Daiwa Securities

Daiwa's View

Background behind valuation corrections

➢ (1) Frenzy of US stocks, (2) China's liquidity withdrawals, and (3) change in central banks' QE stance

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Daiwa Securities Co. Ltd.

Background behind valuation corrections

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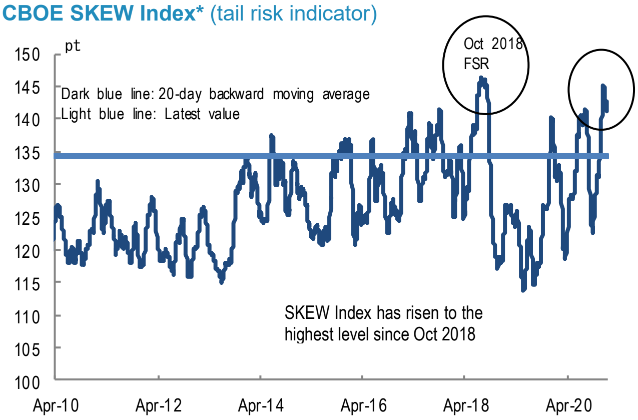
I have the impression that the SKEW Index is correct again. About a week after the S&P 500 Index hit its record high (3,855pt), it slid to 3,714pt. The VIX Index surged to 37 last Wednesday, and then fell to the 20 level at one point. However, the index again rose to the 30 level. The North American High Yield CDS Index (5-year) also suddenly widened to around 320bp from the previous week's level below 300bp.

That said, these are not totally unexpected phenomena. While people have pointed out overheated valuations in terms of yield spreads and other things, the tail risk indicator SKEW Index has also risen to 145pt, almost the same level that it hit in October 2018 when the BOJ warned of risk in its *Financial System Report*. This implies that magma is building up amid excessive optimism. We are concerned that the market correction may be slightly prolonged.

CBOE SKEW Index* (tail risk indicator)

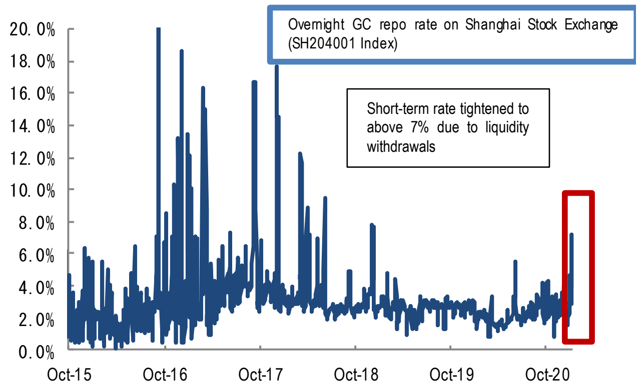


Source: Bloomberg; compiled by Daiwa Securities.
**Indexation of slope of curve shape of implied volatility of S&P 500 out-of-the-money options.*

Last week's magma eruption was probably triggered by (1) the frenzy of US stocks, (2) China's liquidity withdrawals, and (3) the dialing back of the QE stance of major central banks. Since people already know the whole story about US GameStop shares, we will not repeat that here. However, we are concerned about the possibility that this turmoil will result in a blind eye being turned to future trouble in terms of the fact that Senator Elizabeth Warren recognized the need for tighter regulations.

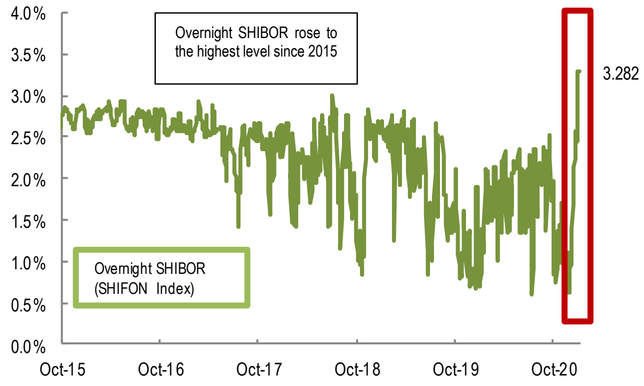
Furthermore, in the context of warnings about overheating, one thing in common at a fundamental level is sudden withdrawals of liquidity by the People's Bank of China (PBOC). During 25-28 January, liquidity worth 568.5bn yuan was withdrawn in total, which led to a surge in the overnight GC repo rate to above 7% at one point on the Shanghai Stock Exchange. (It fell to 2.85% at the end of week.) We also note the move of SHIBOR (SHIFON) as it posted an upside breakout from the 3% upper limit of the historical range.

Overnight GC Repo Rate on Shanghai Stock Exchange



Source: Bloomberg; compiled by Daiwa Securities.

Overnight SHIBOR



Source: Bloomberg; compiled by Daiwa Securities.

During just one month, the overnight SHIBOR surged from 0.64% at the end of last year to 3.28%, the highest level in about five years. The term structure is also showing an inversion. The series of recent measures by the PBOC is probably aimed at simply warning about a sense of overheating. We do not think that it means a shift in its policy direction. However, the bank's warning action at a sensitive time—before the Chinese New Year—came as a surprise to the market last week.

Of course, the fundamental factor that has led to the overheating of risk assets and is currently causing a change in trends is probably (3) the change in the QE stance of major central banks. As more Fed officials have made remarks on the exit strategy, tapering is expected to begin in 2022. The ECB also clearly stated its flexible operation policy for the PEPP in a statement at the January Governing Council meeting. It added wording that "If favourable financing conditions can be maintained with asset purchase flows that do not exhaust the envelope over the net purchase horizon of the PEPP, the envelope need not be used in full." It seems that the BOJ is likely to make its purchase operations more flexible in the future by again widening the band of yield curve control at the March assessment meeting. The Summary of Opinions of the January Monetary Policy Meeting (released last Friday morning) included many opinions that the band should be widened. This has further reinforced people's prior awareness. Accordingly, a cut in the offer amounts in t*he Monthly Schedule of Outright Purchases of Japanese Government Bonds*, which was released last Friday evening, aggravated the situation, although the release was largely in line with projections. The long-term JGB futures price plunged in the night market to Y151.70, around Y0.20 lower than the price before the Summary of Opinions announcement.

In the market, all risk assets appear to be being sold—bonds are also being sold despite risk-off sentiment, and US Treasuries are also falling. This indicates that the fundamental factor behind this market fluctuation is a change in the QE stance of central banks. If the policies of major central banks simultaneously face in the same direction, the impact will be large. In the end, the current correction of valuations appears to have been triggered by (2) liquidity withdrawals amid the major trend of (3) the change in the QE stance of central banks, and (1) the US market frenzy can probably be called a short-lived episode that will come to nothing. Personally, I agree with the following remark by San Francisco Fed President Mary Daly. However, as the turmoil has been excessive, we are unable to eliminate the possibility that adverse consequences could appear. It is possible that the market is now reaching a turning point in many ways.

◆ **San Francisco Fed President Mary Daly.**(29 Jan 2021)

· We're building this bridge, which is barely having many communities hang on, and the stock market is running pretty good and many people who already have money are getting more money. I am not willing to pull that bridge away and injure, in my judgment, the livelihoods of people—because they don't have jobs, they don't have income, they don't have wage growth—simply to ensure that some people who already have stock market wealth don't get more.

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3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, 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

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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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February 2020

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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 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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If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- 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.

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