Daiwa Securities

Daiwa's View

European-version "Happy yield increase" and 20-year JGB auction

➢ Recommend buying 20-year JGBs, despite incomprehensible points

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Daiwa Securities Co. Ltd.

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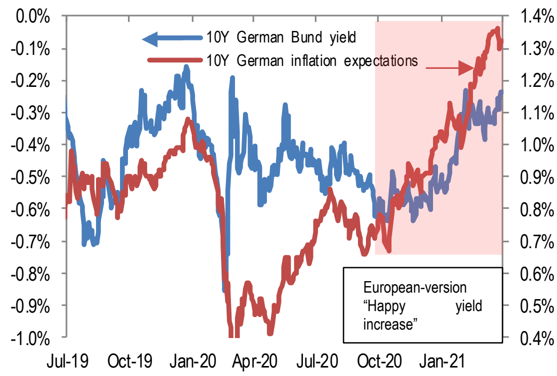
Recommend buying 20-year JGBs, despite incomprehensible points

The April ECB Governing Council meeting to be held on the 22nd may be somewhat uneventful. However, European yield movements have become active in the market, which reads "the future beyond the future." Such movements have reached an unmistakable level also for Japanese investors. Yesterday, the 10-year German Bund yield exceeded –0.22% at one point (closing at –0.235%). It can be said that there was a mini taper tantrum, while market participants were aware of an increase in supply (€800bn in procurement by 2026 via recovery instrument of NextGenerationEU), and also factored in the possibility that the ECB will start to scale back the pandemic emergency purchase program (PEPP).

Why is the ECB taking a wait-and-see stance against the rise in yields? This is probably because recent movements are regarded as "happy yield increase." From a slightly longer-term perspective, the contents of the rise in German yields are close to those of the rise in US yields during July 2020-January 2021. The 10-year German Bund yield rose by around 40bp from –0.64% (at time of US presidential election) to –0.235% (yesterday). However, the 10-year German inflation expectations rose by 63bp from 0.67% to 1.3% during the same period. Despite this rise in yield, the real yield fell by as much as 23bp. As this is not a disordered rise that would lead to a tight financial environment, the ECB would be lacking incentives to aggressively rein in such a rise (similar to Fed at that time).

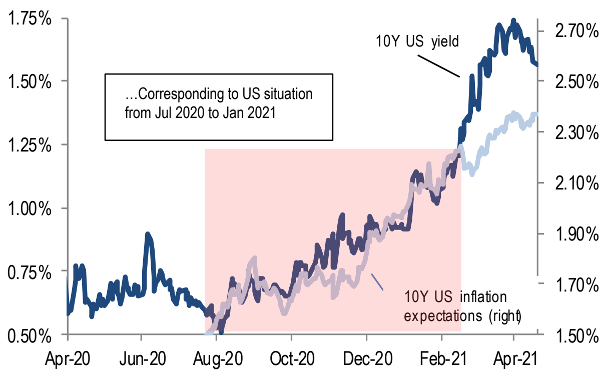
That said, –0.2% is a threshold level, where the 10-year German Bund yield has repeatedly bounced back. The key 10-year German BEI peaked out at slightly below 1.4%. In addition, the 10-year forward 3-month German yield of 0.58% also gives us the impression that the yield has reached the zone that cannot be justified for rate-hike expectations. The 10-year German yield may rise another 10bp or so, but its short-term ceiling may be close.

10Y German Bund Yield, Breakeven Inflation Rate (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Treasury Yield, Breakeven Inflation Rate (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

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Under the circumstances, the 20-year JGB auction is scheduled for today. We now need to think of the bidding stance, keeping in mind the possibility that upside will be limited. Meanwhile, it is true that we are unable to ignore the 20-year JGB auction to be held at around the mid-0.4% level at the beginning of the fiscal year. Looking at forward yields as well, the current level of the 10-year forward 10-year yield (0.85%) is close to the fair level in light of the true value of JGB yields shown in our past reports (slightly cheap).

JGB Yields (as of 19 Apr, %)

JGB	5y	5y5y	10y
Current level	-0.09	0.27	0.09
Upward scenario	-0.04	0.42	**0.19**
Downward scenario	-0.14	0.12	**-0.01**

JGB	10y	10y10y	20y	20y10y	30y
Current level	0.09	0.85	0.45	1.10	0.66
Upward scenario	0.19	1.00	**0.58**	1.25	**0.79**
Downward scenario	-0.01	0.70	**0.33**	0.95	**0.52**

Source: Bloomberg; compiled by Daiwa Securities.

From a long-term viewpoint, now is, of course, the upward phase of US yields. Therefore, it is possible that yields will rise above the fair level. However, at least at the moment, the upward phase of US yields appears to have let up. We thus think that the current levels may continue over the next several months.

In such a situation, we note the possibility of the BOJ's cut in the offer amounts in the monthly purchase schedule to be released at the end of April.

