

Daiwa's View

Upward scenario of JGB yields in latter half of year

➤ Is Japan next?

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Daiwa Securities Co. Ltd.

Is Japan next?

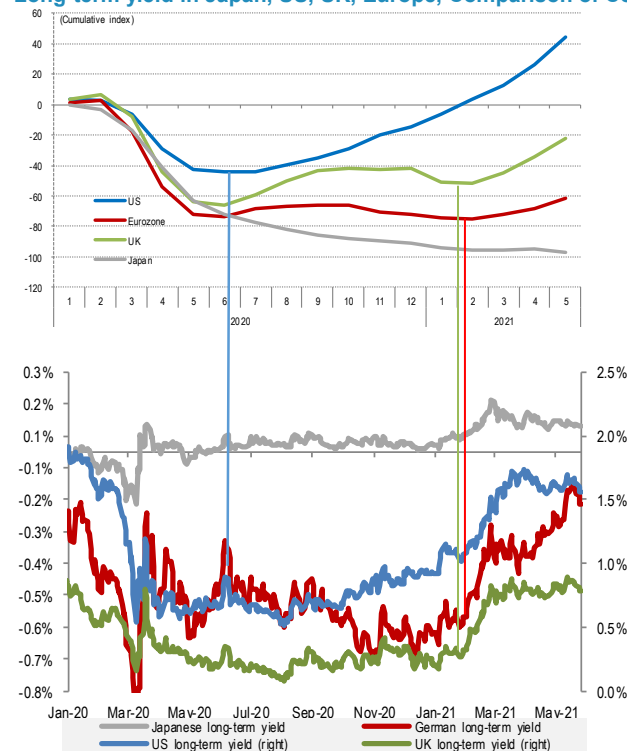
Upward scenario of JGB yields in latter half of year

The sensitivity of JGB yields to European and US yields is declining. If we cannot expect a rise attributed to overseas factors, this would inevitably heighten interest in domestic factors. What are possible domestic factors that would lead to a rise in JGB yields in the latter half of the year?

Excluding technical factors such as a cut in the BOJ's offer amounts in its purchase operations, the market is focused on two domestic factors—the supplementary budget and a rise in the vaccination rate. While [near-term expectations for the former](#) are diminishing, for the latter they appear to be increasing day by day.

US and German yields started to rise on a full scale in July 2020 and January 2021. One characteristic is that a rise in the vaccination rate and a recovery of the PMI were observed then. If this pattern is applicable to Japan, JGB yields may face upward pressure in the latter half of the year in line with a rise in the vaccination rate.

Long-term yield in Japan, US, UK, Europe, Comparison of Composite PMI with Pre-pandemic Level



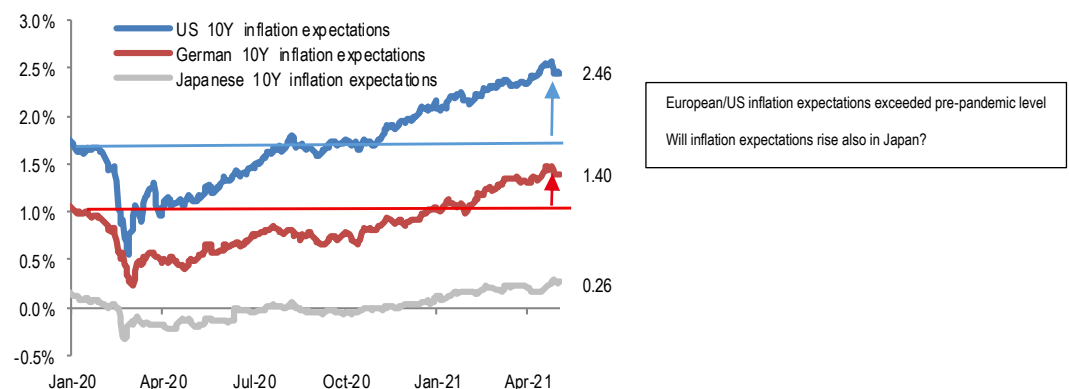
Source: IHS Markit, Bloomberg; compiled by Daiwa Securities.

However, we have to pay attention to two factors when examining the upward scenario of JGB yields. One is whether the rise in the vaccination rate will lead to a V-shaped economic recovery (sharp rebound of Composite PMI on accumulated basis) in Japan, similar to Europe and the US. Japan is slated to hold events such as the Tokyo Olympic Games from 21 July to August and a snap general election by October. Public opinion is currently against holding the games. Partly because of this, if the “forced holding of the Olympic games” causes a resurgence of infections in Japan, this could have fatal consequences for the Suga administration.

Given this Japan-specific situation, in the case of holding the Olympic and Paralympic Games, measures to restrain the flow of domestic people may be adopted around the period of the games in the Jul-Sep quarter. Our senior economist Toru Suehiro¹ pointed out a scenario of the continued restraint in the flow of people in the Jul-Sep quarter, which is throwing into question the possibility that the progress of vaccination will directly lead to a rise in the Composite PMI and then a rise in JGB yields. There is a good chance that such measures will delay the recovery timing.

Even if Japan's economy posts a V-shaped recovery thanks to increased vaccination rollout, there would be another issue—whether inflation expectations in Japan will rise enough to create awareness about the BOJ's exit strategy. Here, there are fundamental problems, such as the difference in price-setting behavior between Japanese and European/US firms (under Japanese business style, excess demand gradually dissolved over time while price hikes are restrained) and the fact that expectation formation for prices is largely adhesive and adaptive in Japan. Due to the prolongation of the state of emergency, it is true that “forced savings” are increasing on a macro level². However, if the inflation rate remains limited even in the case of an explosive consumption from such savings, this may create a sense of resignation that “how on earth can we raise Japan's inflation?”

10Y Breakeven Inflation Rate in Japan, US, Germany



Source: Bloomberg; compiled by Daiwa Securities.

As shown by reactions to the PMI and inflation expectations in Europe and the US, long-term yields reflect fundamentals from a slightly longer-term perspective. In that sense, it is also important to pay attention to inflation expectations (difference with Europe/US) from a longer-term perspective, keeping in mind the scenario³ in which JGB yields may rise in the latter half of the year in line with a rebound of the PMI. If we see the phase of yield increases in the latter half of the year under the situation where Japan's inflation expectations remain low and stable, this could provide an excellent opportunity for JGB investors.

¹ Economist in Equity Research Department, named *ESP Forecast* excellent forecaster in FY19.

² According to analysis in BOX 3 in BOJ's Apr *Outlook for Economic Activity and Prices* report, “forced savings” in 2020 estimated at Y20tn on cumulative basis. With upside/downside risks, it pointed out that private consumption may see a larger-than-expected rebound from somewhat long-term perspective as COVID-19 subsides.

³ In this report, we explain only outline of possible yield scenario. Details of scenario to be explained in subsequent report.

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■ Credit Rating Agencies

[Standard & Poor's]

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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 ¥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%.

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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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