Japan | Fixed Income

12 October 2021
Japanese report: 12 October 2021

Daiwa's View

Buying opportunity if range is maintained, but selling opportunity if range breakout occurs

- I. Buying opportunity if range is maintained
  II. Impact of global slope factor

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.

Buying opportunity if range is maintained, but selling opportunity if range breakout occurs

I. Buying opportunity if range is maintained

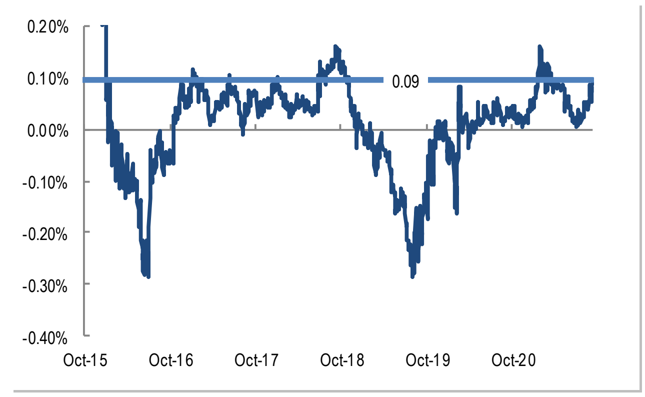
II. Impact of global slope factor

It is always difficult to make a judgment at the upper limit of the range. If the range is maintained, the upper limit would be a good opportunity to buy at the cheapest level. On the other hand, if a range breakout is expected, the upper limit should not be touched. When approaching the upper limit of the range, there are always reasons that seem 'reasonable.' As we scrutinize them more, we get wrapped up in suspicion, thinking "Why did we regard this level as the upper limit of the range based on insufficient grounds?" As a result, we are apt to adopt a wait-and-see stance[1].

Currently, the 10-year, 20-year, and 30-year JGB yields are approaching the thresholds of 0.1%, 0.5%, and 0.7%, respectively. We would like to consider whether the current levels are buying opportunities or selling opportunities in anticipation of a 'substantial' and 'certain' rise in the long term (excluding the wait-and-see stance option). My conclusion is that now is an opportunity to buy.

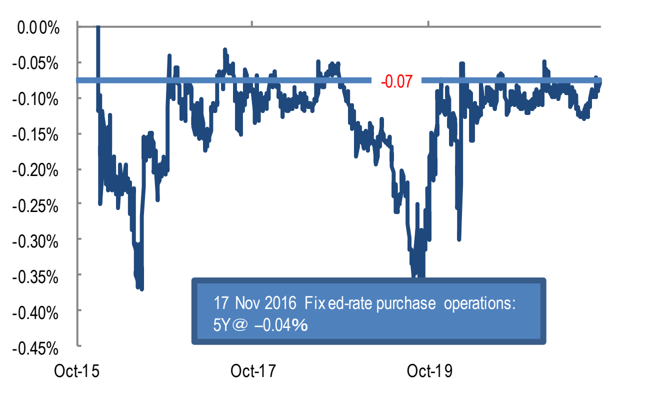
◆ <u>5-year JGB yield</u>
Currently, the 5-year yield, which consists of the first half of the 10-year yield, stands at –0.07%, while the 5-year forward 5-year yield, the latter half, is 0.25% (Bloomberg generic). The 5-year yield of –0.07% is quite a high level, and we have rarely seen cases of the 5-year yield being higher than –0.07% since the introduction of the yield curve control (YCC) policy (right-hand chart below).

10Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

5Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

---

[1] People have a psychological bias in which they react to loss more sensitively than to gains (Prospect theory, the Nobel Prize in Economic Sciences in 2002), and this serves as the driving force prompting a wait-and-see attitude.

