Daiwa Securities

Daiwa's View

10-year and 30-year US yields topped 1.2% and 2%, respectively

- Will this trigger discussions on maturity extension program (operation twist)?

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Daiwa Securities Co. Ltd.

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Will this trigger discussions on maturity extension program (operation twist)?

In the US bond market at the end of the week, the 10-year and 30-year yields topped the threshold levels of 1.2% and 2%, respectively (closing at 1.208% and 2.009%). Superlong forward yields, such as the 10-year forward 10-year yield and 20-year forward 10-year yield, are also above 2.5%, the point of reference for the US neutral interest rate (at 2.58% and 2.53%, respectively). Although this may be, in part, caused by weaker demand in Asia due to the Chinese New Year and the three-day weekend in the US, we cannot downplay this amid changes occurring in fiscal path.

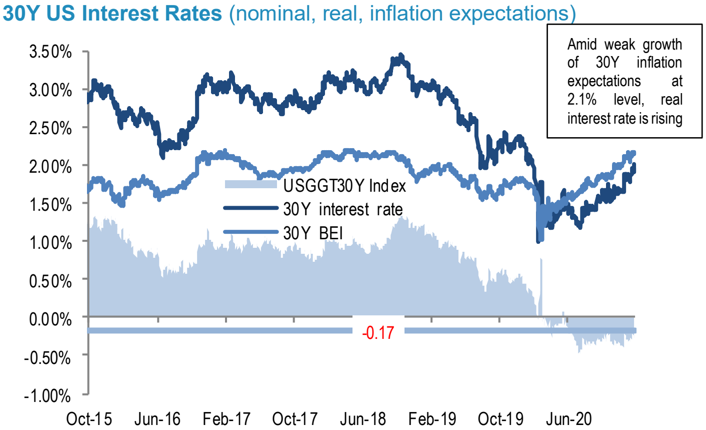
When this happened before, we saw rapid unwinding of short positions after yields reached the same levels. We are watching to see if the market moves similarly this time. If yields post an upside breakout from the current levels, we may get to a point that is "a little further along," in the words of Chicago Fed president Charles Evans. In October 2020, he stated that long-term interest rates were "already very low," while saying that now, "we could get to a point where, a little further along, interest rates are higher on the longer end," and that then there could be an opportunity for asset purchases. (At that time, the 10-year US yield stood at 0.78%.)

Since the point of reference for the US neutral interest rate is 2.5%, an interest rate level above 2.5% means tightening rather than easing. In fact, the 30-year US real interest rate has now edged up to –0.17%, after hitting a bottom of –0.47% in August 2020. This indicates a slightly different landscape with the 10-year zone. If superlong forward yields take root at a level above 2.5%, we may see a resurgence of discussions about QE's maturity extension (extension of weighted average maturity: WAM).

US 20Y Forward 10Y Yield, Longer-run Projection

Source: Bloomberg; compiled by Daiwa Securities.

30Y US Interest Rates (nominal, real, inflation expectations)



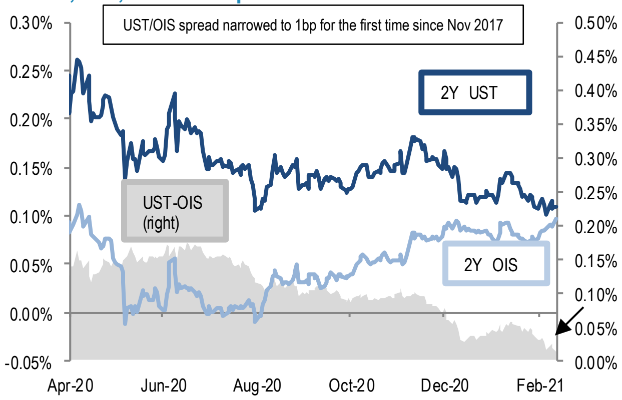
Source: Bloomberg; compiled by Daiwa Securities.

◆ **Chicago Fed president Charles Evans** (20 Oct 2020)

- I don't think there's a lot of scope for portfolio-balance effect to really lower long-term interest rates a lot because they're already very low. So, we could try to do more on asset purchases, but I'm not quite sure how far we would get.
- Now, we could get to a point where, a little further along, interest rates are higher on the longer end, then there could be an opportunity for doing that. And, maybe we're closer, we're within shooting range of 5% on unemployment and we could continue to provide a little more accommodation.

The situation at the front-end of the curve is changing into one in which an extension of WAM is functioning. Last week, the 2-year yield hit a record low, falling below 0.1% at one point. This was caused by improvement in supply/demand conditions for bonds in line with an anticipated decline in the Treasury General Account (TGA, so-called government deposits), including concerns about a resurgence of this summer's debt ceiling issue. The UST/OIS spread in the 2-year zone has narrowed to a mere 1bp for the first time since November 2017[1]. While further rapid decline in the TGA is expected toward the end of June (or end-July), supply/demand conditions in the zone are likely to become tighter.

2Y UST, OIS, UST/OIS Spread



Source: Bloomberg; compiled by Daiwa Securities.

At the FOMC meeting in November 2020, participants anticipated that much higher levels of reserves could put undue downward pressure on money market rates. The list of countermeasures included managing the levels of short-term interest rates, expanding the overnight reverse repurchase agreement program, and implementing the maturity extension program.

Now, concerns are increasing about tight supply/demand conditions for short-term bonds, while superlong yields are rising to what are close to tightening levels. This means the emergence of a perfect environment for implementing the maturity extension program on both sides of the curve. If so, the possibility of another operation twist, which was pointed out in our 10 December 2020 report, appears to have increased. For example, if we see a change in the dot chart (in the Summary of Economic Projections to be released at the March FOMC meeting) in a direction implying a rate hike within 2023, reflecting Biden's fiscal policy, the extension of the WAM may become more likely. We will be watching to see if the minutes of the January FOMC meeting to be released this week (on the 17th) mention this.

◆ **Minutes of FOMC meeting on 4-5 Nov 2020** (25 Nov 2020)

- Participants commented on how a higher level of reserves associated with the expansion in the Federal Reserve's asset holdings might affect the banking sector and money markets. A few participants raised concerns about the possibility that much higher levels of reserves might create pressure on banks balance sheets, including on regulatory ratios, or could potentially put undue downward pressure on money market rates. Most participants judged that the Federal Reserve had effective tools to address these circumstances. Some participants noted that, if needed, the Federal Reserve could consider various steps to manage the levels of short-term interest rates and the quantity of reserves, such as adjusting administered rates, expanding the overnight reverse repurchase agreement program, or implementing a maturity extension program.

[1] The OIS is rising slightly due to mounting expectations of earlier rate hikes by the Fed.

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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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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.
** 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.

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