

Daiwa's View

Continuing correction of optimism

- Flattening pressure may strengthen

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Daiwa Securities Co. Ltd.

Flattening pressure may strengthen

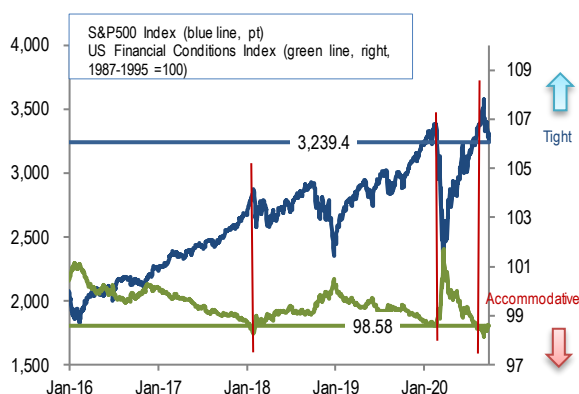
Continuing correction of optimism

Last night, US stocks again faced a decline across the board—the DJIA was down 1.92% (–525 points) and the NASDAQ Index dropped 3.02% (–330 points). The DJIA fell below 27,000 points for the first time since 4 August.

It can be said that [the jinx](#) of “the US Financial Conditions Index of below 98.5 causes a plunge in stock prices” occurred again. When financial conditions become overly accommodative, the Fed’s stance changes to a somewhat suppressive one in order to avoid exacerbation of the imbalance via excessive risk taking. This is in line with the Fed’s mandate of aiming for average inflation of 2% and maximum employment.

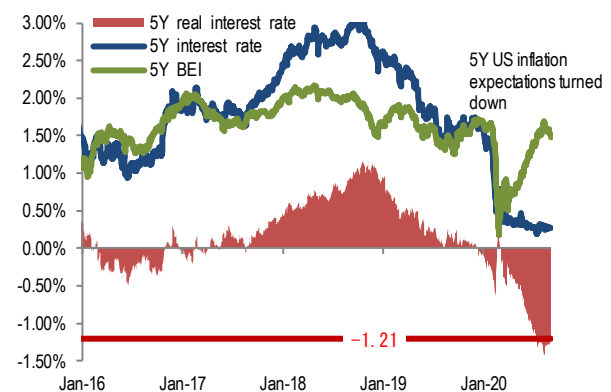
Despite destabilizing US stocks, US yields remain stable, [as we expected](#). However, we may need to pay some attention to the fact that inflation expectations have started to decline after a pause in the uptrend. As we have pointed out, this rise in inflation expectations was not a real change in inflation expectations but was driven by improvement in liquidity premium (= supply/demand conditions). Either way, we have a strong impression that we had often heard the story of “a rise in inflation expectations (decline in real interest rate) → spike in risk asset prices.” We are therefore concerned about a certain level of reactionary moves.

US Stock Price, Financial Conditions Index



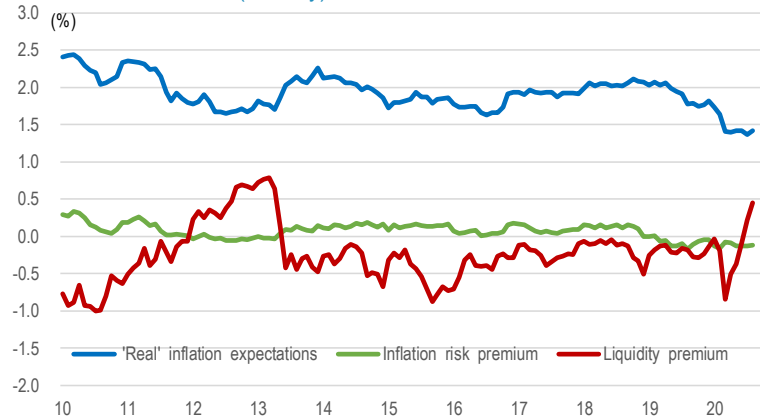
Source: Bloomberg; compiled by Daiwa Securities.

