Daiwa's View

Orderly depreciation of the yen, reflecting rising 5-year US yield

➢ USD/JPY exchange rate is unlikely to greatly exceed 'the Kuroda line' (Y125)

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.

Orderly depreciation of the yen, reflecting rising 5-year US yield

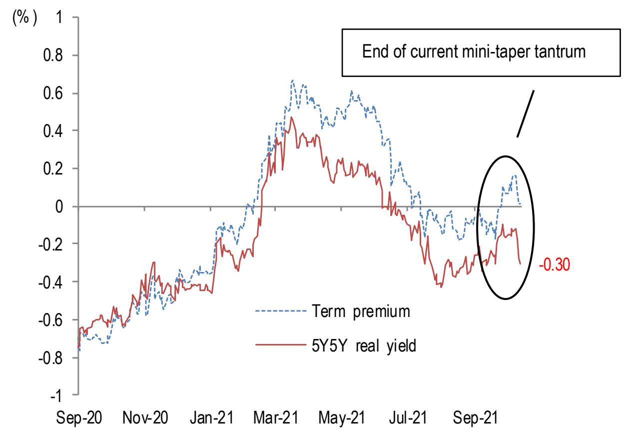
USD/JPY exchange rate is unlikely to greatly exceed 'the Kuroda line' (Y125)

◆ 10-year US Treasury yield returned to around center of range

With the 10-year US Treasury yield declining to 1.51%, the 5-year forward 5-year US real yield, which is a superior alternative variable of the term premium, fell to –0.30%. It appears that the 'mini taper tantrum' since late September has ended its course. As mentioned in our past report regarding crude oil prices and yields, the surge in energy prices due to supply constraints (time lag until supply increases) is a temporary factor leading to higher yields (although it is difficult to accurately forecast the timing of the reversal).

Observing the 10-year US yield by breaking it down into the 'first half' of the 5-year yield and the 'latter half' of the 5Y-forward 5Y yield, the former and the latter stand at 1.05% and 2.05%, respectively, almost returning to our forecast levels for end-2021. This means that the recent rise in yields was just fluctuation within the range mainly due to temporary factors (providing a buying opportunity).

5-year Forward 5-year US Real Yield, Term Premium



Source: Bloomberg; compiled by Daiwa Securities.

US Yield Forecasts for end-2021 (%)

UST	5Y	(5YOIS)	5Y5Y	(5Y5YOIS)	10Y
Current level	1.05	0.93	2.05	1.87	1.51
Main scenario	1.00	0.90	2.00	1.50	1.50
Upside scenario	1.15	1.05	2.46	2.15	1.75
Downside scenario	0.80	0.71	1.75	1.44	1.25

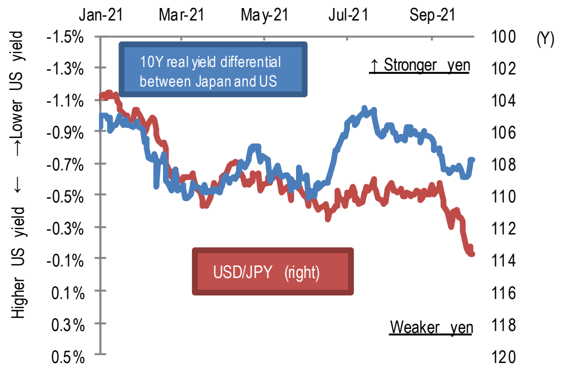
Source: Compiled by Daiwa Securities.
Note: Fractional point partially rounded up to show in 0.05% increments.

◆ Orderly depreciation of the yen, reflecting rising 5-year US yield

While US yields have returned to around the center of the range, the 10-year JGB yield remains at the upper limit of the range at around 0.08%. We can point out the market's awareness of the depreciating yen, which has weakened to the upper half of the Y113/$ range, as well as the de-facto 'loss of effectiveness' of negative interest rates due to the BOJ's lavish IOER provision as factors behind this divergence in Japanese and US yields. In particular, there appear to be cases of some investors who observe forex rates based on 10-year yields misunderstanding the current depreciation of the yen as an 'unexplainable phenomenon.'

