Daiwa Securities

Daiwa's View

Moody's (*) downgraded US credit rating to Aa1

- We need to carefully watch for possible wide-ranging impact, because, while the downgrade may tend to lead us to think about a higher term premium, the impact of a sovereign downgrade is not as simple as a corporate bond downgrade
- Impact on short-term/intermediate JGB zone will probably be limited
- Market valuation of Japan is currently higher than that of France, but if Japan's valuation were to fall to the same level as France, yields could rise by about 15bp in superlong zone

FICC Research Dept.

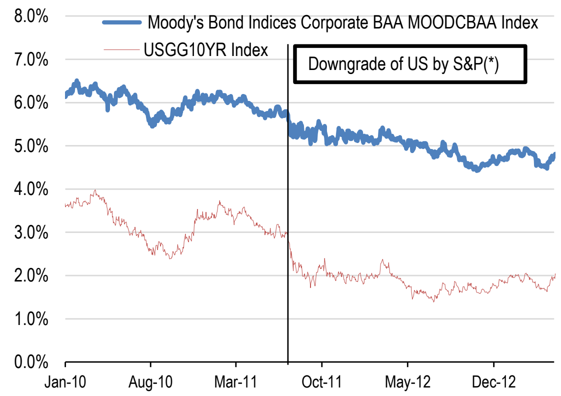
Eiichiro Tani
81-3-5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

Moody's (*) downgraded US credit rating to Aa1

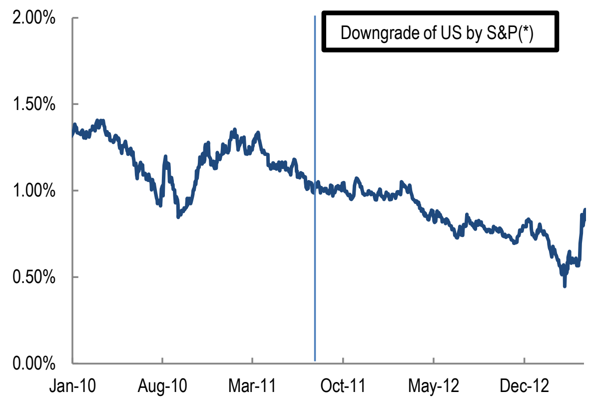
On 16 May, Moody's (*) announced that it had downgraded the US from Aaa to Aa1. This event likely reminded many market participants of the time when S&P (*) downgraded the US in August 2011 (AAA → AA+). Initially, there were major expectations that the 2011 downgrade would result in US yields rising due to widening of the risk premium. However, market attention shifted to the overall issue of sovereign debt, which led to the European debt crisis, and a sharp decline in the US long-term yield due to a flight to quality.

US Long-term Yield and Corporate Bond Yield Around Time of US Downgrade in 2011



Source: Bloomberg; compiled by Daiwa.

10yr JGB Yield Around Time of US Downgrade in 2011



Source: Bloomberg; compiled by Daiwa.

People may speculate that the latest action will have a greater impact than last time because the US has lost the highest rating at both S&P (*) and Moody's (*). For the time being, the US Treasury term premium should be carefully monitored. However, the credit rating of a major developed nation whose currency serves as a kind of cornerstone and its fulfillment of obligations on local currency-denominated government bonds are profound issues. Therefore, considering the impact of these downgrades is not as simple as when considering the downgrading of corporate bonds. We will likely need to carefully keep an eye out for how this might have a wide-ranging impact.

On 18 May, Treasury Secretary Scott Bessent stated, "Moody's (*) is a lagging indicator—that's what everyone thinks of credit agencies. … We didn't get here in the past 100 days. It's the Biden administration and the spending that we have seen over the past four years that we inherited," and "we are determined to bring the spending down and grow the economy." As Moody's (*) has repeatedly warned of a downgrade, it is uncertain whether the latest downgrade will serve as a new catalyst.

(*) indicates unregistered credit rating agencies. Please see the disclaimer at the end of the document.

Impact on JGB yields

Will the US downgrade affect JGB yields? In the short-term/intermediate zone (with residual maturities of up to five years), the impact will probably be limited. To begin with, price movements in this zone tend to essentially reflect trends with the BOJ's policy interest rate, and Japanese financial institutions (depository institutions) continue to be the main investors in this zone. If the long-term yield were to surge led by the term premium, Japanese financial conditions would tighten unexpectedly, and the BOJ's stance on additional rate hikes would become more cautious. That could push down the rate-hike path (market projections for the terminal rate).

However, greater attention may now be needed with regard to the superlong JGB zone compared to the situation in 2011 when the downgrading of the US credit rating by S&P (*) roiled the market. Back then, the duration needs of Japanese life insurers had a dominant influence on the determination of superlong JGB yields. However, foreign investors now have increased pricing power in the superlong JGB zone.

