

Daiwa's View

True value: Part 2

- True value of JGB yields is around 0.7%; 20-year yield is at a level where we should buy on dips

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Daiwa Securities Co. Ltd.

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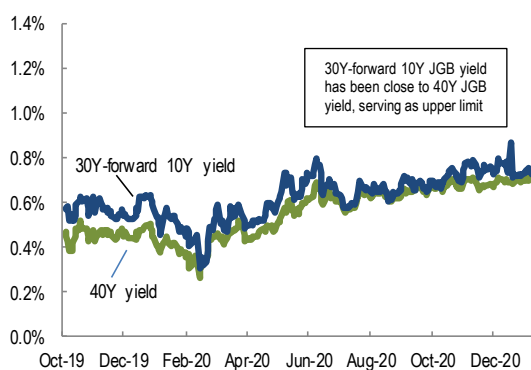
True value: Part 2

[Yesterday](#), we discussed 10-year JGBs. Today, we talk about 20-year JGBs.

Even though the 10-year JGB has recently been facing upward pressure due to a sense of caution about the BOJ's March assessment meeting, the 10-year/30-year spread and the 10-year/40-year spread have not faced marked steepening pressure (bear steepening is mainly seen in the 10-year and 20-year sectors). One notable point is why strong adverse effects have not emerged in the superlong zone, such as the 30-year and 40-year sectors, despite the fact that the BOJ is aiming to moderately steepen the yield curve. In our view, this is because the components of superlong yields longer than 20 years were already close to their true values (fair levels) prior to the assessment meeting. If so, these 'true values' would provide useful hints when examining the upper limit of the 20-year yield.

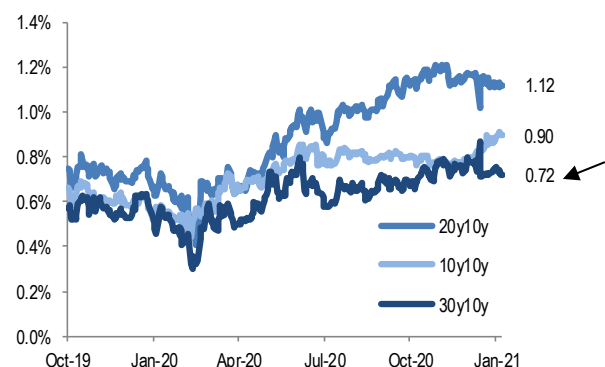
Currently, the 30-year forward 10-year yield, which is calculated by using the 30-year yield and 40-year yield stands at 0.72%, while the absolute level of the 40-year yield is 0.715% (left-hand chart below, all are BBG generic). The 30-year forward 10-year yield is stable compared to other 10-year forward yields (such as the 10-year forward 10-year yield), and it has functioned as the upper limit of the 40-year yield. This is close to the relationship between the longer-run projection and the 30-year yield in the US. In short, the 30-year forward 10-year yield may imply that the value corresponding to the longer-run projection is approximately 0.7% in the world of JGB yields. As the BOJ has already left the shape of the yield curve controlled by the market by reducing the offer amounts in purchase operations in the superlong zone (25 to 40 years), the economic true value might well be largely reflected in the zone.

40Y JGB Yield, 30Y-forward 10Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

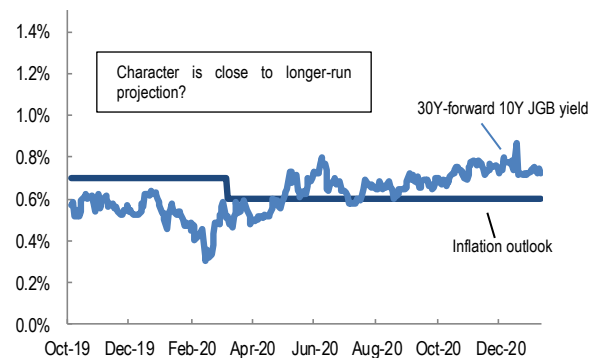
10Y-, 20Y-, 30Y-forward 10Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Why is it 0.7%? When looking for hints about this, I focused on the five-year ahead inflation outlook for enterprises among large non-manufacturers in the BOJ Tankan (JPINGLN5 Curncy). Personally, I have the impression that this index provides a figure that comes closest to hitting the mark when it comes to Japan's inflation expectations. This figure had been at around 1.2% until around 2014, and then edged downwards. Recently, it has been at around 0.6-0.8%. Working on the assumption that the natural rate of interest in Japan is generally 0% for the most part, we add the above-mentioned inflation expectations, which leads to an estimated longer-run projection in Japan of 0.7% (= 0 + 0.7%). Of course, there is no such thing as perfect data. However, we think that the 0.7% value can serve as a reference when thinking about the longer-run projection in Japan.

Inflation Outlook of Enterprises in BOJ Tankan (5-year ahead, among large non-manufacturers), 30Y-forward 10Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

If the longer-run projection in Japan is around 0.7%, the theoretical upper limit of the policy interest rate, 10-year yield, and 20-year yield would also be around 0.7%. In this picture, the Japanese yield curve becomes flat at 0.7% in all maturity zones when the BOJ raises the policy rate to 0.7% in the future.

However, as mentioned in [yesterday's report](#), the upper limit of the 10-year JGB yield in the current uptrend is expected to be at around 0.1% at most. If so, a 20-year yield of 0.7% is impossible in practice. If we calculate in reverse a 10-year forward 10-year yield that is necessary for the 20-year yield to rise to 0.7%, given a 10-year yield of 0.1%, the 10-year forward 10-year yield comes to around 1.2%. In short, this 1.2% is also impossible (after the July 2018 assessment meeting, the uptrend of the 10-year forward 10-year yield stopped at around 1.2%).

Of course, this 10-year forward 10-year yield of 1.2% is not an actual reachable level, and simply indicates an estimated/theoretical upper limit. If so, what percentage would be a realistic point of reference for the upper limit? It is probably a 10-year forward 10-year yield of 1%. As this is the threshold level where a carry and roll-down return of 1% is committed, it seems likely to become a psychological threshold as well.

A 10-year yield of 0.1% + a 10-year forward 10-year yield of 1% results in a 20-year yield of around 0.6%. If I were an investor and the 20-year yield rose to 0.6%, I would go all-in. That said, as the carry and roll-down return in this case is quite attractive at around 1.1%, it would be difficult for the 20-year yield to reach even the 0.6% level in practice. A more realistic level is a 20-year yield of around 0.5%, and this level achieves a carry and roll-down return of 1%—e.g., a 10-year yield of 0.05% plus something extra and a 10-year forward 10-year yield of 0.9% plus something extra.

Currently, a balance has been established with a 10-year yield of 0.055-0.06% and a 10-year forward 10-year yield of 0.89%, levels that are very close to 'realistic upper limits' based on my estimates. Although no one can say that yields will not rise in the near term, we think that the additional upside potential is becoming limited, given 0.7% as the true value of JGB yields and a point of reference for the 10-year yield's upper limit of 0.1%. We should buy on dips at the current level.

JGB Yield Simulation

| JGB | 10Y | 10Y10Y | 20Y | 20Y10Y | 30Y |
|-------------------|------|-------------|-------------|-------------|-------------|
| Current | 0.06 | <u>0.89</u> | 0.47 | <u>1.12</u> | 0.67 |
| Upward scenario | 0.11 | 1.00 | <u>0.55</u> | 1.20 | <u>0.75</u> |
| Downward scenario | 0.00 | 0.78 | <u>0.39</u> | 1.04 | <u>0.59</u> |

Source: Bloomberg; compiled by Daiwa Securities.

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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]

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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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- 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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