Daiwa's View

Continuing surge in term premium

➢ Market may remain sensitive until Jackson Hole symposium

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Daiwa Securities Co. Ltd.

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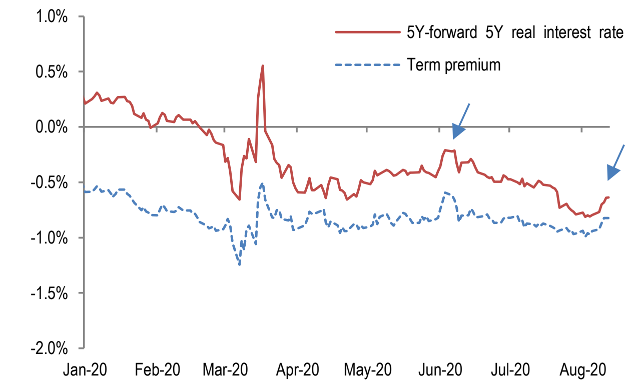
Yesterday's 30-year US Treasury auction garnered attention, and its weak result pushed up the 10-year US yield to the 0.7% level for the first time since 23 June. We note that the current rise in yields is accompanied by a rebound of the term premium, as we pointed out in our report dated 12 August.

Over just five business days from 6th through 12th August, it was confirmed that the term premium rose by 15bp (from −0.97% to −0.82%). Combined with last night's 5bp rise in the 5-year forward 5Y real interest rate, the term premium appears to have already risen by as much as 20bp this time.

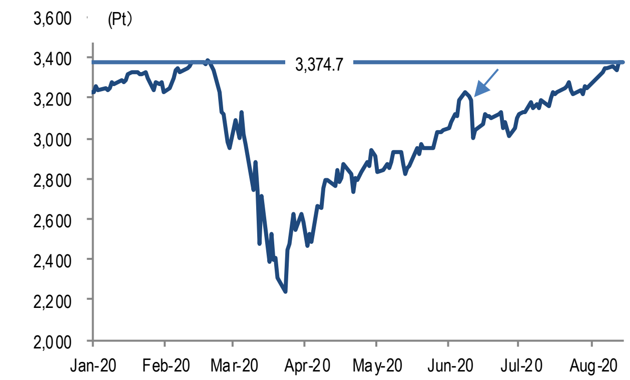
In late May to early June this year, there was a similar movement in which the term premium surged by around 20bp (−0.85% to −0.62%) over just six business days, from 29 May to 5 June, which boosted the 10-year US yield from 0.65% to 0.89%. The main cause of the rise in the term premium in June was a rapid reduction in Treasury purchases by the New York Fed.[1] Since the Fed showed a dovish stance both in terms of interest rates and QE at the FOMC meeting on 9-10 June, it successfully diminished concerns about the supply/demand imbalance and stopped the surge in the term premium (refer to next page).

5Y-forward 5Y US Real Interest Rate, Term Premium of 10Y Treasury Bonds



Source: Bloomberg; compiled by Daiwa Securities.

S&P 500 Index



Source: Bloomberg; compiled by Daiwa Securities.

[1] Factors behind the rapid reduction in purchases were an improvement in market liquidity and accommodative monetary conditions, as well as rising stock prices reflecting the improved environment. As for the current rise, we note the similarity with the June market in terms of the fact that the term premium is rising again amid a rally in stock prices.

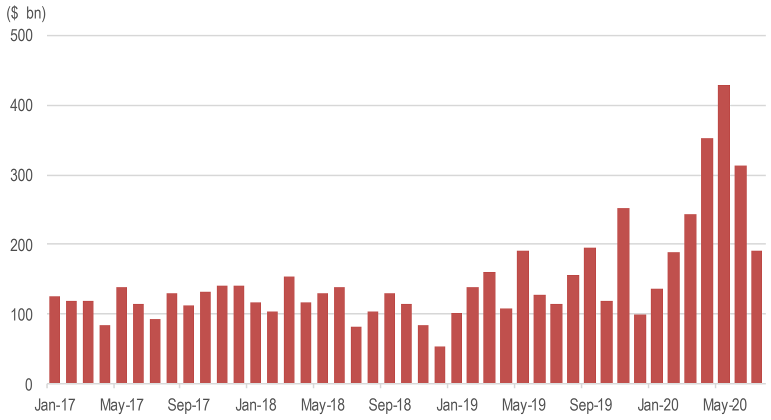
◆ **Daiwa's View** (11 Jun 2020)

・The Fed strengthened its stance on purchases of assets (particularly Treasuries), which has been the biggest focus of attention. To begin with, there was a change to forward guidance with respect to asset purchases. In short, the guidance was changed from "the Federal Reserve will continue to purchase Treasury securities and agency residential and commercial mortgage-backed securities in the amounts needed to support smooth market functioning, thereby fostering effective transmission of monetary policy to broader financial conditions" to "over coming months the Federal Reserve will increase its holdings of Treasury securities and agency residential and commercial mortgage-backed securities at least at the current pace to sustain smooth market functioning."

The New York Fed also made a statement in which the increment pace was clarified at $80bn/month for US Treasuries and $40bn/month for agency mortgage-backed securities (MBS). These figures are equal to the monthly-converted numbers based on the latest purchase pace. Announcing the specific scale—at least $80bn/month for Treasuries—is the first step towards a shift to open-ended QE. The period described as "over coming months" itself also serves as a bridge towards further clarification of the monetary policy stance, which is expected to be announced in autumn or later.

The main cause of the current rise in the term premium is probably, once again, concerns about the supply/demand imbalance. We, therefore, presume that the underlying cause is concerns about an increase in bond issuance. Companies are now easily conducting large-scale bond issuances in line with an end to the earnings results announcement season. This, combined with the issuance of additional Treasuries due to a record expansion of government expenditures, appears to be raising concerns about the supply/demand balance for bonds across the board. Yesterday, Apple issued corporate bonds in four parts totaling $5.5bn.[2] As of end-July, the amount of US corporate bonds issued had already reached $1,856.4bn, and this figure is expected to set a substantial record high in 2020.

Issuance Amount of US Corporate Bonds (monthly)



Source: Bloomberg; compiled by Daiwa Securities.

While the FOMC meeting in June constrained the surge in the term premium, the next meeting is not scheduled until 16 September. Regarding the current rise in the term premium, we, therefore, forecast that the Jackson Hole symposium to be held on 27-28 August will attract attention. It is highly likely that the market will remain sensitive until then. At this year's online symposium hosted by the Kansas City Fed under the theme "Navigating the Decade Ahead: Implications for Monetary Policy," we will likely be able to obtain some hints about the ongoing review of the policy framework by the Fed—probably new clues regarding the adoption of a soft, average 2% inflation target, which is currently regarded as the most realistic.

[2] Apple's corporate bonds issued yesterday were "general corporate purpose" bonds, enabling the firm to use them for share buybacks and dividend payments. Apple's bonds are the object of major purchases by the Fed's corporate bond facility. Therefore, this can effectively be seen as a framework in which money for share buybacks is financed by the Fed at a low interest rate.

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[Standard & Poor's]

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[Moody's]

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February 2020

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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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