

Daiwa's View

Continuing decline in European yields

- Market aware of “deepening of negative interest rates”

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Daiwa Securities Co. Ltd.

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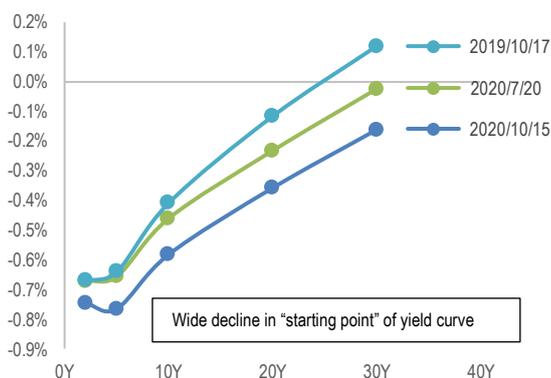
Continuing decline in European yields

European yields continue to decline. Thus far, German yields had bounced back with a -0.55% support level at the beginning of August and the end of September, but this time yields fell below -0.58% beyond the support level.

We confirm the left-hand chart below, which plots yield curves of German government bonds with some time interval. Thus far, the decline in German yields had mainly been “flattening.” However, we have recently found a decline in the starting point of the yield curve (short-term yields) and that the curve is coming close to an image of a “parallel shift.” When we draw 1-year forward and 2-year forward yield curves by using forward yields, they show a picture in which an inverted yield curve will revert back to normal in the process of a cut in the policy rate to -0.8% to -0.9% . These price movements show that the market is aware of the “deepening of negative interest rates” in the current phase.

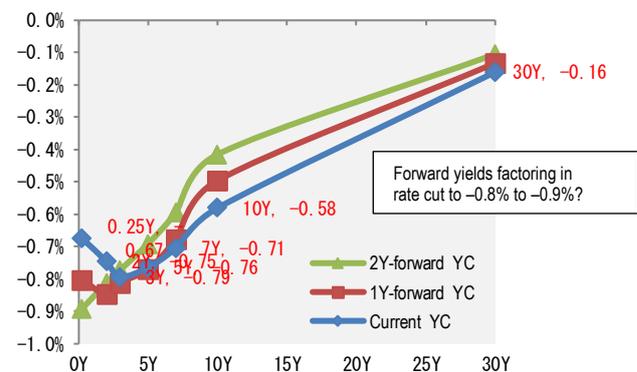
In fact, yesterday ECB executive board member Yves Mersch made an affirmative remark on additional easing, especially on deepening of negative interest rates, saying that we still have “the instrument of interest rate in our toolbox and it’s available.” As the previous ECB Governing Council meeting did not provide any particular hints regarding additional easing, many market participants projected that the ECB would choose an increase in the Pandemic Emergency Purchase Programme (PEPP) as a policy tool in the case of additional easing. Therefore, amid the spread of recent moves newly factoring in deepening of negative interest rates, the impact on the market appears to be increasing.

Yield Curve of German Gov't Bonds



Source: Bloomberg; compiled by Daiwa Securities.

Forward Yield Curve of German Gov't Bonds



Source: Bloomberg; compiled by Daiwa Securities.

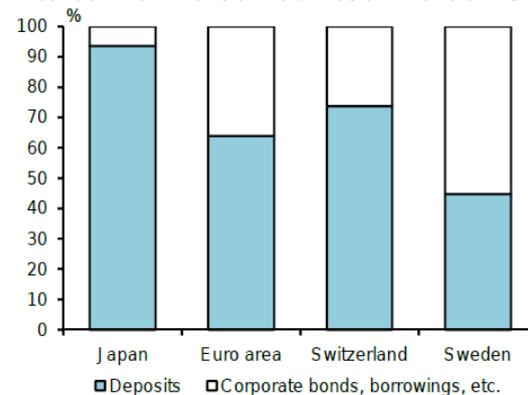
We already pointed out that expectations for additional easing are likely to increase globally toward the end of this year/fiscal year. However, we note that more people have started to factor in “rate cuts” instead of “QE.” The Australian government bond market has already been completed factoring in a rate cut at the November meeting. As everybody knows, central banks in the UK and New Zealand are preparing to make negative interest rates a new effective option. That said, this is a story of rate cuts in positive territory or internet rates in shallow negative territory. What is most notable is an action by the ECB, whose policy interest rate is already in deep negative territory. If the ECB resumes “deepening negative interest rates,” which was suspended from the viewpoint of the side effects, monetary easing in major developed nations is likely to enter a new stage.

The following paragraphs are re-post of a part of [our 18 September report](#). We have the impression that the market has taken a step forward from “the point where such a mental exercise is necessary” stated in the last paragraph.

ECB may have advantage over BOJ in any competition to drive negative interest rates lower

Furthermore, although it has been a while since this has been a topic, if this does devolve into a competitive deepening of negative interest rates, the ECB likely has a competitive advantage over the BOJ. Because the liability structures of most of Europe’s financial institutions are characterized by insufficient deposits relative to loans, the ECB’s supply of funding at negative interest rates that are lower than the policy rate makes it easier to deal with any side effects on lenders. The liability structure of Japan’s financial institutions is weighted toward deposits (i.e., they have deposit surpluses, and [these have been exacerbated by the pandemic](#)), such that even if the BOJ were to further lower negative interest rates in conjunction with expanding its supply of funding at negative rates (or pay interest on reserves, which would have same effect), it would create an even bigger challenge for Japanese banks struggling to invest the deposits that they have attracted with positive interest rates.

Breakdown of Financial Liabilities at Financial Institutions



Note: Data as at fiscal 2017.

Source: S&P Global Market Intelligence; BOJ.

Source: *Extracted from BOJ Financial System Report (Apr 2019).*

Safe assets that still pay a positive yield are the easy choice for investing deposits that were attracted with positive yields. Consequently, if the competitive easing described above becomes a reality, 20-year JGBs, the yield on which has risen to around 0.4%, will likely become a perfect place to park funds. Of course, a full-fledged easing competition has yet to begin and is nothing more than a mental exercise at this stage, but the truth is that we have moved a step closer to the point where such a mental exercise is necessary.

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- 2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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■ Credit Rating Agencies

[Standard & Poor's]

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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))

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[Fitch]

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Other Disclosures Concerning Individual Issues:

- 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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- 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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