Daiwa's View

Will inflation-led rise in yields come again?

➢ Excess portion of increased yields has already been resolved; now is the time for careful observation, and keeping an eye out for trends

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Daiwa Securities Co. Ltd.

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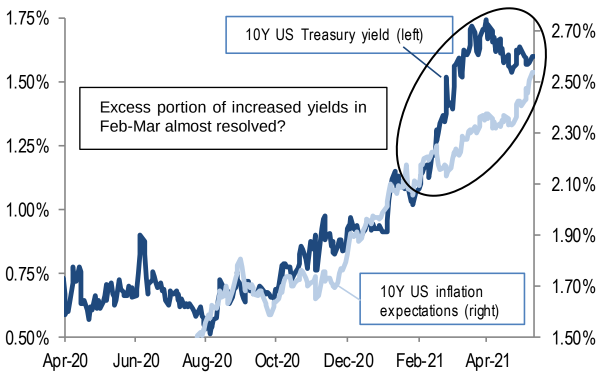
Will inflation-led rise in yields come again?

Yesterday, the 10-year US Treasury yield moved within the recent range of between 1.55% and 1.60%. Meanwhile, the recent rise in inflation expectations (BEI) warrants attention. If inflation expectations continue to rise at the current pace, the nominal yield may also be reaching the point where it could easily rise.

During the period from July 2020 through January 2021, the US nominal yield and inflation expectations were rising at almost the same pace, making the real yield low and stable. Subsequently, yields substantially rose in February-March 2021 led by the term premium. Since April, yields have temporarily declined in reaction to the surge.

However, underlying inflation expectations continued to rise during this period. Therefore, the 'excess portion' of increased yields was steadily resolved. Combined with the recent surge in commodity prices, inflation expectations rose further. As a result, the situation has finally returned to one in which the degree of rise in inflation expectations matches that of the nominal yield in the span since July 2021. In other words, there is a possibility that the excess portion of increased yields has already been resolved.

10Y US Treasury Yield, Breakeven Inflation Rate

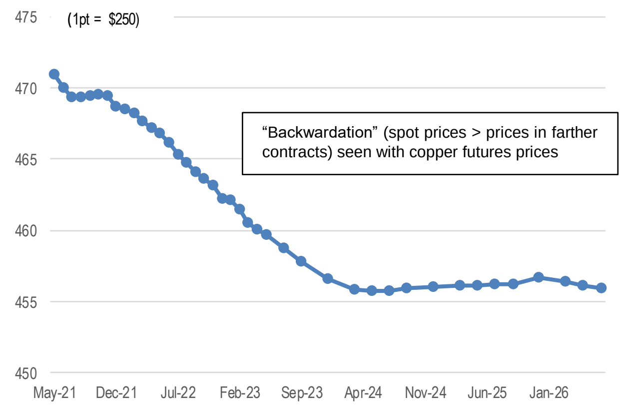


Source: Bloomberg; compiled by Daiwa Securities.

The rise in inflation expectations in the latter half of 2020 should be described as a 'desirable rise' in the sense that it was approaching the Fed's target. However, with the absolute BEI level starting to exceed 2.5%, the situation now is different from then. If inflation expectations continue to rise, the situation may reach the point described by Treasury Secretary Janet Yellen on 3 May when she said "it may be that interest rates will have to rise somewhat to make sure that our economy doesn't overheat."

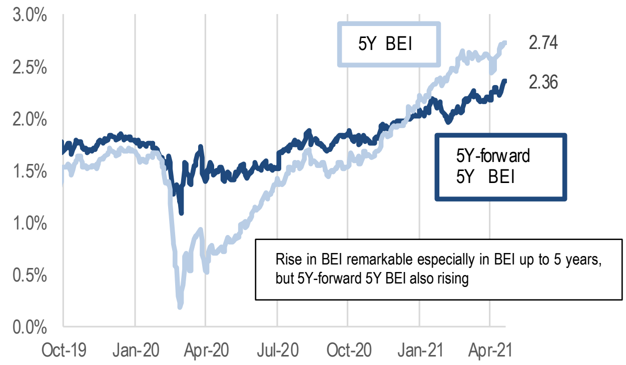
That said, we are not sure at this stage whether long-term inflation expectations will continue to rise. For example, regarding commodity prices, which are spiking speculatively, backwardation has been seen with copper futures prices. This implies that supply constraints are partially contributing to the currently observed surge in spot prices (left-hand chart below). With respect to US inflation expectations, as well, the 5-year BEI rose to 2.74%. Meanwhile, the level of the 5-year forward 5-year BEI (which indicates long-term inflation expectations) is at around 2.36%, staying at almost the same level as the Fed's target (CPI-based 2.33% ≒ PCE-based 2.06-2.16%). It is true that the level of long-term inflation expectations is also edging up somewhat. However, we think that now is the time for careful observation, and keeping an eye out for trends.

CMX Copper Futures Price (HGA)



Source: Bloomberg; compiled by Daiwa Securities.

US Breakeven Inflation Rate (5Y, 5Y-forward 5Y)



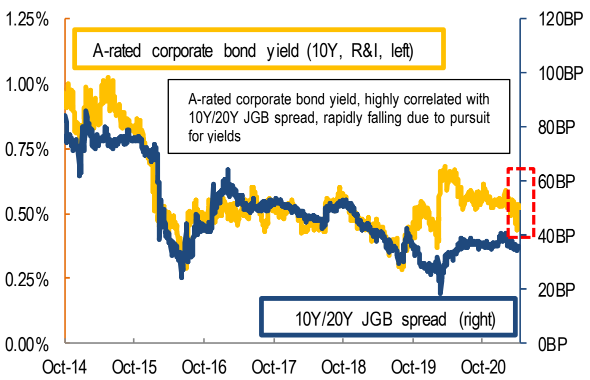
Source: Bloomberg; compiled by Daiwa Securities.

◆ **Preference for carry income tending to grow in the JGB market**

Compared to the US and Europe, where they have been cautiously watching for a new round of inflation-led rises in yields, there has been little speculation about higher volatility with JGBs. If we can assume that volatility will remain low and stable, putting more focus on carry and roll-down return would be an inevitable consequence. In fact, appetites for selecting corporate bonds with high carry income are increasing even more.

Historically, the 10-year/20-year JGB yield spread and yields of A-rated corporate bonds (yen bonds that can gain yields of safety assets plus something extra) tend to correlate. Given this, we think that the tendency to outperform of maturities of more than ten years, which are attractive in terms of carry and roll-down return, is likely to continue (chart below). We should be cautious about higher yields in the US and Europe, as well as expansion of fiscal expenditures to cope with the declaration of an extension of the state of emergency. However, we recommend a buying stance when a dip is formed, given the difference in fundamentals between the US/Europe and Japan.

A-rated Corporate Bond Yield, 10Y/20Y JGB Yield Spread



Source: Bloomberg; compiled by Daiwa Securities.

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In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

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2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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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Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

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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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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

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[Fitch]

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The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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February 2020

IMPORTANT

Conflicts of Interest: Daiwa Securities Co. Ltd. may currently provide or may intend to provide investment banking services or other services to the company referred to in this report. In such cases, said services could give rise to conflicts of interest for Daiwa Securities Co. Ltd.

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).

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
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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