

Daiwa's View

Return to reflation trade was short-lived

- Steady accumulation of side effects from overheating

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Daiwa Securities Co. Ltd.

Steady accumulation of side effects from overheating

Return to reflation trade was short-lived

[Speculation](#) about a return to reflation trade turned out to be short-lived, with US Treasury yields posting sharp bull flattening yesterday. The 10-year Treasury yield fell back to 1.48% (down 5bp) and the 5-year/30-year spread again flattened to a level slightly below 120bp. As expected, price movements seen at the end of last week were apparently a correction to the speed of flattening (charts below).

Since May, the bond market has often followed a pattern in which (1) short positions were set up before the release of economic data in anticipation of overheated inflation and (2) yields declined due to short-covering with the announcement of strong economic data. This time, as short positions appear to have been covered at an earlier stage, reflation trade may be decreasing. Triggered by the June FOMC meeting, the structure [has changed](#), making it difficult to assume a return to simple reflation trade.

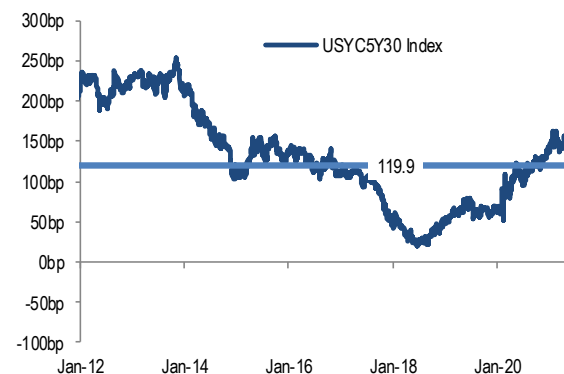
Meanwhile, [I have pointed out](#) that, triggered by the June FOMC meeting, the high-yield corporate bond spread would become a litmus test for judging whether risk-off will come. With the correction after the June FOMC meeting being short-lived, the spread is hitting a record low in line with expectations. In terms of strong US economic indicators, this is an appropriate move. However, if prices of assets (incl. real estate) remain overheated, the Fed's exit strategy could easily lead to a hawkish surprise. In that case, the yield curve would tend to twist and flatten.

10Y US Treasury Yield



Source: Bloomberg; compiled by Daiwa Securities.

US Treasury 5Y/30Y Spread

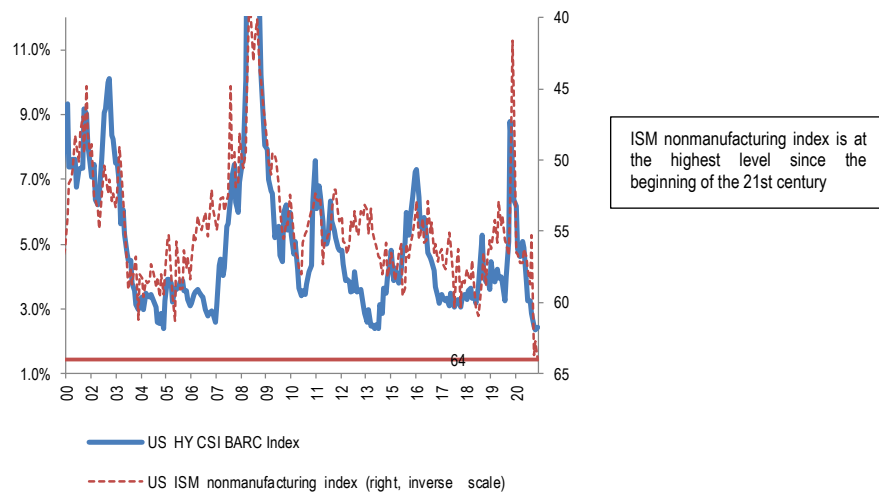


Source: Bloomberg; compiled by Daiwa Securities.

- ◆ Loosening of covenants could cause financial risks in the future
Today's *Nikkei* (morning edition) included an article about a lack of discipline in the corporate bond market, with the headline describing that low-rated corporate bonds constitute a loophole around discipline. It pointed out that the ratio of the issuance of corporate bonds with looser financial covenants (which limit financial deterioration) to the total has risen to more than 20% in the European high-yield bond market, expressing concern that this could cause financial risks in the future. When corporate bond spreads tighten excessively, we see a collapse of the power balance between borrowers and lenders, and then start to see looser covenants. Historically, this trend is inevitable, and it tells us that the side effects of excess easing are turning into risks in the future.

That said, the fact that the North American high-yield market is now hitting record lows is natural in terms of business sentiment. Unlike with investment-grade corporate bonds, investors of high-yield corporate bonds are very aware of default risk. Therefore, when the ISM nonmanufacturing index is at the strongest level since the beginning of the 21st century, the fact that the spread level is hitting record lows in line with a stronger need for investment in high-yield corporate bonds is consistent with fundamentals (chart below).

US High-yield Bond Index, ISM Nonmanufacturing Index (from 2000 to date)



Source: Bloomberg; compiled by Daiwa Securities.

The question is sustainability. Given the methods for compiling the index, we can say that the ISM index will never remain at a level above 60. We think that the current high ISM index is reflecting temporary overheating caused by President Biden's fiscal policies and the Fed's zero interest rate plus QE. Once the ISM peaks out towards its historical 'cruising speed' (the 50 level) with an end to policy support, the current spread level will be regarded as overvalued. If the market were to become aware of high default risk among high-yield corporate bonds with the arrival of an unexpected recession (although this is unlikely to happen soon), an increase in the number of the aforementioned cov-lite corporate bonds is likely to pose a serious threat to financial stability.

Bloomberg consensus estimates for the ISM manufacturing index (due out this week) and non-manufacturing index (due next week) are 61 and 64, respectively. If they are at these levels, it would be safe to say that near-term default risk is low. On the other hand, evidence is accumulating relating to the side effects of overheating that could cause financial risks in the future. If asset prices remain overheated, central banks are likely to provide a hawkish surprise.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")

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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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