

Daiwa's View

Impact of Logan speech

- 20-year sector, TIPS to normalize due to correction to not “level” but “distortion”

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Daiwa Securities Co. Ltd.

20-year sector, TIPS to normalize due to correction to not “level” but “distortion”

Impact of Logan speech

In her [speech](#) on 8 April, Ms. Lorie Logan of the New York Fed referred to adjustments of QE asset purchases. This speech appears to have had a certain degree of impact on the market. The Logan speech implied not an operation twist but “passive” adjustments of operations that were fully anticipated.

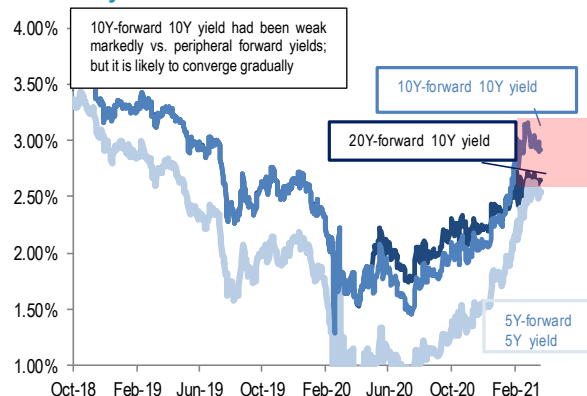
As is well known, the New York Fed is focusing on transparency, competitiveness of purchase prices, and the impact on market functions (market neutrality) in its key principles of operations. It thus seeks to carry out the FOMC directive in an efficient and effective manner by preferentially buying overly undervalued Treasuries in the sector with an advance disclosure of the schedule and the purchase amount.

However, we knew that adjustments of operations would be needed sometime soon because of the increase in the outstanding amount of coupon bearing bonds and longer maturity due to the increased issuance since the outbreak of the COVID-19 pandemic. If operations are adjusted in the near future, this would have a relative impact on the 20-year sector, Treasury Inflation-Protected Security (TIPS), and inflation expectations (BEI), all of which have been distorted substantially thus far.

◆Desk Operations: The New Normal (8 Apr 2021)

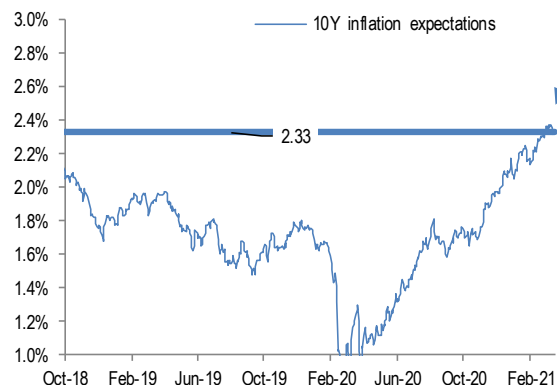
As the Desk considers how to approach operations, we first and foremost seek to carry out the FOMC directive in an efficient and effective manner. In doing so, there are important operational choices to be made. The Desk's approach to these choices is guided by key principles, a few of which I would like to highlight today. First, we aim to be transparent, providing information to market participants and the public to ensure fairness and promote understanding of our purchase operations. We also seek to obtain securities at competitive and appropriate prices for the Federal Reserve, as this will ultimately benefit the U.S. taxpayer. In addition, unless otherwise appropriate for efficient and effective implementation under the directive, we endeavor to operate in a manner that is relatively neutral to the securities available for purchase and in a way that limits the potential for our operations to affect normal market functioning. In practice, we follow this principle by purchasing Treasury securities across sectors in approximate proportion to the universe of Treasury securities outstanding and by concentrating our purchases of agency MBS in recently produced securities. I would like to discuss a few changes that we have made or are planning in the Desk's Treasury, agency MBS, and agency CMBS operations that help us adhere to these guiding principles.

US Treasury Forward Yields



Source: Bloomberg; compiled by Daiwa Securities.

US BEI



Source: Bloomberg; compiled by Daiwa Securities.

◆ 20-year sector

It was somewhat surprising that Ms. Logan mentioned the specific “20-year” sector in the speech. That said, the weakness of the 20-year (10-year forward 10-year yield) has been marked thus far relative to peripheral forward yields (left-hand chart above). As this sector resumed issuance after the outbreak of the pandemic, it was probably referred to as a good example of sectors that need supply/demand adjustments. Due to the distortion of supply/demand conditions, the 10-year forward 10-year yield is now at a high level of 2.92%. This is expected to converge to the direction of the 5-year forward 5-year yield (2.54%) and the 20-year forward 10-year yield (2.65%).

