

Daiwa's View

If rise in yields led by term premium

- Investment in US Treasuries may be becoming more attractive

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Daiwa Securities Co. Ltd.

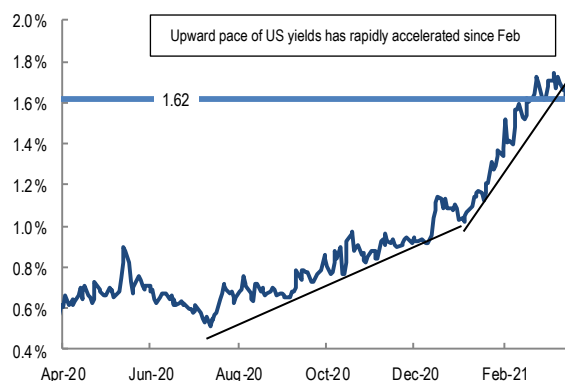
Investment in US Treasuries may be becoming more attractive

If rise in yields led by term premium

In the minutes of the March FOMC meeting released on 7 April, it was pointed out that “a significant portion of the increase in yields was associated with an increase in term premiums.” [The IMF's analysis](#) released on 5 April also pointed out that “Much of the increase in US interest rates is due to a rising term premium¹.”

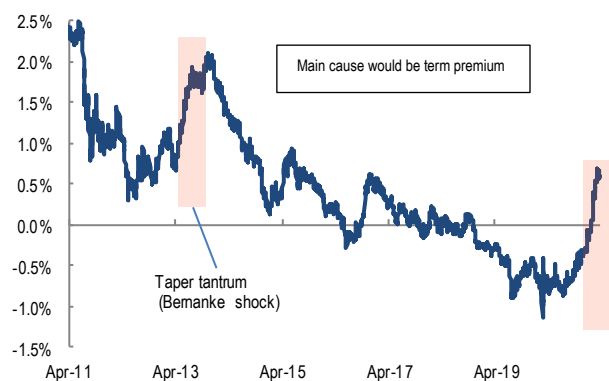
The US long-term interest rate had risen at a pace of roughly 10bp/month during August 2020 (when it bottomed at around 0.5%) to January 2021. Since February 2021, this pace has rapidly accelerated to 30bp/month, pushing up the rate to a level beyond 1.7% at a stroke (chart below). It is highly likely that the “term premium” was involved in the background of this remarkable upward pace.

US 10Y Treasury Yield



Source: Bloomberg; compiled by Daiwa Securities.

Term Premium of US 10Y Treasury Yield (ACM model)



Source: Bloomberg; compiled by Daiwa Securities.

◆ IMF: How Rising Interest Rates Could Affect Emerging Markets (5 Apr 2021)

Much of the increase in US interest rates is due to a rising term premium, which could reflect rising investor uncertainty about inflation and the pace of future debt issuance and central bank bond purchases.

◆ Minutes of March FOMC meeting (7 Apr 2021)

Model- and survey-based estimates suggested that a significant portion of the increase in yields was associated with an increase in term premiums. Higher term premiums could reflect the outlook for more expansive fiscal policy and an associated upward revision in the expected path for Treasury debt out-standing. Increased uncertainty over the outlook for longer-term interest rates as well as technical factors may also have contributed to the rise in term premiums.

¹ As background factors of rise, minutes pointed out outlook for expansionary fiscal policy by Biden administration and resultant concerns about further issuance of Treasuries and technical factors (which appear to point to SLR issue), and IMF said that rise “could reflect rising investor uncertainty about inflation and the pace of future debt issuance and central bank bond purchases.”

The term premium, generally described as “reward against risk of holding bonds with long maturities,” is the estimated value derived by a theoretical model. It is derived as the divergence between the actually observed interest rates and the estimated value of the policy interest rate path based on the pure expectation hypothesis (risk-neutral yield). More intuitively and practically, as a result of the fact that the term premium reflects various concerns in the market, this is a concept of showing the degree of deterioration in the bond supply/demand conditions.

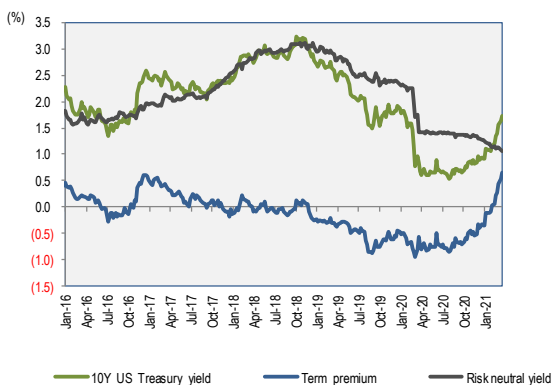
In thinking of the interest rate outlook, it is important to recognize whether the rise in yields is led by the term premium. This is because, in the case that the rise in yields is led by the term premium, this means that the risk neutral yield (= pure outlook for rate hikes) has not risen to the level that the actual rise in US Treasury yields implies.

Regarding the current case, due to the progress of the Fed's exit strategy, the long-term upward trend of US yields is, of course, expected to continue, which is a foregone conclusion. However, a second round of President Joe Biden's fiscal plan called for tax hikes on the revenue side in order to “reduce federal debt over the long term.” This may calm the term premium by easing concerns about fiscal discipline.

In addition, the portfolio investment assets by region for February (released yesterday by MOF) confirmed that Japanese investors' net selling of US and Australian bonds came in at Y788.9bn and Y655.4bn, respectively. Looking at trends by investor type, net selling of foreign bonds at banks (ordinary accounts) stood at Y1.6tn in February and more than Y1tn in March. These figures point to the possibility that Japanese investors, especially banks, played a role as a background factor of the expansion of the term premium in February and March. If so and if Japanese investors cease such action from the start of the new fiscal year (or invert direction), this may contribute to a calming of the term premium of US Treasuries, in line with weaker concerns about fiscal discipline of Biden's fiscal plan.

If we assume that (1) the original upward pace of interest rates, which is estimated by the exit strategy, is 10bp/month, and (2) the 30bp/month pace seen in February and March was exceptional and caused by the surge in the term premium (deterioration of bond supply/demand conditions), it can be calculated that the overshoot of the US long-term interest rate over the two months was 40bp. If so, due to expansion of the term premium in this period, investment in US Treasuries may be now becoming attractive. If yields return to the trendline since August 2020, we would not be surprised if we see a stop in the rise in yields over the next several months or an around 30bp drop over the short term. If a recovery is tested, the point of reference in selling on rally would be 1.4-1.5%, which is expected to be achieved in returning to the past trendline.

US 10Y Treasury Yield, Term Premium (ACM model)



Source: Bloomberg; compiled by Daiwa Securities.

US 10Y Treasury Yield



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]

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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