

Daiwa's View

Rise in tail risk

- Investors seeking undervalued hedges against plunge

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Daiwa Securities Co. Ltd.

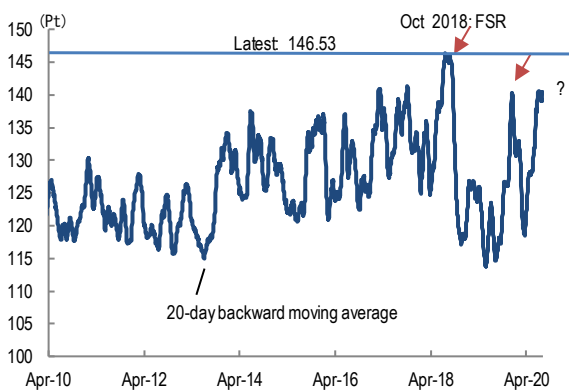
Investors seeking undervalued hedges against plunge

Rise in tail risk

The SKEW Index, which shows an increased chance of tail risk (plunge in stock prices), is rising again. This is an indicator for the skew of risk perception among market participants, which is extracted from the stock option market. Track records show that the index was right on the mark regarding the market plunge in October 2018 and February 2020. Recently, the index is also being carefully watched by the BOJ, as witnessed by the fact that it is mentioned in the minutes of the BOJ's June Monetary Policy Meeting (MPM).

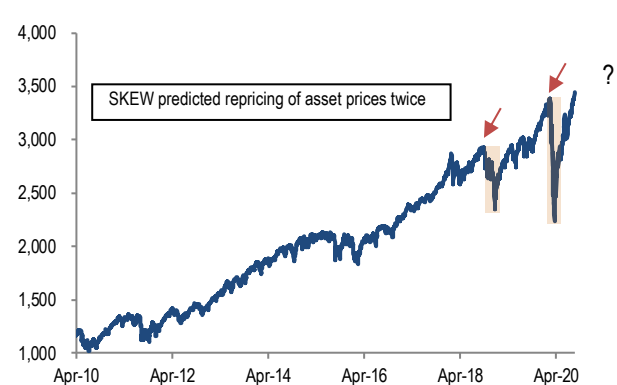
The SKEW Index temporarily declined in July from a level that "a few members" were concerned about at the June MPM. However, the index turned up again and has now risen to the level on par with that in October 2018 and January 2020. This is a phenomenon of throwing into question the sustainability of the stock market, which is hitting record highs. Triggered by some kind of event, a repricing of asset prices could spread, as seen in February 2020.

US Tail Risk Indicator: SKEW*



Source: Bloomberg; compiled by Daiwa Securities.
*Indexation of slope of curve shape of implied volatility of S&P 500 out-of-the-money options.

S&P500 Index



Source: Bloomberg; compiled by Daiwa Securities.

◆ Minutes of the BOJ's Monetary Policy Meeting on 15-16 Jun (20 Jul 2020)

• A few members pointed out that global financial markets were focusing on the downside tail risk of a significant plunge in stock prices, as the Cboe SKEW index—which captures the skew of US stock market participants' recognition of risks—had been at a high level. These members then noted that the markets had actually exhibited unstable developments, such as a plunge of more than \$1,800 in the Dow Jones Industrial Average in June.

◆ BOJ Financial System Report (Oct 2018)

• In fact, a tail risk indicator (SKEW) extracted from the stock options market has continued to rise. Given this fact, a repricing of assets such as stocks could spread, triggered by a snapback in interest rates, among other events.

While the VIX Index has been edging down, the “real fear index” of the SKEW Index, which shows a downside tail risk, has been rising remarkably. This highlights the fact that some (level-headed) investors are seeking/building undervalued hedges against a plunge.

In Japan, the political situation is likely to remain subject to speculation given the health of Prime Minister Shinzo Abe and the status of the COVID-19 pandemic, and thereby we would likely to see more tail risk hedges than Europe and the US. If we assume that such hedging needs are increasing potentially, we are unlikely to see a one-sided rise in JGB yields that would fuel on the stock rally.

Regarding yesterday's 20-year JGB auction, we were worried about the impact of a barrage of supply of superlong JGBs in [our pre-auction report](#). However, the lowest accepted price substantially exceeded the market average estimate (by Y0.1). Moreover, as witnessed by [the additional issuance](#) worth Y117.0bn in the non-price-competitive auction II, the result was extraordinarily strong.

There are various interpretations regarding the factors of this result. But, we think that one background factor is an aspect of the realization of the aforementioned needs to hedge against tail risk. Either way, we presume that many investors were not able to take the necessary amount in yesterday's auction. Therefore, the tone might have changed yesterday with respect to superlong JGBs, which had tended to soften due to concerns about deterioration in the supply/demand conditions in comparison with European and US bonds. Our eyes are on whether JGBs will straightforwardly follow yesterday's bear steepening of European and US government bonds.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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- 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 ¥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%.
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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.

** 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.

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Corporate Name: Daiwa Securities Co. Ltd.

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