Daiwa Securities

Daiwa's View

Implication of US interest rate topping 1%

➢ End of "happy interest rate increase"

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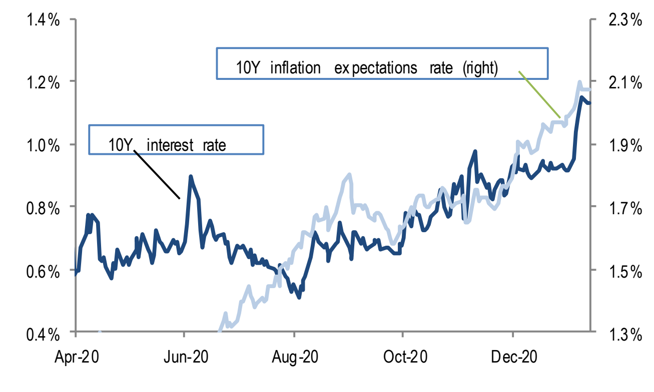
Implication of US interest rate topping 1%

End of "happy interest rate increase"

Since August 2020, the 10-year US real interest rate had been stable at around –1%. This was because, although the nominal interest rate had risen at a pace of around 10bp/month, the inflation expectations rate had also risen at a similar pace. This is a phenomenon that should be called a "happy interest rate increase," in our view. While the Fed continued with easing, it welcomed the rise in inflation expectations. Bond investors had a better outlook for investment returns in the future, and stock investors enjoyed support from the low real interest rate.

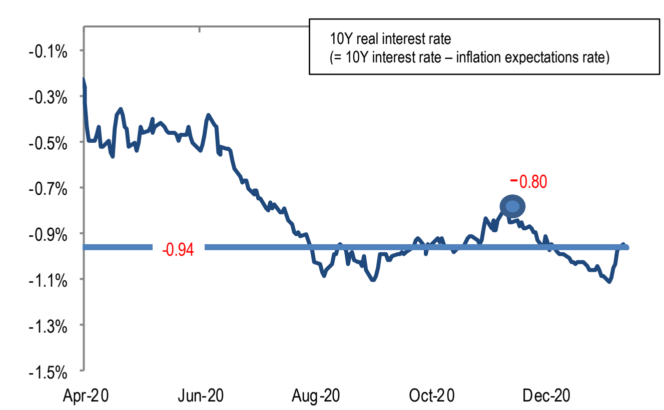
However, amid the recovery of the level of inflation expectations to 2%, the nominal interest rate, inflation expectations, and the real interest rate exceeded the threshold of 1%, 2%, and –1%, respectively. This pushed up the nominal interest rate to the level above 1%. From now, the hurdle is high that inflation expectations will rise further.[1] We can say that interest rates have entered the stage where it is easier for a further rise in the nominal interest rate to directly push up the real interest rate. In other words, it is highly likely that the "happy interest rate increase" has ended.

10Y US Interest Rate, Inflation Expectations Rate (BEI)



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Real Interest Rate

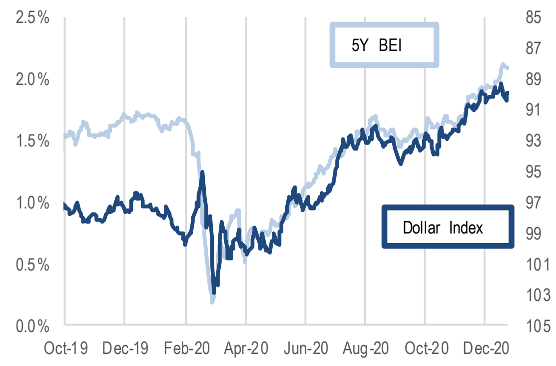


Source: Bloomberg; compiled by Daiwa Securities.

The foreign exchange market appears to be seeing these changes sensitively. Since March 2020, the 5-year US BEI had risen in step with the Dollar Index. However, recently the trends of these figures have diverged (left-hand chart on next page). This phenomenon can be largely explained by the relative difference between real interest rates, The USD/JPY rate also rebounded from the Y102 level when the relative difference between Japanese and US real interest rate reversed course (right-hand chart on next page).

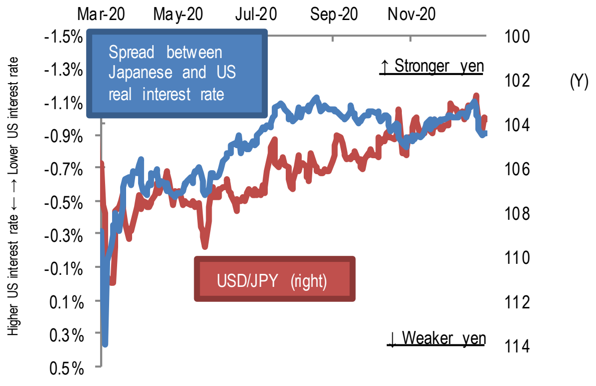
[1] Over past 20 years, upper limit of 10-year US inflation expectations rate was 2.5%, and rate touched this level only in short space of time.

5Y US Inflation Expectations (BEI)**, Dollar Index**



Source: Bloomberg; compiled by Daiwa Securities.

Relative Difference Between Japanese and US Real Interest Rate, USD/JPY



Source: Bloomberg; compiled by Daiwa Securities.

Nobody has a reason to object to a "happy interest rate increase" which is accompanied by a rise in inflation expectations. However, if a rise in interest rates from now is accompanied by a rise in the real interest rate, this would have a direct impact on the degree of monetary accommodation. Therefore, the Fed's stance is definitively important.

In this respect, Dallas Fed president Robert Kaplan said on 7 January that "If the steepening, which I would expect, occurs because of stronger economic growth, fiscal stimulus and better economic prospects, I think that's to be expected. I'd be hesitant to step in and take action that could distort that natural trend." Chicago Fed president Charles Evans also sent a signal toward the exit, saying that "it could be the case that things are going a lot better, and we do end up doing some type of tapering" in late 2021 or early 2022[2]." These hawkish remarks by Fed officials probably served as a factor to accelerate the rise in interest rates in January.

◆Chicago Fed President Charles Evans (7 Jan 2021)

- We could get to the point where the economy is doing well but inflation is not doing enough, and in fact we would need to do more in terms of asset purchases. That could be the case. It could be the case that we alter the maturity structure of the purchases too, in either direction.
- It could be the case that things are going a lot better, and we do end up doing some type of tapering" in late 2021 or early 2022. It's too early for me to have a strong judgment on that. I think by the springtime— maybe it's June—we have a better idea of what a sustainable path is for the recovery dynamics, and how quickly the unemployment rate is coming down.
- (By mid-year), we'll be in better place. I'm looking for growth in the order of 4% this year. Inflation implications are not as strong as I'd like.

On the following day (8 Jan), however, Fed vice chair Richard Clarida made a remark aiming to contain the formation of market expectations for tapering—"My economic outlook is consistent with us keeping the current pace of purchases throughout the rest of this year." The Fed often uses the communication way to control market expectations by offering hawkish remarks from regional Fed presidents and dovish remarks from chair and vice chairs. Therefore, this pattern may be used again this time.

This week, Vice Chair Richard Clarida and Chair Jerome Powell are scheduled to make a speech on the 13th and 14th, respectively. Mr. Powell's stance regarding factors leading to the rise in the real interest rate would serve as a test of the question of whether interest rates will continue to rise from now.

[2] We intend to explain expected schedule of tapering in different report.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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February 2020

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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 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%.

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.
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