US 5Y Interest Rate, Real Interest Rate, Inflation Expectations (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

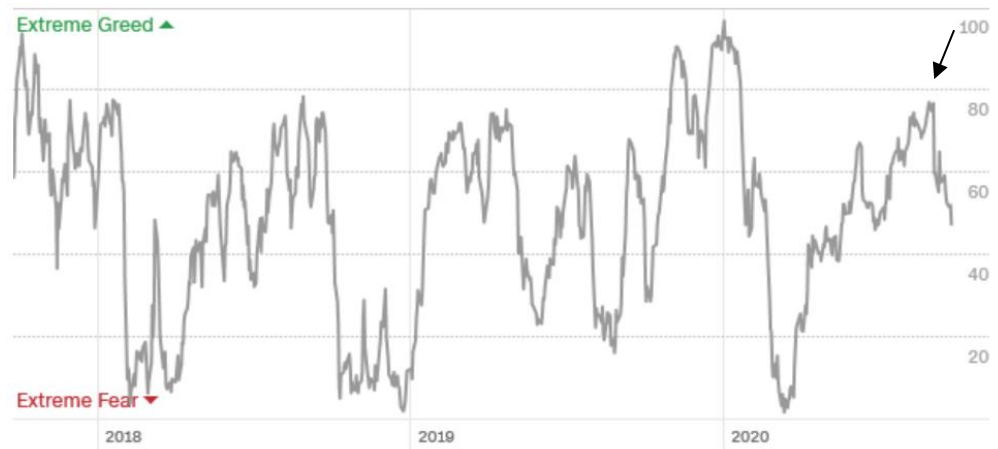
Breakdown of 5Y US BEI (monthly)



Source: Fed; compiled by Daiwa Securities.
Note: Liquidity premium plotted in reverse sign.

Another focus of attention is the possibility that [investor sentiment, which had approached a euphoric level at a stroke](#), has again started to move toward pessimism (chart below). Thus far, investors had purchased risk assets, underestimating fundamental factors. Therefore, once investor sentiment awakes from optimism, it easily reacts to negative factors, rather than positive factors. As fluctuation caused by this sharp swing in investor sentiment is wilder than that derived from a change in fundamentals, it is quite troubling.

Fear & Greed Index

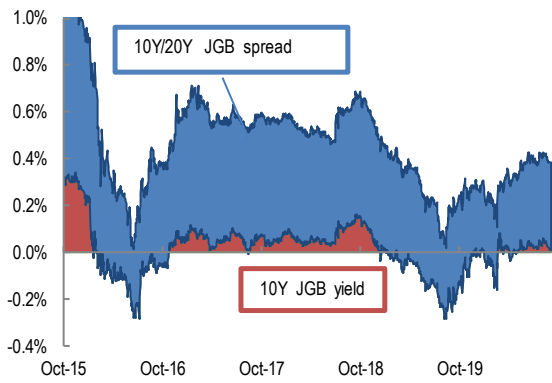


Source: CNN website; compiled by Daiwa Securities.

Due to a series of changes at the end of September—an important timing in terms of financial results, the inflow of funds to “safe asset” government bonds is increasing. Regarding JGBs as well, we are somewhat cautious about buying at higher prices from the current level where the 10-year yield has declined close to 0%. If JGB futures prices rise amid growing risk-off mode, the 10-year JGB yield may again fall into negative territory in line with a drop in the 7-year yield.

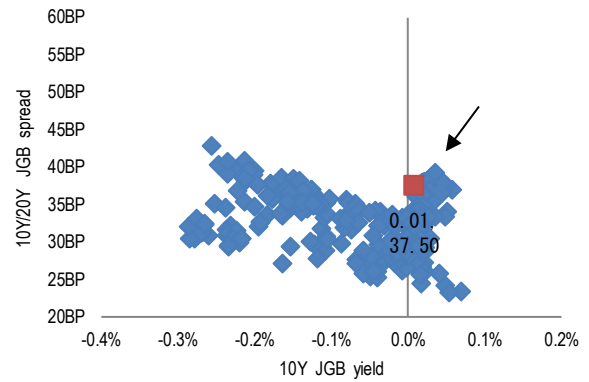
If so, the 10-year/20-year spread may tighten from the current 38.5bp to around 35bp (often seen when 10-year yield in shallow negative territory) due to flattening pressure caused by fund flow to pursue positive yields (chart on next page). Also, in terms of the aspect of hedging these developments, we recommend buying 20-year JGBs, which are currently yielding around 0.4%.

JGB 10Y Yield, 10Y/20Y Spread (trends)



Source: Bloomberg; compiled by Daiwa Securities.

JGB 10Y Yield, 10Y/20Y Spread (dispersion)



Source: Bloomberg; compiled by Daiwa Securities.

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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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- 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 ¥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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- 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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