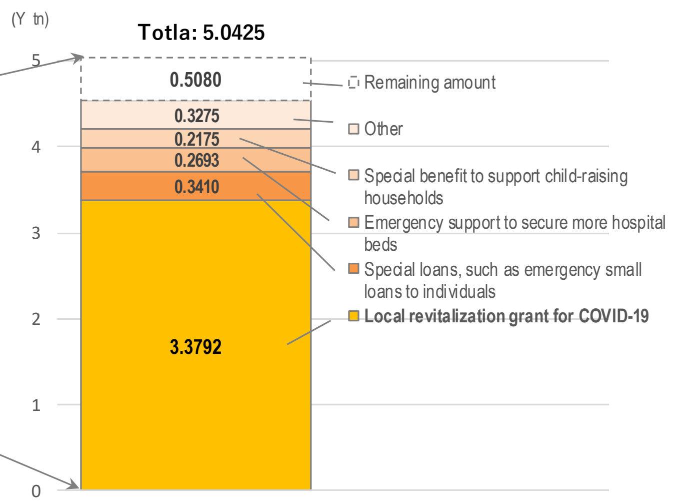
Over the roughly 3-month period from 25 December to 23 March, Y4.5345tn of this Y5.425tn was used, leaving only Y508bn. About 75% of the amount already used, Y3.3792tn, was granted to regional governments throughout Japan as provisional local revitalization grants, and most of that appears to have been in the form of subsidies to dining & drinking establishments that had their operating hours shortened under the second SOE (right panel in the chart below).

Measures Covered by FY20 COVID-19 Discretionary Reserves



Source: Ministry of Finance; compiled by Daiwa Securities.

Usage of FY20 COVID-19 Discretionary Reserves Left Over by Third Supplementary Budget



Source: Ministry of Finance; compiled by Daiwa Securities.

If usage of these discretionary reserves continues at the same pace of Y4.5tn every three months, the Y5tn of COVID-19 discretionary reserves provided for in the FY21 budget would be nearly used up after the Apr-Jun quarter. There is a possibility of moves in the regular session of the Diet to form, before the session ends on 16 June, an initial supplementary budget to replenish the discretionary reserves and make them sufficient to cover the period from summer to fall and beyond. This makes it important to see whether the pandemic's resurgence spreads throughout Japan and whether local public bodies ask dining & drinking establishments to shorten their operating hours.

In the FY20 FILP plan, fiscal loan funded by FILP bonds (JGBs) was Y60tn (including amounts carried forward from FY19), but that funding only totaled Y19tn up to February this year. Another question to ask if a supplementary budget is formed is the amount and timing of any reductions to FILP bond issuance.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Fitch]

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February 2020

Daiwa Securities

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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%.

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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- 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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