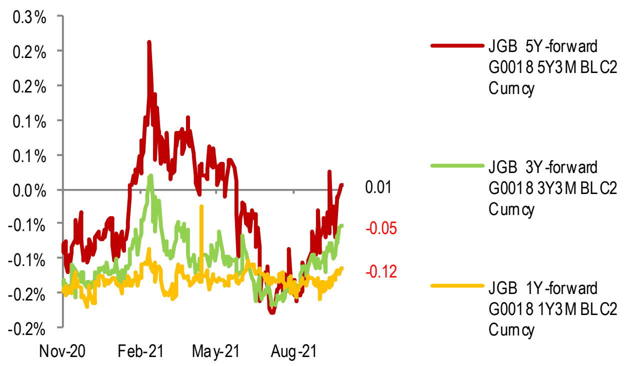
Why has the 5-year yield not continued at this level? This is probably because this level cannot be sustained unless we assume acceleration of an exit strategy by the BOJ.

Looking at forward 3-month yields, the 1-year forward 3-month yield of –0.12% (within the term of BOJ Governor Kuroda) factors in continuation of the negative interest rate policy. Meanwhile, the 3-year forward 3-month yield stands at –0.05%, pricing in a nearly 50% chance of removal of the negative interest rate policy. The 5-year forward 3-month yield is at +0.01%, factoring in a 100% chance of withdrawal from the negative interest rate policy within five years.

In addition, the 7-year yield now stands at –0.02%. The 2-year forward 5-year yield, which is arrived at through back calculation using the 5-year and 7-year yields, is +0.01%. Therefore, we can say that the yield curve has now finished pricing in a shorter maturity in the YCC target in two years (0% target from 10-year yield to 5-year yield).

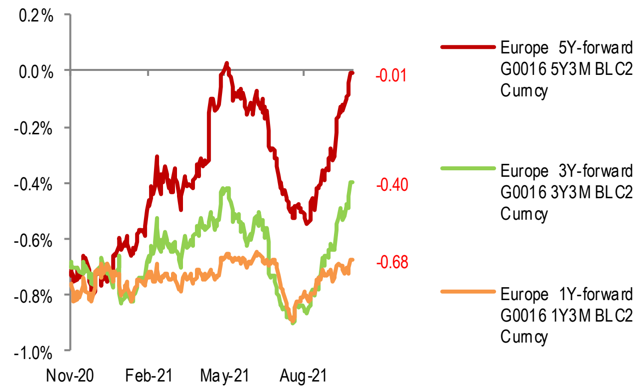
As the term of Governor Kuroda (which lasts until Apr 2023) will expire in two years, we may see a removal of the negative interest rate policy or a shorter maturity for the YCC target in line with a change in governor. However, if we assume that the JGB curve has fully factored this in, these are small risk factors. In contrast, if we assume that the BOJ does not remove the negative interest rate policy or shorten the maturity for the YCC target against the current market pricing, the current 5-year and 7-year yields may be too high (attractive in terms of investment).

JGB 3M Forward Yields



Source: Bloomberg; compiled by Daiwa Securities.

German Bund 3M Forward Yields



Source: Bloomberg; compiled by Daiwa Securities.

Our interpretation based on market rates has led to the above-mentioned conclusion. However, is it true? Comparing forward 3-month yields in Japan and Europe by way of experiment (above charts), we see that behavior with each maturity is very similar in Japan and Europe (rate hike within three years and removal of negative interest rate policy within five years).

This implies that JGB yields are probably currently rising due to the correlation with yields in Europe (overseas), which are pricing in the exit strategy at central banks in the US and Europe (where fundamentals are different from those in Japan), rather than due to drivers mainly consisting of Japanese fundamentals—pricing in the BOJ's exit strategy as mentioned above.

