Daiwa's View

Another factor behind US yields' continued lack of upward momentum

➢ Impact of China credit impulse?

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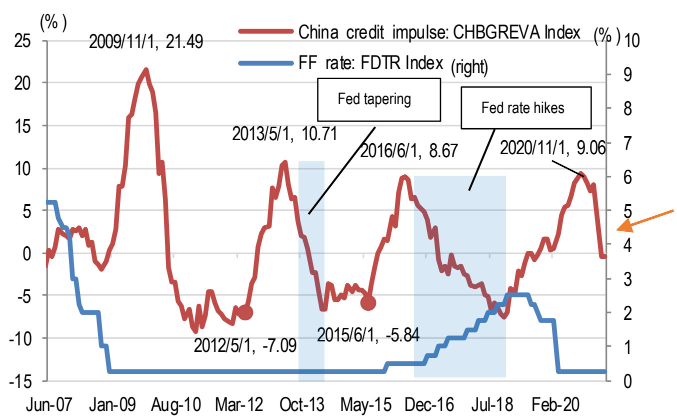
Impact of China credit impulse?

Yesterday, the 10-year US Treasury yield was again pushed backed to 1.59%.

At the beginning of the fiscal year, no one imagined that US yields would be losing upward momentum to this level. In FY21, the 10-year US Treasury yield started from 1.74%, which points to the upper limit of the recent range. As US economic indicators announced during this period were more than satisfactory (Economic Surprise Index also at around zero), the reasons for the lack of upward momentum for US yields cannot be explained by current economic indicators.

Many people are likely watching the "China Credit Impulse Index," which shows the growth rate of credit (such as loans) relative to the GDP growth rate. Historically, the index substantially rose when the Chinese government stepped on the accelerator, while it plunged when it hit the brakes (chart below). The global financial crisis in 2008, the European debt crisis in 2012, the China shock in 2015, and recent COVID-19 crisis served as direct causes of expansion of this credit impulse. As the end to the COVID-19 crisis is coming in sight, froth is being seen across the market due to excess liquidity. Under the circumstances, the Chinese government is now probably stepping on the brakes. The Credit Impulse Index has thus sharply declined to –0.4% after peaking at 9.06% in November 2020. Frankly speaking, this would not be an encouraging chart.

China Credit Impulse, US Federal Funds Rate



Source: Bloomberg; compiled by Daiwa Securities.

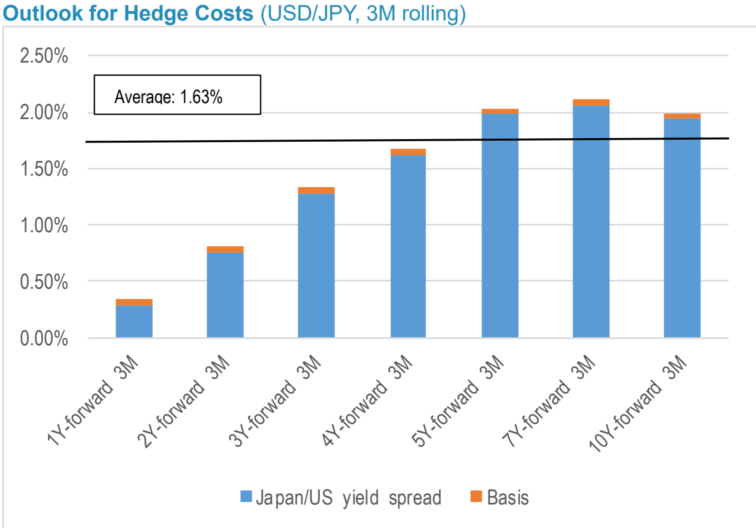
According to the chart on the previous page, we find that (after global financial crisis) the Fed steered toward the exit strategy every time when the China credit impulse hit a peak. Of course, the Fed did so after confirming the US economic recovery. However, the chart shows that we cannot downplay China's role as an external factor that brought about the recovery.

If we emphasize the fact that the China credit impulse is now heading down, we can imagine that it will take time for the Fed to implement the upcoming exit strategy similar to the case from 2013. In this case, tapering was implemented as scheduled, but there was one cycle of the China credit impulse before "full-scale rate hikes" were implemented from late 2016. In other words, these rate hikes from late 2016, in part, benefited from the tailwind of expansion of the China credit impulse, which bottomed in June 2015.

Currently, the US interest rate market is factoring in rate hikes starting from end-2022/the first half of 2023 and a relatively fast pace of rate hikes. However, it is obvious that this assumes steady economic expansion. If the China credit impulse continues to decline and US economic indicators weaken with a time lag, this may make it difficult to implement a smooth early exit strategy factored in by the market. Given the precedents, we think that tapering will be probably implemented as scheduled, but rate hikes may be pushed back compared to the timing currently factored in by the market.

If so, US yields are likely to decline led by the intermediate zone. On top of this, an important change will also arise in terms of the outlook for "hedge costs" of foreign bonds invested from the yen. In our trial calculation based on the OIS curve, we estimate that hedge costs over the next ten years will average out at around 1.63%. However, if the current OIS curve overly factors in rate hikes (leading to decline), hedge costs actually paid in the future may be lower than the aforementioned estimated figures. For JGBs, the lack of a rise in US yields itself is a tailwind (factor of lowering yields). However, if foreign bonds invested from the yen become more attractive due to lower hedge costs, this will become a headwind (thus raising yields).

Outlook for Hedge Costs (USD/JPY, 3M rolling)



Source: Bloomberg; compiled by Daiwa Securities.

Daiwa Securities

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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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 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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- 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.

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