Daiwa Securities

Daiwa's View

Accelerated steepening

- US 5-year/30-year yield spread topped high of 2017

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Daiwa Securities Co. Ltd.

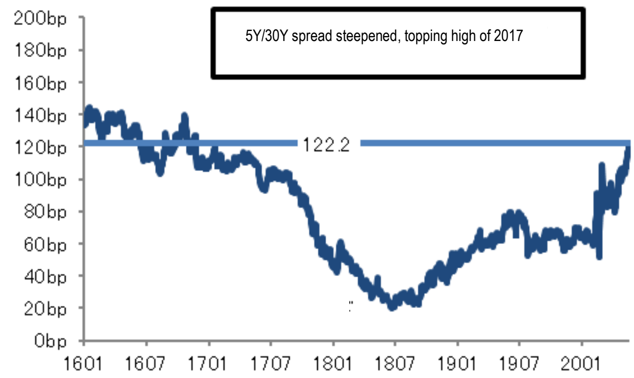
Accelerated steepening

US 5-year/30-year yield spread topped high of 2017

Amid accelerated steepening in the global bond market, the US 5-year/30-year yield spread substantially widened to 122bp yesterday, topping the high of 2017. The aspect of responding to the appreciation of the euro, which appears to have broken out of its trendline after the decision on additional easing at yesterday's ECB Governing Council meeting (expansion of Lagarde bazooka), was also confirmed. Therefore, the steepening will not be a temporary move.

At yesterday's Governing Council meeting, the ECB decided on new additional easing. Specifically, the decision includes (1) an increase in the pandemic emergency purchase programme (PEPP; up €600bn from €750bn to total of €1,350bn), (2) extension of the period of the PEPP (from end-2020 to at least end-Jun 2021), and (3) reinvestment of the maturing principal payments from securities purchased under the PEPP (until at least end-2022). The euro was substantially purchased and broke out of its trendline, reflecting (1) the greater-than-expected increase in the PEPP (market consensus was €500bn), (2) a definite commitment to the reinvestment of proceeds from maturing bonds in the PEPP, and (3) the fact that President Christine Lagarde emphasized flexibility of the PEPP (flexibility on capital keys) at the post-meeting press conference. The spread of 10-year Italian government bonds vs. German Bunds, which symbolizes the risk preference in Europe, also tightened from 191bp to 174bp. As such, market sentiment is very strong.

Chart: 5Y/30Y US Treasury Yield Spread



Source: Bloomberg; compiled by Daiwa Securities.

Chart: EUR/USD

Source: Bloomberg; compiled by Daiwa Securities.

In such a situation, we need to carefully watch the phenomenon that yields have been rising over the past several days in the zone where the effect of the Fed's forward guidance is limited. Although we are generally saying "steepening," it has started to show a difference in terms of tenor. The US 3-month forward yields also clearly show such a tendency. While the "1-year forward" and "2-year forward" yields, which look set to be influenced by the introduction of the YCC by the Fed, remain low and stable, the "5-year forward" yield

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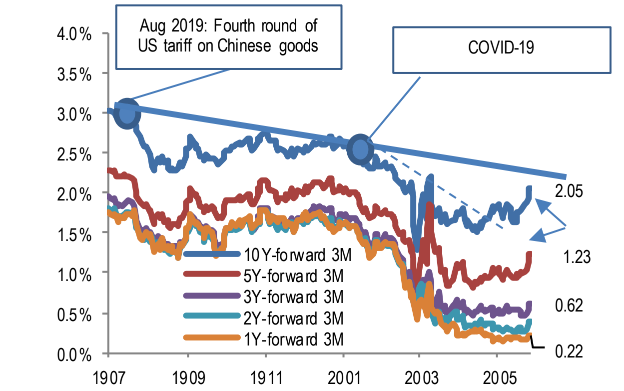
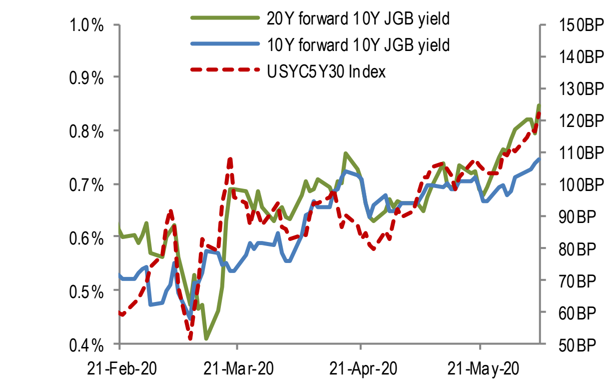
turned around after a long interval. The "10-year forward" yield is also continuing to rise, and it has almost returned to its trendline[1] although it had temporarily moved away from the trendline since the COVID-19 crisis. In addition to the stock rally and bottoming-out of business sentiment, the trend of euro appreciation (≈ correction of strong dollar) has now come in sight on expectations for a recovery in Europe. Due to this, "concerns about the US economy falling to deflation," which have been pointed out by some market participants, are apparently being eliminated. It can be said that the Fed has saved its honor.