In that respect, the speech by Fed Vice Chair Richard Clarida on 17 May 2021 appears to indicate the possibility that my interpretation is valid. In this speech, he went into detail about a yield fluctuation model that took into consideration global factors of the sovereign bond market. He also explained that "yields along any given sovereign curve tend to rise and fall—and steepen and flatten—together over time," and that two factors—(1) the level factor and (2) the slope factor—were able to account for most yield fluctuations[2]. He stated that the level and slope factors reflected the real equilibrium rate and monetary policy

[2] This is a general conclusion that is accepted by famous models and analyses, including the Nelson-Siegel model and principal component analysis.

stance, respectively, that the slope factor was a major operational target for central banks, and that the first factor was basically beyond the central bank's control.

Vice Chair Richard H. Clarida (17 May 2021)
There is a rich academic and practitioner literature devoted to modeling and interpreting fluctuations in domestic sovereign yield curves. A fundamental empirical regularity that motivates much of this research is that, across time and geography, yields along any given sovereign curve tend to rise and fall—and steepen and flatten—together over time. This empirical regularity led Litterman and Scheinkman (1991) to hypothesize and demonstrate that in the market for U.S. Treasury securities, a very small number of common factors—two or, at most, three—are able to account not only for most of the time-series variation, but also for the cross-sectional dispersion in yields across the entire Treasury curve. Moreover, the two most empirically important factors extracted statistically from the Treasury yield curve have intuitive geometric interpretations as "level" and "slope." The "level" factor has approximately an equal effect on yields across the maturity spectrum—thus, changes in the level factor are often referred to as "parallel shifts" in the yield curve—and accounts for most of the variance in yields across the full range of maturities. The "slope" factor has an effect that is increasing (monotonically) in maturity—thus, changes in the slope factor are often referred to as "steepening" or "flattening" pivots in the yield curve.

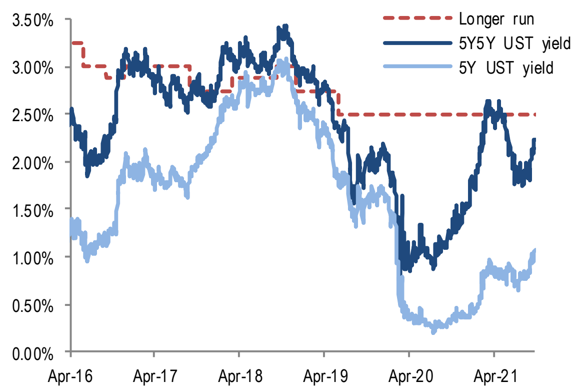
The introduction to this report may be a little long, but the important point we are making is that the slope factor tends to be highly correlated globally. This indicates the high possibility that, as the ECB and the Fed move toward the exit, JGB yields also temporarily factor in similar moves. However, if the actual actions by each central bank are not the same, yield fluctuations in line with global factors (that are inconsistent with fundamentals) would eventually reverse course. Of course, factors behind the 5-year JGB yield now being at a high level include the BOJ's lavish IOER provision via special COVID-19 operations and the Special Deposit Facility to Enhance the Resilience of the Regional Financial System. However, we think that this effect, which is shared globally, is large.

◆ 5-year forward 5-year JGB yield

In fact, the 5-year forward 5-year JGB yield has not risen as much as the 5-year yield. The former is now 0.25%, still 5bp lower than 0.30%, which was logged when the 10-year yield topped 0.10% in the past. Because of this, we could interpret the situation as having strong upside potential. However, it appears that the relatively stable developments have been caused by other factors. If we were to comment in line with the context of the above-mentioned speech by Fed Vice Chair Clarida, now would be an exit market (sloping factor market), and not a market with a rising equilibrium rate (level factor market).