◆ Treasury Inflation-Protected Security (TIPS) and inflation expectations (BEI)

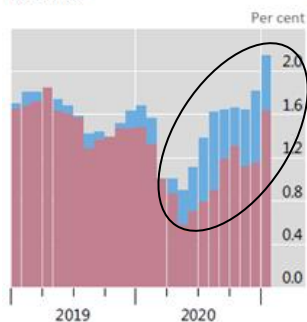
As the BIS Quarterly Review [pointed out](#) in the past, the market outstanding amount of (coupon-bearing) US Treasuries has increased by 15%, while the amount of TIPS declined by more than 5% amid the increase in Treasury issuance and operations since the COVID-19 crisis. The tighter supply/demand conditions for TIPS lowered the real yield, which appears to have consequently exaggerated inflation expectations (BEI). However, as the aforementioned Logan speech mentioned the TIPS sector, relatively tight supply/demand conditions for TIPS since the COVID-19 crisis are likely to ease. This is likely to lead to less exaggeration of the BEI, which is calculated as the residual between the yield of coupon-bearing bonds and that of TIPS. As the supply/demand factor is realized as an “inflation premium” in the BIS’s trial calculation (chart below), this premium may move toward previous levels.

Factor Analysis of Inflation Expectations, Market Outstanding Amount of Nominal US Treasuries and TIPS

Inflation risk premia rose as the net supply of TIPS¹ dwindled vs US Treasuries

Graph D

US inflation risk premia climbed in late 2020²



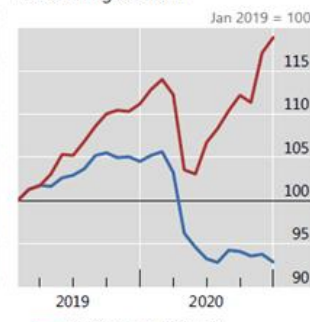
10-year inflation break-even decomposed into:
 Expected inflation
 Inflation premium

The Fed increased its footprint in the debt market



Share of securities outstanding held by the Fed:³
 Nominal US Treasuries
 TIPS¹

Net of Fed holdings, TIPS outstanding declined⁴



— Nominal US Treasuries
 — TIPS¹

Source: Extracted from BIS Quarterly Review.

■ ◆Desk Operations: The New Normal (8 Apr 2021)

Treasury Purchase Operations

Last March, when conditions were highly disrupted in the U.S. Treasury market, we purchased a wide range of securities to address broad market dysfunction—and, at times, we weighted purchases more heavily toward sectors in which conditions were especially strained. Adjustments made to the size and composition of purchases were announced in the Desk's purchase calendars, often released multiple times a week.

As market conditions stabilized, we adjusted purchase allocations to be roughly proportional to the amounts outstanding across the nominal Treasury coupon and TIPS coupon curves, and we lengthened the purchase calendars to provide more predictability in our planned operations.

As our Treasury purchases transitioned to a more proportional allocation, there were still sectors of the curve that we refrained from purchasing. For example, the Desk generally has avoided purchasing bills, both to avoid increasing scarcity value in these securities arising from strong investor demand and because bill purchases have relatively little impact on financial conditions.

Even in this steadier operating regime, we continue to adjust our purchase approach consistent with our principles. For example, we conduct periodic reviews of our allocations across purchase sectors and make modest changes in response to the evolving market environment. During the past year, issuance of Treasury securities has increased markedly as the U.S. Treasury has sought to fund pandemic-related fiscal stimulus expenditures. Even with this new issuance, the distribution of Treasury coupons outstanding has been fairly stable given the large outstanding stock of Treasury debt. However, modest shifts have occurred. In particular, the introduction of the 20-year Treasury bond has increased amounts outstanding around the 20-year maturity point. In addition, the pace of increase in TIPS issuance has been slower relative to nominal coupon securities. With net issuance expected to remain high in the near term, we anticipate that the composition of outstanding supply will continue to evolve. As a result, we plan to make minor technical adjustments to our purchase sectors and increase the frequency at which we update purchase allocations to remain roughly proportional to the outstanding supply of nominal coupon securities and TIPS. We expect to announce these as a part of a normal purchase calendar release in coming months.

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In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

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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.
- 4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")

The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (<http://www.standardandpoors.co.jp/unregistered>) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (<http://www.standardandpoors.co.jp>)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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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]

The Name of the Credit Rating Agencies group, etc

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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

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- 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

Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association