Daiwa Securities

Daiwa's View

US Economic Surprise Index turned negative

➢ Will this trigger flattening?

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Daiwa Securities Co. Ltd.

Will this trigger flattening?

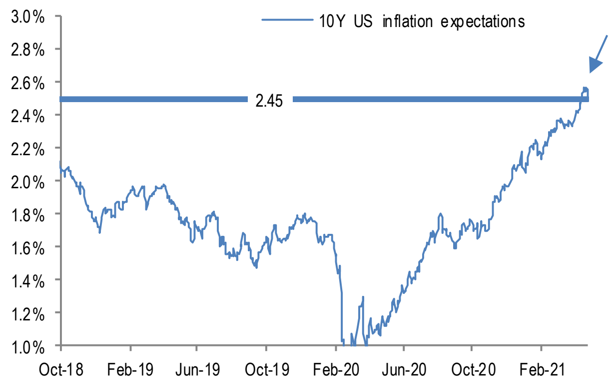
US Economic Surprise Index turned negative

The 10-year US Treasury yield declined to 1.63%. Apparently, Treasuries were bought back to the level before the announcement of the FOMC minutes. However, the 30-year yield slid beyond the level before the minutes announcement, which intensified bull flattening of the curve (10-year: 1.64→1.67→1.63, 30Y: 2.36→2.37→**2.33**). There was a change also in inflation expectations (breakeven inflation rate: BEI). The 10-year BEI, which hit a recent peak at 2.55% before the minutes announcement, declined rather sharply (2.55→2.5→2.45). These yield trends appear to have served as a factor to support growth stocks (DJIA < NASDAQ).

As yesterday's yield declines accelerated after the release of the Philadelphia Fed Index (Philly), the relationship with economic indicators also warrants attention. The headline itself of the Philly was strong at 31.5, but the figure substantially undershot the strong advance estimate (forecast: 41.5, actual 31.5, previous month 50.2). Recently, the phenomena of such undershoots vs. estimates have been widely observed. It is striking that the US Economic Surprise Index finally fell into negative territory yesterday for the first time since the outbreak of the COVID-19 pandemic.

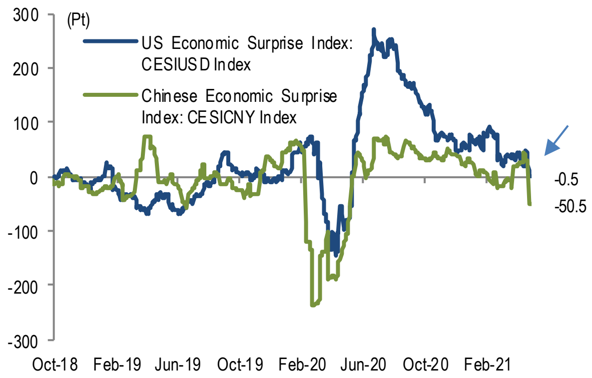
Moreover, the Economic Surprise Index in China, whose economy recovered ahead of other nations, declined to –50.5, lower than that in the US. Like this, with the Economic Surprise Indices in major nations the US and China now falling in negative territory, the global yield uptrend is unlikely to accelerate even if the European Economic Surprise Index alone fares well (134.6 as of 20 May). That said, in terms of the "level" of economic indicators, a quite strong economic recovery is confirmed by these figures. Therefore, central banks will likely steadily proceed with the exit strategy.

10Y US Treasury BEI



Source: Bloomberg; compiled by Daiwa Securities.

Economic Surprise Indices (US, China)

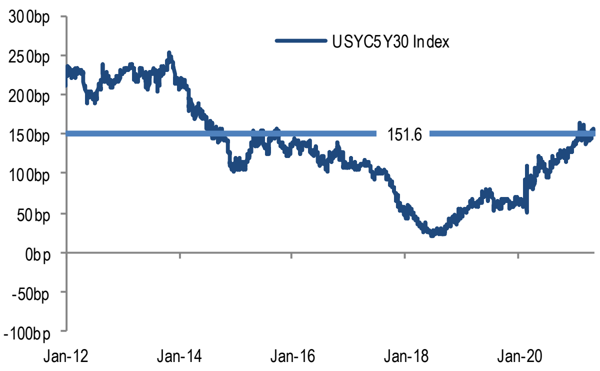


Source: Bloomberg; compiled by Daiwa Securities.

If we assume that the market has entered a new phase of "deterioration in the Economic Surprise Indices" + "progress of the exit strategy," the US Treasury yield curve also may be in the turning phase from steepening to flattening, although this may be a somewhat premature discussion. In fact, after the taper tantrum in 2013, the steepening of the yield curve was short-lived, followed by the flattening phase. This would be an unignorable precedent in forecasting yield trends after the start of the tapering.

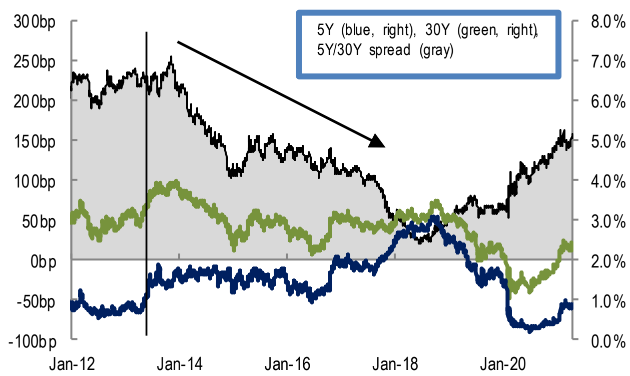
In examining the "30-year" yield level, which is important as an end-point of the yield curve, the level of the Fed's longer-run projection is important. Regarding the longer-run projection, the New York Fed yesterday released the responses to surveys of primary dealers and market participants, in which both groups expected the longer-run federal funds rate (median) to continue to decline (primary dealers: 2.31%, market participants: 2.00%, current level: 2.50%). Under the combination of "the drop in the longer-run projection" and "the prospect of earlier rate hikes," it is easier for the 5Y/30Y spread to face flattening pressure.

US Treasury 5Y/30Y Spread



Source: Bloomberg; compiled by Daiwa Securities.

US Treasury 5Y Yield. 30Y Yield, 5Y/30Y Spread



Source: Bloomberg; compiled by Daiwa Securities.

These US yield curve trends would be an unignorable factor in placing bids on the 20-year JGB auction to be held today. Putting aside discussions regarding the timing, the Fed's direction is clear—the consensus is that US long-term yields will face upward pressure in line with the progress of the exit strategy. Such US yield trends are expected to put upward pressure on JGB yields, which appears to be becoming the consensus in the JGB market (although correlation declining slightly recently).

Meanwhile, if the steepening of the US Treasury yield curve ends despite tapering as mentioned above, this would be an obstacle when the shape of the JGB yield curve steepens from now (yet to become consensus). If so, buying-on-dips is recommended when a dip is formed after the auction, although participants are certainly aware of the possibility that today's auction may tail at a level below 0.45%.

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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

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).

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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.

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