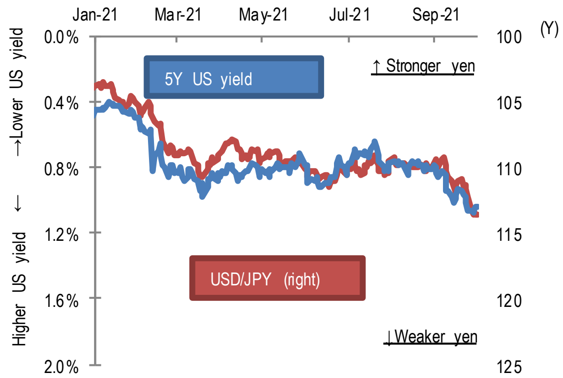
As is clear from the charts below, since the June FOMC meeting, which was a hawkish surprise across the board, the yield correlated with (spot) forex rates has changed from the 10-year real yield differential between Japan and the US to the 5-year US Treasury yield (rate-hike prospect). Basically, forex rates tend to reflect short-term yield differentials. However, with the policy interest rate now around zero in both Japan and the US, forex rates recently tend to reflect long-term yield differentials. However, if the Fed moves towards rate hikes, it would be natural to see forex rate trends in line with a 5-year yield reflecting a rate-hike path. In other words, we can say that the current depreciation of the yen constitutes orderly movements reflecting an uptrend in US yields.

USD/JPY, 10-year Real Yield Differential Between Japan and US



Source: Bloomberg; compiled by Daiwa Securities.

USD/JPY, 5-year US Yield

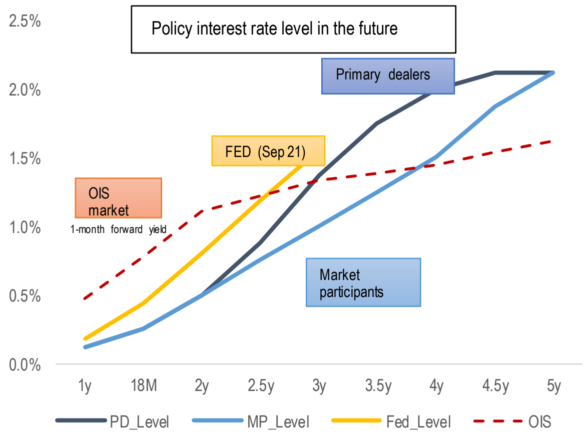


Source: Bloomberg; compiled by Daiwa Securities.

If we assume that this correlation will continue, we can get an idea of future yen depreciation using an estimated 5-year US yield. For example, with the market now pricing in a 1Y-forward 5Y yield of 1.5% and a long-term forward yield of 2%, we can estimate that the USD/JPY exchange rate one year from now will be Y118-119, and that it will be around Y125 at the final stage of rate hikes. Of course, this is just a rough estimation because forex rates have many variable factors besides yields. In June 2015, BOJ Governor Haruhiko Kuroda stated that the yen was not expected to weaken further (beyond Y125), and, given the aforementioned correlation, we do not think the USD/JPY exchange rate is likely to greatly exceed 'the Kuroda line' (around Y125) for now.

In addition, the short-term zone of the US Treasury market is now factoring in excessive rate hikes that are higher than the Fed's dot plot. Therefore, the pace of the uptrend in the 5-year US yield is expected to slow down. If so, rapid depreciation of the yen, which has proceeded in line with the 5-year yield, may let up. In that case, it would probably calm current concerns among some JGB market participants that the BOJ, fearing bad depreciation of the yen, might guide yields to high levels within the YCC range.

Rate-hike Pricing in US Market



Source: Bloomberg, Fed, New York Fed; 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