When foreign investors have increased pricing power, their perspective becomes more important. Currently, the on-the-run 30-year JGB (CTJPY30 = JX86) yield is about 2.95% on a simple yield basis or about 2.82% on a compound yield basis. When this yen-denominated cash flow is converted into dollars, the yield of the "dollar-denominated 30-year JGB" is around 5.53%—with a dollar-denominated asset swap spread (ASW) of +142bp, 59bp higher than the US Treasury ASW. In terms of dollar-denominated government bonds, JGBs have much wider dollar-denominated ASW than Swiss or German bonds, but tighter such ASW than French bonds, and are situated between the UK and French bonds.

30yr Government Bond Yields, Dollar-denominated ASW by Nation

On-the-run 30yr government bonds	ISIN	Maturity date	Local currency-denominated yield (%, compound)	Local currency-denominated ASW (bp)	Dollar-denominated yield (%)	Dollar-denominated ASW (bp)	
US	**US912810UK2**	**5/15/2055**	**4.94**	**82**	**4.94**	**82**	
Switzerland	CH0344958472	05/24/2055	0.37	-25	4.25	15	
Germany	DE000BU2D004	8/15/2054	3.04	44	4.64	52	
Australia	AU0000300535	6/21/2054	5.06	56	4.65	53	
UK	GB00BPSNBB36	07/31/54	5.39	81	5.16	104	
Japan	**JP1300861R49**	**3/20/2055**	**2.82**	**65**	**5.53**	**142**	* G+60bp
France	FR001400OHF4	5/25/2055	3.97	128	5.67	156	
Italy	IT0005611741	10/1/2054	4.41	179	6.31	219	

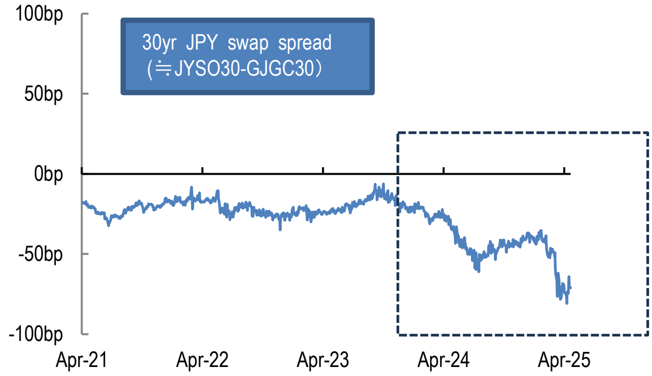
Source: Bloomberg; compiled by Daiwa.

Caution is warranted regarding change in foreign investors' perspective

If the impact from the US downgrade were to spill over to Japan, we could see a change in the current relative position of the JGB's dollar-denominated ASW, which is now between the UK and French bonds, but somewhat closer to French bonds. For example, if valuations of JGBs were lowered to be on par with French bonds (with the dollar-denominated ASW changing from +142 to +156bp), the dollar-denominated yield would rise to around 5.67% (about 75bp higher than the US Treasury yield). In this case, if we assume that the cross-currency basis swap (XCCY) remains unchanged, the yen-denominated ASW on JGBs would widen from around +65bp to around +80bp, and the 30-year JGB yield could rise to just under 3% on a compound yield basis, or around 3.2% on a simple yield basis.

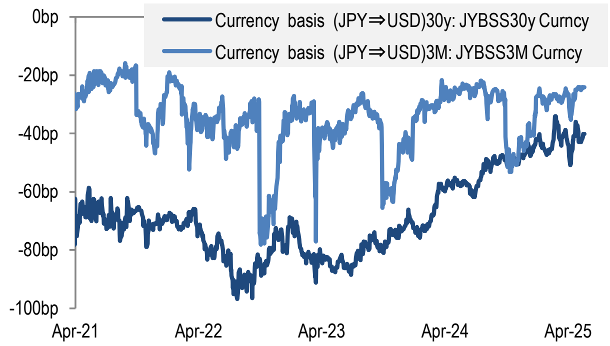
Of course, the above scenario is just one example of what might happen in the future. One important fact that we must remind ourselves of is that the downgrading of the US in 2011 led to the European debt crisis, resulting in other nations/regions being impacted more than the US. This time as well, we need to remain keenly aware of the fact that, for the time being, in addition to having an impact on the US term premium, the downgrade could also result in drawing the focus of attention on the debts of other nations/regions (incl. Japan).

30yr JPY Swap Spread



Source: Bloomberg; compiled by Daiwa.

USD/JPY Currency Basis Swap (30yr)



Source: Bloomberg; compiled by Daiwa.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

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, Japan Security Token Offering Association