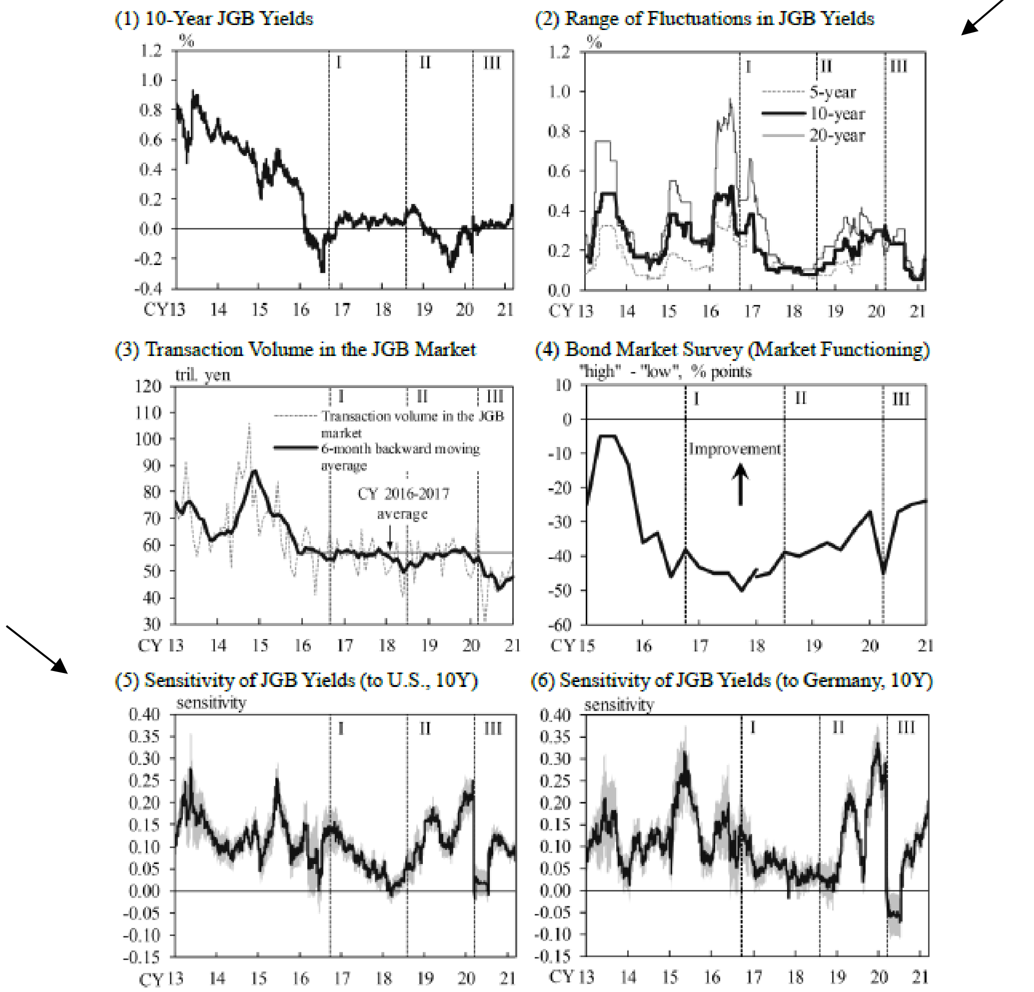
There is an opinion that the BOJ tries to maintain a steep yield curve by reducing the offer amounts in the monthly operation schedule, triggered by the flattening of the 10-year/20-year spread compared to that before the assessment. In this case, as a cut at the end of this month is quite possible, market participants will need to pay attention to the BOJ's operation trends in the short term.

Meanwhile, we are also curious about the BOJ's intension behind the somewhat drastic cut in the offer amounts at the end of March. Materials to explain the background of the BOJ's assessment included the chart to show JGB yield sensitivity to US Treasuries (Chart 10 [5]) and that to represent the range of JGB yield fluctuations (difference between maximum and minimum values in JGB yields in preceding six months, Chart 10 [2]). These indicators seem to be used as a reference in gauging the functioning of the JGB market (charts on next page).

Accordingly, if the BOJ restrains a slight decline from the upper side toward the middle within the range of the JGB yield band in line with a drop in US yields by reducing the offer amounts in operations, it would be more difficult for the fluctuation range to widen and the correlation with overseas yields would also weaken. If we assume that the BOJ pre-emptively cut the offer amounts at the end of March to a cruising speed so that market participants were able to trade in the market without paying attention to the "BOJ's intervention" variable, the BOJ may not reduce the offer amount at the end of this month. In this case, it is natural to think that the central bank will not intervene in every moderate change in JGB yields within the band. This is likely to lead to a market formation that is more focused on fundamentals.

As it has not been long since the assessment meeting, there are some incomprehensible points with respect to the BOJ's stance on the monthly operation schedule. However, given the timing of the start of the new fiscal year, the possibility that the rise in yields will be limited over the next several months, and the absolute yield level of 0.45% that can be seen as largely fair, we recommend buying 20-year JGBs at today's auction, despite acknowledging the incomprehensible points and the possibility that the upside will be limited after the auction.

Functioning of JGB Market (materials to explain background of assessment)



Notes: 1. I: Introduction of QQE with Yield Curve Control (Sept. 2016), II: Strengthening the Framework for Continuous Powerful Monetary Easing (July 2018), III: Enhancement of Monetary Easing in Light of the Impact of the Outbreak of the Novel Coronavirus (COVID-19) (Mar. 2020).

2. (2) shows the difference between the maximum and minimum values in JGB yields in the preceding 6-months.

3. (3) shows the gross amount of outright purchases by banks, investors, and bond dealers.

4. (5) and (6) show rolling regression estimates for 90-day windows. The shaded areas represent ±1 standard errors.

Sources: Bloomberg; Japan Securities Dealers Association; Bank of Japan.

Source: Extracted from BOJ materials.
Note: Arrows added by author.

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[Standard & Poor's]

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[Moody's]

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[Fitch]

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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%.

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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