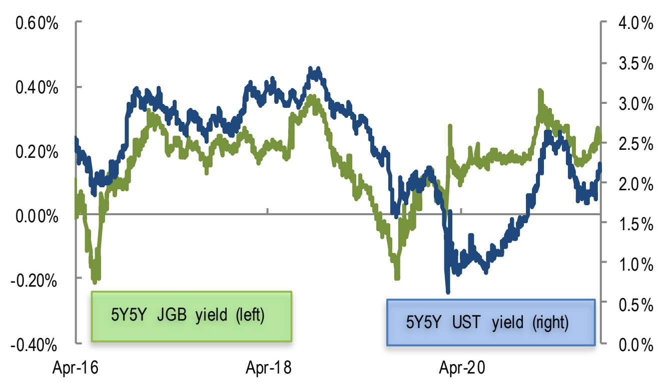
Currently, crude oil prices are temporarily pushing up global long-term yields, and this is a misleading factor. As clearly shown by the longer run and the 5-year forward 5-year US yields, the yield uptrend in Feb-Mar 2021 was obviously a global level factor market. On the other hand, one main topic since the Fed's hawkish shift at the June FOMC meeting has probably been an exit market (charts on next page).

5Y UST Yield, 5Y5Y UST Yield, Longer Run



Source: Bloomberg; compiled by Daiwa Securities.

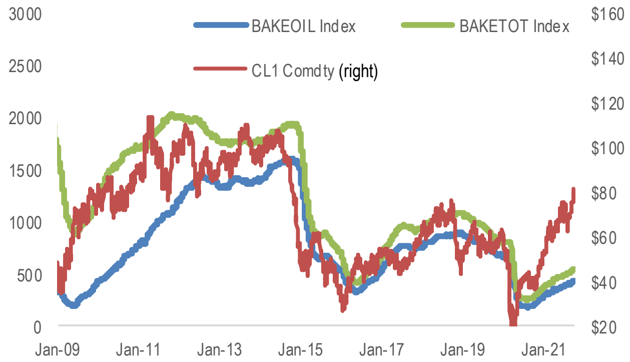
5Y5Y Yields in Japan and US



Source: Bloomberg; compiled by Daiwa Securities.

The contribution from resource prices here is a misleading factor. However, rising resource prices, which are now pushing up long-term forward yields, are probably temporary. Historically, a surge in the WTI crude oil futures price raises rig counts of shale oil, and starts to constrain the rise in prices. There is a possibility that oil producing nations will decide to change course and increase output in order to damage shale oil producers, and that crude oil prices will be pushed down (to the $50 level, which is regarded as cost level at most shale oil producers). Energy prices are the product of politics. Looking at this in the longer term, the rise in forward yields due to this factor is unlikely to continue.

Baker Hughes Rig Count, WTI Crude Oil Future Price



Source: Bloomberg; compiled by Daiwa Securities.

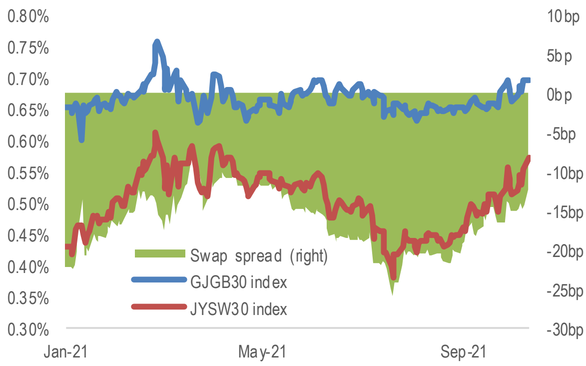
We will now summarize what we have stated above. Due to the exit strategy at the ECB/Fed and the contribution from the global slope factor, the 5-year JGB yield has now excessively priced in an exit strategy by the BOJ. The 5-year forward 5-year yield has been relatively stable because the market topic is not the global rise in the equilibrium rate. However, we are slightly concerned about the misleading impact from surging energy prices. That said, these factors appear to be temporary.

Based on my overall judgment regarding the situation, my conclusion is that now is a buying opportunity. I am not sure about the 'maximum wind speed,' but positions after entry at the current levels would easily generate treasures in the future (unrealized gains) from the standpoint of long-term investment. We also recommend buying the 20-year sector as a 10-year/20-year spread of at least 38bp is added onto the current level. Given demand at a level of at least 0.50%, which is regarded as a guideline of cost at depository institutions, we think this conclusion will become even more convincing.

