

# Daiwa's View

## Tail risk already realized

- Short positions becoming disadvantageous

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Daiwa Securities Co. Ltd.

### Short positions becoming disadvantageous

#### Tail risk already realized

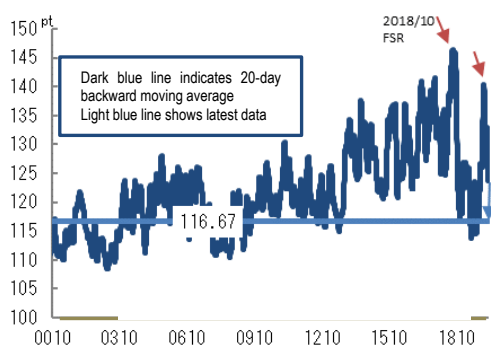
*The three stages of a bear market:*

*The first stage, when just a few thoughtful investors recognize that, despite the prevailing bullishness, things won't always be rosy, the second stage, when most investors recognize that things are deteriorating, and the third stage, when everyone's convinced things can only get worse (extracted from Mastering the Market Cycle by Howard Marks).*

Yesterday, the DJIA plunged by \$1,338, closing at below \$20,000. Due to the rise in yields, bond prices also declined and corporate bond spread widened further. According to Warren Buffett's proverb, "We should be cautious especially when others lack caution." Now everyone believes in the advent of an economic recession.

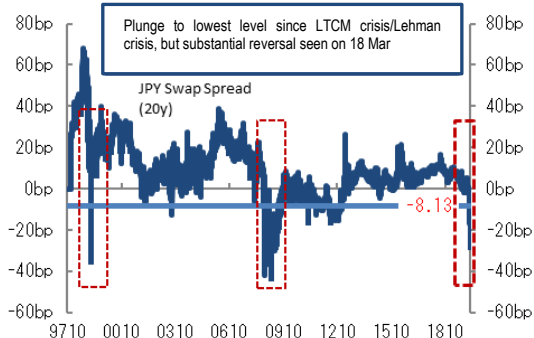
Will the market plunge from now? One notable point is that the tail risk indicator (SKEW) extracted from the stock options market has declined to the lower end of its range since 2000. This indicator was used when the BOJ warned of a repricing risk in its *Financial System Report* in October 2018. Soon afterward, the risk was realized in line with the warning. In the current coronavirus market turmoil, the market plunged after the surge in the SKEW index (Chart 1). While the S&P500 Index has now dropped by as much as around 1,000 points, the SKEW Index has declined to the 116 level, close to the lower end of its historical range. This seems to imply limited room for a further tumble. This probably means that (1) the tail risk has already been realized and (2) the market has substantially factored in an extreme scenario.

Chart: US Stock Tail Risk Indicator (SKEW)



Source: Bloomberg; compiled by Daiwa Securities.

Chart: Yen Swap Spread (20Y)



Source: Bloomberg; compiled by Daiwa Securities.

While the market has factored in a pessimistic scenario, policy responses have been proceeding steadily. [Yesterday, we reported](#) that the Fed had decided to reopen a Commercial Paper Funding Facility (CPFF), which was established at the time of the global financial crisis. Moreover, it announced that it would relaunch the Primary Dealer Credit Facility (PDCF), which was also established during the global financial crisis (starts 20 Mar).

This is a measure to boost the recovery of currently required “market liquidity.” Going forward, this scheme would virtually eliminate the burdens on funds of inventory investment at market makers certified as primary dealers by the New York Fed when they make markets for eligible collateral securities. Such securities include investment-grade corporate debt securities, international agency securities, commercial paper, municipal securities, mortgage-backed securities, and equity securities (excl. ETF, mutual funds, and others), in addition to AAA-rated CLO and CMBS.

◆ Fed (17 Mar 2020)

**Federal Reserve Board announces establishment of a Primary Dealer Credit Facility (PDCF) to support the credit needs of households and businesses**

To support the credit needs of American households and businesses, the Federal Reserve Board on Tuesday announced that it will establish a Primary Dealer Credit Facility, or PDCF. The facility will allow primary dealers to support smooth market functioning and facilitate the availability of credit to businesses and households.

The PDCF will offer overnight and term funding with maturities up to 90 days and will be available on March 20, 2020. It will be in place for at least six months and may be extended as conditions warrant. Credit extended to primary dealers under this facility may be collateralized by a broad range of investment grade debt securities, including commercial paper and municipal bonds, and a broad range of equity securities. The interest rate charged will be the primary credit rate, or discount rate, at the Federal Reserve Bank of New York.

More detailed terms and conditions and an operational calendar will be subsequently released. The PDCF is established under Section 13(3) of the Federal Reserve Act, with approval of the Treasury Secretary.

In addition, full-fledged responses by the European authorities are in progress, although belatedly. Today, the ECB announced a bond purchase program worth €750bn to cope with the COVID-19 pandemic. This appears to be aiming to address the dive in European government bonds. Yesterday, media report had it that the EU authorities discussed the use of the European Stability Mechanism (ESM), a relief fund in the euro zone, although an official decision has not yet been made. If outright monetary transactions become available via the utilization of ESM, this would enable the ECB to buy a large amount of European government bonds in a different scheme from QE. Those who have actually experienced the Lehman crisis and European financial crisis must know how powerful the effect from this measure is.

Although we cannot say that the market has returned to normal, the collapsed balance of risk assets appears to be recovering. Once the direction of the scenario (even tail risk one) is settled, we should be able to find superior assets that can bear the scenario. Regarding the JPY swap spread (spread between JGB yields and swap rates) on which we touched yesterday, the figure suddenly improved sharply to a single-digit level in negative territory. While the government/authorities have been taking action increasingly seriously, the market has already factored in the bad scenario as shown by the above-mentioned SKEW Index. No one knows the actual timing of a bottoming-out. However, as the balance between positives and negatives is approaching an even level, short positions are expected to become disadvantageous.

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Registered Credit Rating Agencies are subject to the following regulations:

- 1) Duty of good faith.
- 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]

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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>)

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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](https://www.moody.com/pages/default_ja.aspx)))

##### Assumptions, Significance and Limitations of Credit Ratings

Credit ratings are Moody's Investors Service's ("MIS") current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. MIS defines credit risk as the risk that an entity may not meet its contractual, financial obligations as they come due and any estimated financial loss in the event of default. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk, or price volatility. Credit ratings do not constitute investment or financial advice, and credit ratings are not recommendations to purchase, sell, or hold particular securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information, is given or made by MIS in any form or manner whatsoever.

Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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#### [Fitch]

##### The Name of the Credit Rating Agencies group, etc

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For the details of assumption, purpose and restriction of credit ratings, please refer to "Definitions of ratings and other forms of opinion" on the website of Fitch Rating Japan Limited.

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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), Nippon Healthcare Investment Corporation (3308), Japan Rental Housing Investments (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).
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(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

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