

Daiwa's View

Currency basis may worsen slightly in latter half of year

- Uncertain factor for hedge costs

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp



Daiwa Securities Co. Ltd.

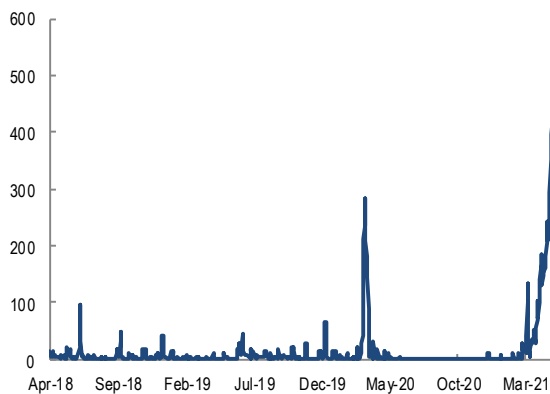
Uncertain factor for hedge costs

Currency basis may worsen slightly in latter half of year

The data that probably underwent the greatest change in May is the outstanding amount of the reverse repo facility at the Fed. The amount increased from \$183.2bn as of 30 April to \$458.3bn on 27 May. As is well known, this is a by-product of Supplementary Leverage Ratio (SLR) regulations and a sharp decline in the US Treasury General Account (TGA).

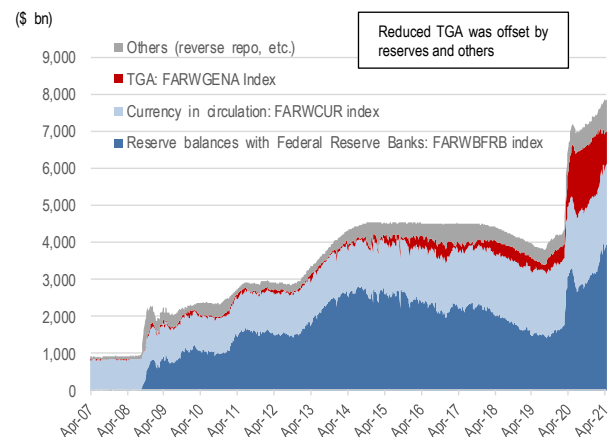
Due to the plunge in the TGA, the market was concerned about deterioration of SLRs at banks caused by short-term interest rates falling into negative territory and a surge in reserves. Therefore, the Fed made the excellent move of loosening CP requirements in the reverse repo facility in order to establish a system that can absorb the impact of the reduced TGA via two routes of increased excess reserves at banks and the outstanding amount of the reverse repo facility. For example, compared to early February, the TGA decreased by around \$850bn, while the outstanding amount of reserves and reverse repo transactions increased by \$650bn and \$480bn, respectively (due to QE, the overall balance sheet at the Fed expanded).

Outstanding Amount of Reverse Repo Facility



Source: Bloomberg; compiled by Daiwa Securities.

Fed's Balance Sheet (procurement side)



Source: Bloomberg; compiled by Daiwa Securities.

That said, what is important for us are the implications of this series of changes for the market. With the applied rate for overnight reverse repo transactions at 0%, the market appears to have been surprised by the increase in the bid amount despite the applied rate being so low. At vendors, some opined that such an increase was caused by the existence of abundant cash (→ risk-on factor).

It is true that the increase in the outstanding amount of the reverse repo facility shows financial institutions' intention to park money at the Fed even at 0%. Nevertheless, it is half incorrect to interpret that this indicates the existence of abundant cash in the US market.

This is because, if the Fed had decided to extend easing measures with the SLR past March 2021, the outstanding amount of the reverse repo facility would not have increased to this extent¹. In that sense, as a background factor for the surge in reverse repo transactions, we can't ignore the fact that it is becoming difficult for banks to use balance sheets due to banking regulations. Senator Elizabeth Warren [prevented](#) the extension of SLR easing measures, and based on her recent remark in response to Fed Vice Chairman for supervision Randal Quarles, banking regulations are unlikely to be loosened in the near term.

Remark by Senator Elizabeth Warren against Fed Vice Chairman for Supervision Randal Quarles (25 May 2021)

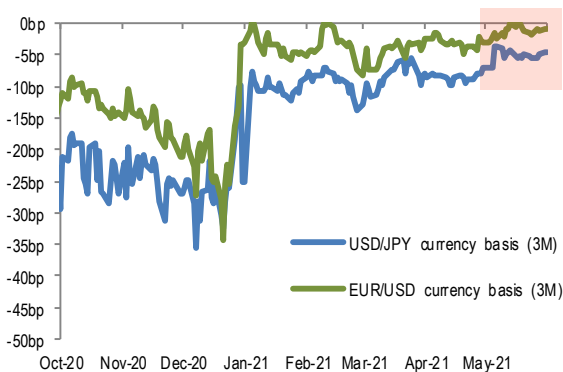
Our financial system will be safer when you're gone. I urge President Biden to fill your role with someone who will actually serve.

As short-term interest rates are currently in negative territory, demand for CP carrying positive yields is increasing substantially. This appears to be leading to a change in the supply/demand balance for the dollar in the currency basis market (procurement < release), as well as improvement in the currency basis. However, once the drop in the TGA ends, special demand for CP will likely end its course as well. This implies that the better environment for procuring US dollar-denominated CPs at non-US financial institutions, one of the major reasons behind the current improvement in the currency basis (and decline in dollar LIBOR), is temporary².

Of course, current conditions are unlikely to worsen significantly in the short term. However, the true nature of something that has been hidden due to the drop in the TGA thus far may emerge in the latter half of the year. If there is a possibility that the currency basis will worsen (normalize) in the latter half of the year when dollar funding generally increases, we may also need to recognize the currently observed decline in hedge costs as a temporary phenomenon when investing in foreign bonds from the yen.

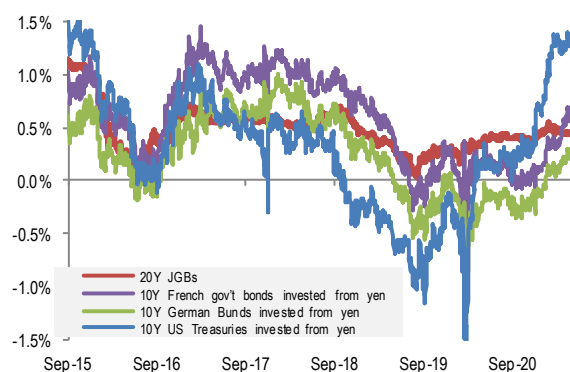
In our view, when it comes to JGBs, as well, uncertainty about the outlook for hedge costs from the latter half of the year has the potential to make JGBs more attractive relative to foreign bonds invested from the yen.

Currency Basis Swap (USD/JPY, EUR/USD, 3M)



Source: Bloomberg; compiled by Daiwa Securities.

Yields of JGBs and Foreign Bonds Invested from Yen



Source: Bloomberg; compiled by Daiwa Securities.

¹ Because excess reserves at banks are not counted as targets of SLR regulations.

² If the applied rate for the reverse repo facility is raised in June [in line with the consensus estimate among primary dealers](#), the CP procurement environment at foreign banks may start to normalize from the point at which the rate hike occurs.

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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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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).

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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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