

Daiwa's View

Implication of deeper LCH/JSCC spread in negative territory

- While steepening implied in previous cases, narrower swap spread appears to be implied this time

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Daiwa Securities Co. Ltd.

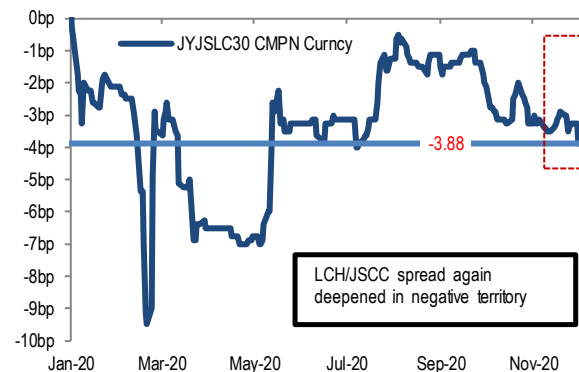
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Implication of deeper LCH/JSCC spread in negative territory

Recently, the 30-year LCH/JSCC spread has declined to -3.8bp , deeper in negative territory. The deepening implies that overseas investors have a relatively bearish stance toward this maturity, which should be noted.

Due to the liquidity shortage at the time of the COVID 19 crisis in March 2020, the 30-year LCH/JSCC spread sharply worsened to -10bp at one point. Then, reflecting steepening pressure on the yield curve caused by concerns about a further issuance of JGBs, the spread again deepened in negative territory and mostly stayed at around -7bp in Apr-May. Subsequently, the negative spread shrank in June and August amid the unwinding of steepener trade. These LCH/JSCC spread movements were largely explainable as transactions to monetize steepening pressure on JGB yields.

LCH/JSCC Spread (30Y)

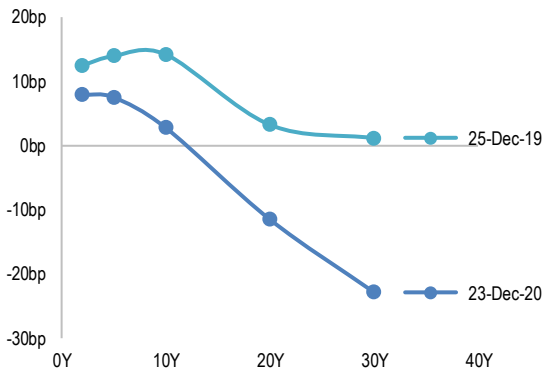


Source: Bloomberg; compiled by Daiwa Securities.

This time, however, the LCH/JSCC spread is deepening in negative territory amid flattening pressure on JGBs. We thus can recognize a certain degree of difference from this year's price movements thus far.

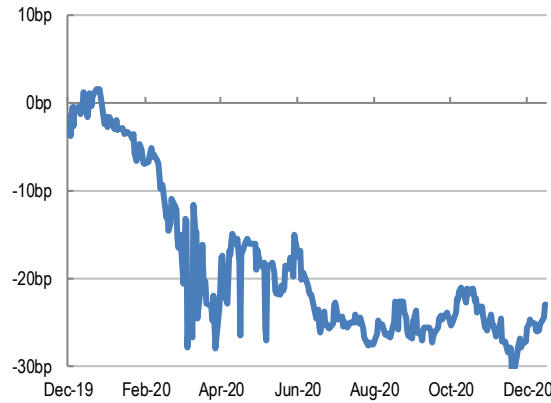
The comparison of the swap spread between now and Christmas last year in the chart below clearly shows that the swap spread has substantially declined over the past year (inversion of yield curve, spread in over ten-year zone falling below zero). If we assume that this phenomenon has reversed, a worrisome point would be the impact on JGBs in the 30-year sector, whose negative spread is the deepest.

JGB/Swap Spread



Source: Bloomberg; compiled by Daiwa Securities.

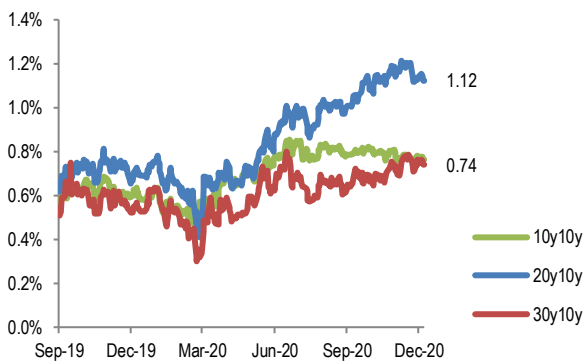
30Y JGB/Swap Spread



Source: Bloomberg; compiled by Daiwa Securities.

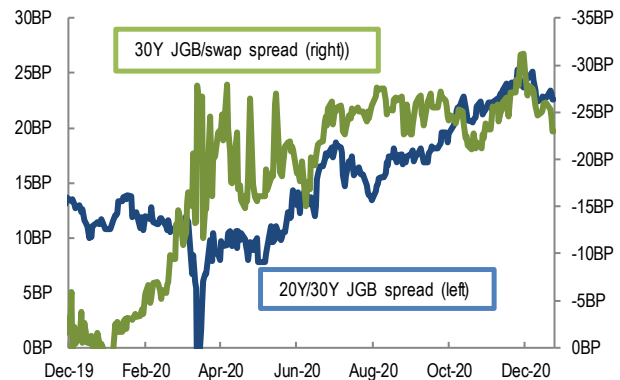
In order to observe superlong JGBs, we confirm current levels of three 10-year forward yields—i.e., the 10-year forward 10-year yield, 20-year forward 10-year yield, and 30-year forward 10-year yield, which stand at 0.77%, 1.12%, and 0.74%, respectively. In the past, these three forward yields largely tend to move at close levels. Since May 2020, however, the 20-year forward 10-year yield has been markedly underperforming. Since the outbreak of the pandemic, the correlation between the underperformance of 30Y JGBs and the negative swap spread in the 30-year sector appears to be getting stronger, although this may be a coincidence (right-hand chart below).

JGB 10Y forward yields



Source: Bloomberg; compiled by Daiwa Securities.

30Y JGB/Swap Spread, 20Y/30Y Spread



Source: Bloomberg; compiled by Daiwa Securities.

Under the circumstances, if the 10-year forward 10-year yield and the 30-year forward 10-year yield maintain the current levels as well as the 30-year JGB/swap spread reverses, we may see pressure to return the 20-year forward 10-year yield to the historically balanced level¹. In the case that the 20-year forward 10-year yield approaches 1%, the 30-year JGB yield is expected to decline (outperform) by another 3-4bp, although the 0.7% level is unlikely.

¹ As increase in issuance of 20-year JGBs deferred in JGB issuance plan associated with latest economic package, 10-year forward 10-year yield is unlikely to weaken.

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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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[Fitch]

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Daiwa Securities Co. Ltd. and Daiwa Securities Group Inc.: Daiwa Securities Co. Ltd. is a subsidiary of Daiwa Securities Group Inc.

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).

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

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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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