

Daiwa's View

Impact of China Evergrande Group's debt woes on JGB market

- The main scenario is that JGB yields will remain low and stable, but higher volatility in overseas markets warrants attention

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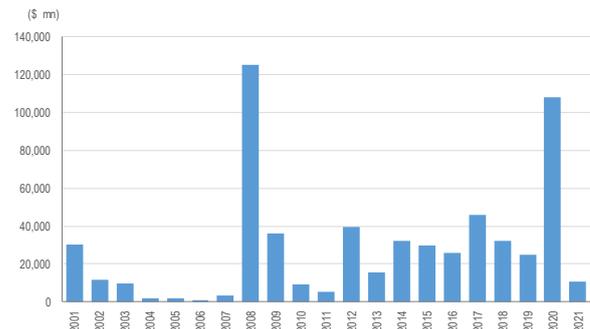
Daiwa Securities Co. Ltd.

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Impact of China Evergrande Group's debt woes on JGB market

The Hong Kong stock market plunged on 20 September due to liquidity concerns regarding China Evergrande Group (hereinafter referred to as "Evergrande"). With the impact spilling over to Europe and the US, risk assets were bearish across the board. Price movements were facilitated, in part, due to (1) market participants being cautious about a hawkish shift by the Fed at the FOMC meeting, the results of which are to be released in the early hours on the 23rd Tokyo time and (2) the number of market participants being limited this week, as Japanese and Chinese markets are closed due to national holidays. If Evergrande defaults on \$19.3bn in dollar-denominated bonds, that will likely have a certain degree of impact on the US credit market, as well.

Amount of Defaulted Dollar-denominated Corporate Bonds

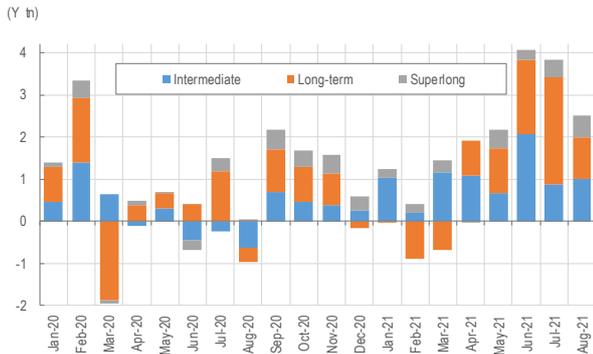


Source: Bloomberg; compiled by Daiwa Securities.

How will the JGB market be affected by this kind of growing risk sentiment caused by the overseas market? Investment in long-term JGBs by overseas investors has been particularly pronounced in FY21. [After posting record-high net buying of Y2.5tn in July](#), overseas investors logged net buying of more than Y1tn in August, which was confirmed [in the Trading Volume of Over-the-Counter Bonds released on the 21st](#). In forecasting investment behavior by overseas investors, we can refer to the BOJ's working paper on the investment behavior of overseas investors in the cash JGB market, which was published in September 2020. This paper states that overseas investors (1) increase investment in JGBs due to declines in JGB yields (oriented towards following the market) and (2) decrease investment when uncertainty increases (risk off), which is represented by rises in the VIX. While it is estimated that basis swaps (improvement in yen procurement costs on a dollar basis) contribute to net buying of intermediate JGBs, investment in long-term and superlong JGBs increases due to tightening of the long-term/short-term yield spread between the US and Japan.

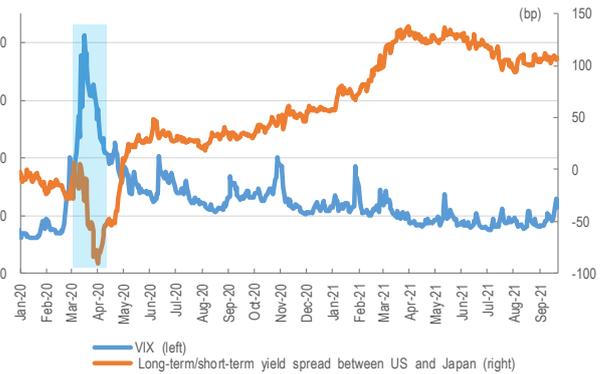
According to a model in the above-mentioned paper, a 1-point rise in the VIX reduces overseas investors' investment in JGBs by around Y500bn/month¹. In fact, when the VIX rose to the 80 level in March 2020, their net selling of long-term JGBs amounted to slightly below Y2tn. Meanwhile, during global yield declines due to risk-off sentiment, it is estimated that US long-term yields drop more than Japanese long-term yields. Tightening of the long-term/short-term yield spread makes investment in JGBs more attractive, which eases the risk-off impact due to rises in the VIX. Accordingly, when volatility rises beyond the normal range, we need to be cautious about realization sales by overseas investors.

Trading Value of Coupon-bearing Bonds by Overseas Investors (net)



Source: Japan Securities Dealers Association; compiled by Daiwa Securities.

VIX Index, Long-term/short-term Yield Spread Between US and Japan



Source: Bloomberg; compiled by Daiwa Securities.

The VIX rose from 20.81 on the 17th to nearly 30 at one point on the 20th, but it settled down to the mid-20 level on the 21st New York time. Going forward, the market may follow the “Buy the Fact” dictum, digesting factors such as the results of the FOMC meeting and whether the coupons of Evergrande’s dollar-denominated bonds will be paid on the 23rd. In addition, the environment surrounding the JGB market is favorable, as witnessed by excess funds at domestic financial institutions, [anticipated prolongation of the yield curve control policy by the BOJ](#), and relatively weak upward pressure on prices amid a supply shock. Therefore, the main scenario is that JGB yields will remain low and stable. Meanwhile, we need to pay a certain degree of attention to a rise in volatility in overseas markets.

¹ Due to a 1-point rise in the VIX, overseas investors decrease investment in intermediate JGBs and long-term/superlong JGBs by Y22.6bn and Y33.3bn, respectively. In addition, due to a 1-bp tightening of the long-term/short-term yield spread between US and Japan, which is the difference between “the 10-year US Treasury yield – 3-month Libor” and “the 10-year JGB yield – 3-month Libor,” overseas investors increase investment in long-term JGBs by Y7.3bn. However, the paper reports that domestic investors, such as major banks, regional banks, and life/nonlife insurers, have no reaction to the VIX, and demonstrate strong aspects of contrarian investment regarding domestic yields and strong seasonality on a semiannual and quarterly base.

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