Chart: US 3M-forward Yields



Source: Bloomberg; compiled by Daiwa Securities.

Chart: 5Y/30Y US Yield Spread and Forward 10Y JGB Yields

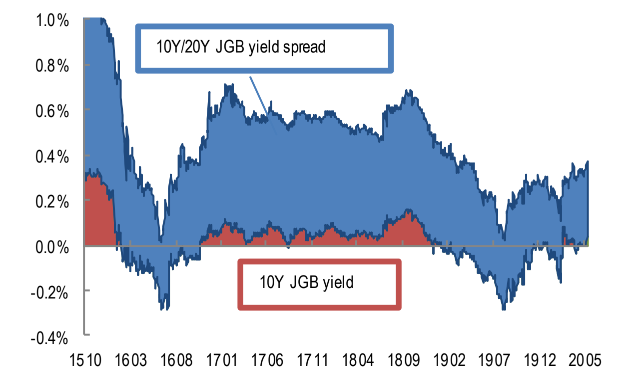


Source: Bloomberg; compiled by Daiwa Securities.

Yesterday, JGB yields also steepened sharply. Although we can point out the poor result of the 30-year JGB auction, a more essential background would be global steepening. As the 30-year LCH-JSCC spread continued to tighten yesterday (–7 → –6 → –4 → –2.63bp), overseas investors' inactive stance to JPY superlong swaps is becoming clear in line with our concerns.

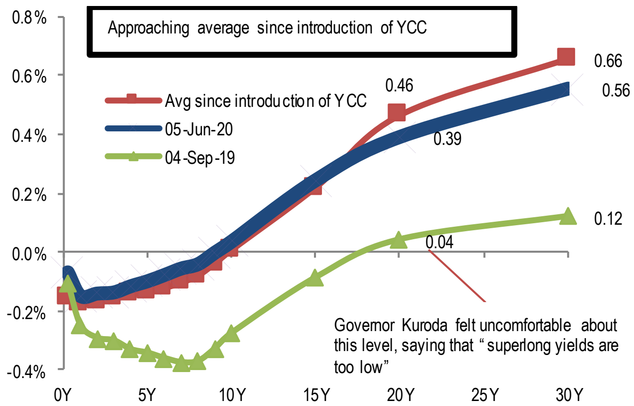
Another focus of attention is the fact that the 10-year JGB yield has started to clearly enter positive territory. As is well known, once yields in the up to 10-year zone surface in positive territory, Japanese investors' money, which was parked in the superlong zone to avoid negative interest rates, should start to return to the up to 10-year zone. Accordingly, a rise in the 10-year yield to positive territory has a significant impact on the 20-year yield level. Looking at the past, there are many cases that the 10-year/20-year spread widened at an accelerated pace when the 10-year yield clearly exceeded 0% (see chart below). Yesterday, the 10-year/20-year spread was stuck at 35bp despite a rise in the 10-year yield. However, if the 10-year yield stays in the lower 0% range, the 10-year/20-year spread may widen to the high 30bp range and the 20-year yield may reach 0.4%.

Chart: 10Y JGB Yield and 10Y/20Y Spread



Source: Bloomberg; compiled by Daiwa Securities.

Chart: JGB Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

[1] "While 10-year forward 3-month yield represents component of yields specific to superlong zone, 5-year forward 3-month yield indicates component of yields specific to long-term zone.

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[Standard & Poor's]

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[Moody's]

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[Fitch]

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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%.

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- 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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