◆ 30-year JGB yield

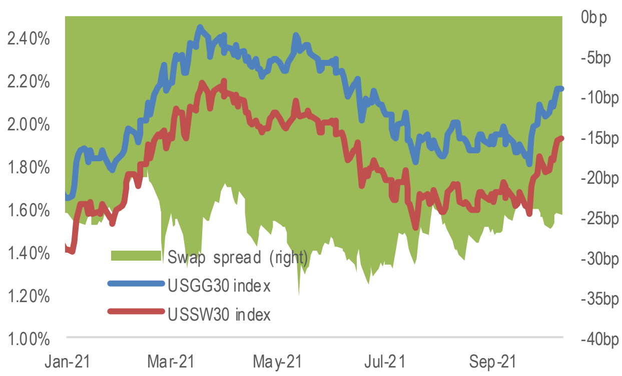
The 30-year JGB yield is also interesting. As the swap spread has now substantially tightened in the 30-year JGB sector, JGBs have outperformed swaps considerably. This is a development unique to the Japanese market, as similar tightening of the swap spread is not observed in the US market.

30Y JGB Yield, Swap, Swap Spread



Source: Bloomberg; compiled by Daiwa Securities.

30Y UST Yield, Swap, Swap Spread



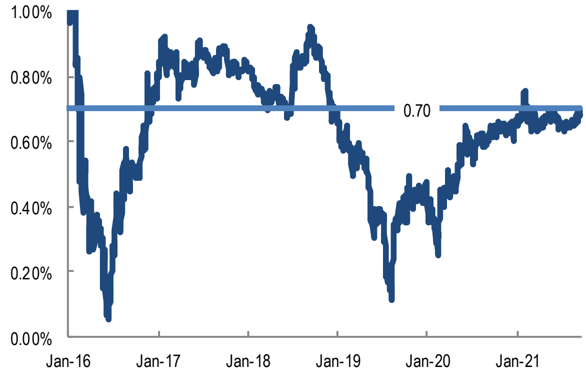
Source: Bloomberg; compiled by Daiwa Securities.

We can interpret this as indicating that the 30-year yield will rise going forward. However, we need to examine this from the perspective of why the swap spread has tightened? The reason for the rise in swap rates is relatively simple. We think it was a highly sensitive reaction to the rise in forward yields due to surging energy prices.

Meanwhile, the rise in the 30-year JGB yield has been relatively constrained, and we think this is probably because the absolute yield of 0.70% has reached a very attractive level for life insures (major investors) compared to cost. In other words, it is possible that they are actively buying JGBs on dips in the current uptrend, while refraining from investment during the swap rate downtrend thus far.

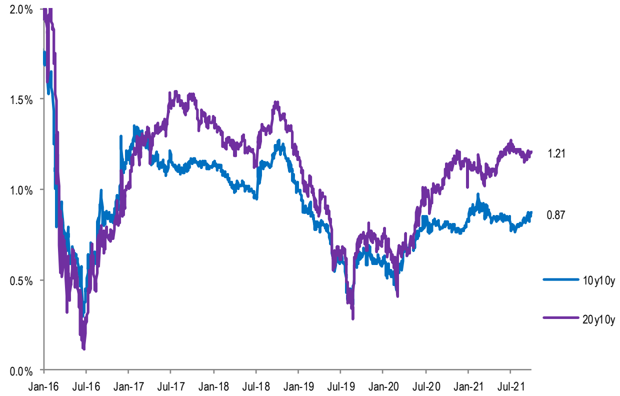
If the current market topic is a rise in the equilibrium rate, the 30-year JGB yield is likely to rise further. If not, the upside potential (upside risk) of this sector will not be that strong. Here, too, we think the current time is a good opportunity to buy on dips.

30Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

JGB 10Y Forward Yields



Source: Bloomberg; compiled by Daiwa Securities.

IMPORTANT

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:
https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf

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.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association