Daiwa's View

'Rate-hike frenzy' to let up

➢ Yields likely to temporarily post bull-steepening in the absence of excessive pricing of rate hikes

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.

'Rate-hike frenzy' to let up

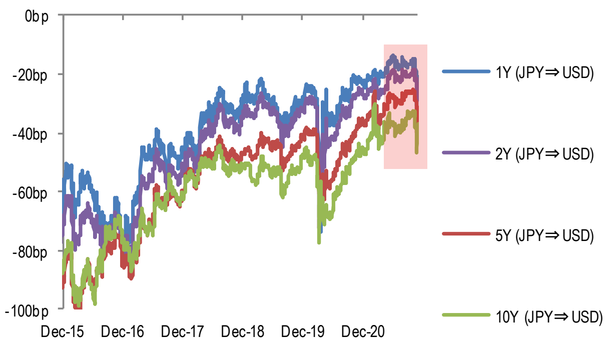
Yields likely to temporarily post bull-steepening in the absence of excessive pricing of rate hikes

Yesterday, the Bank of England (BOE) decided to maintain its policy interest rate at 0.10% against the market consensus. This triggered a sharp drop in global yields (down 5-15bp).

Amid a series of events at central banks—the RBA, FOMC, and BOE—this week's bond market was awash in fears about rapid and sharp rate hikes by central banks, which were falling behind the curve. Particularly when the Australian sovereign bond yield surged due to the removal of the yield curve control by the RBA, the credibility of central banks' forward guidance declined, throwing the short-term market into a state of virtual confusion. However, due to yesterday's decision by the BOE, the 'rate-hike frenzy' since late October appears to have temporarily let up as the BOE was expected to raise rates ahead of other major central banks. Yesterday, the MOVE Index declined to 64 from 78 at the beginning of the month. Going forward, it is expected to decline further (i.e., normalization).

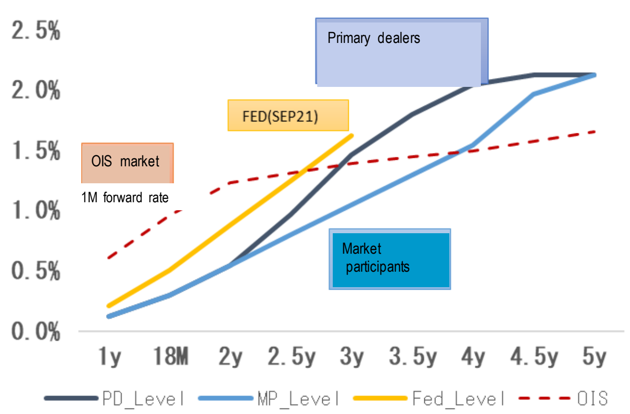
The short-term market may seem conservative, but it is the foundation for the government bond market. Government bonds are also the foundation for corporate bonds (corporate financing), and the stock market is established on top of that. Less transparency and depletion of liquidity in the short-term market, which is the point of origin of all risk assets, spread to the currency basis market. This caused deterioration of both the USD/JPY and EUR/JPY rates at the fastest pace in years in the currency basis swap market. This indicates a situation in which purchases of term dollars are not smooth. It was possible that market confusion would worsen, depending on this week's decision by central banks. However, due to yesterday's decision by the BOE, this risk appears to have decreased substantially.

USD/JPY Currency Basis



Source: Bloomberg; compiled by Daiwa Securities.

Forecasts for Future Policy Rate Level



Source: Fed, New York Fed, Bloomberg; compiled by Daiwa Securities.

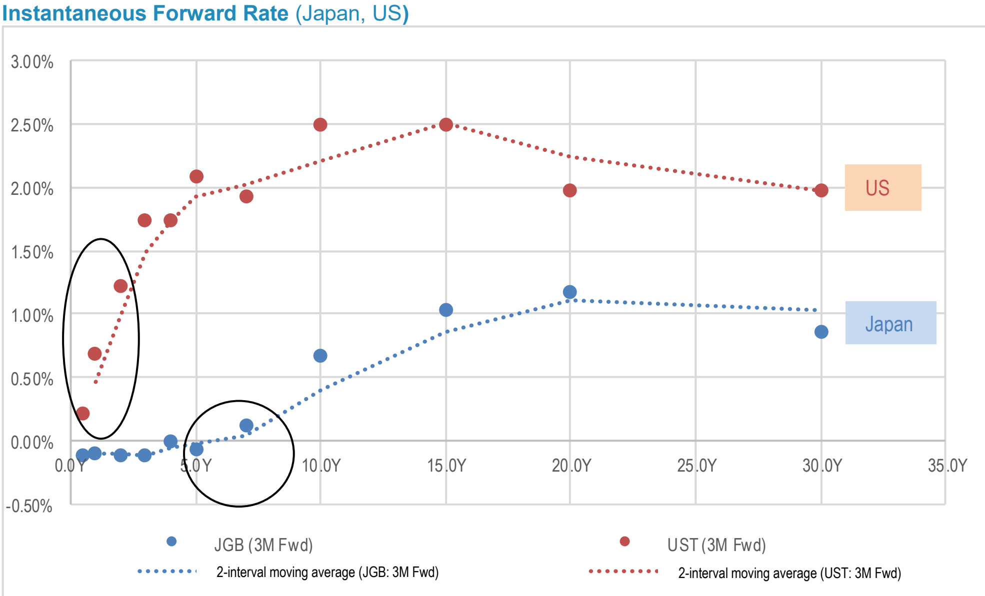
Important disclosures, including any required research certifications, are provided on the last page(s) of this report.

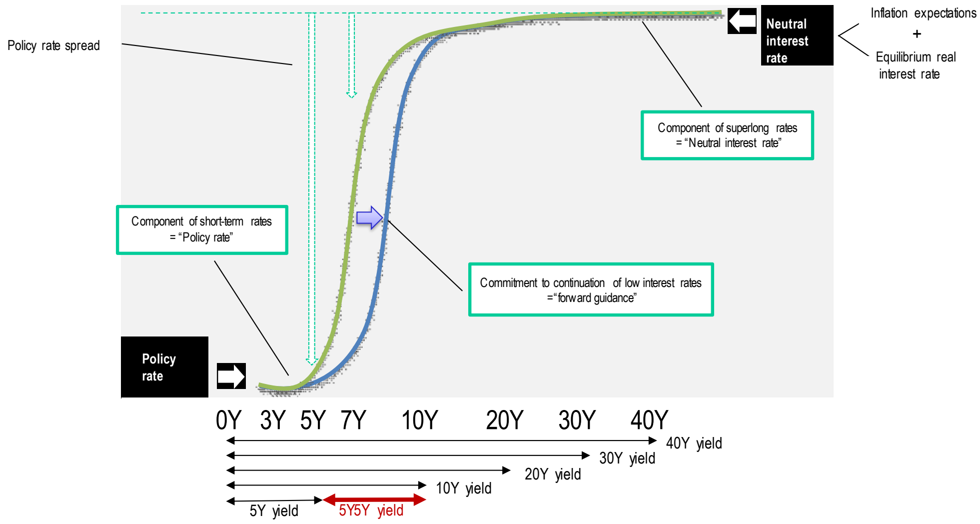
FICC

The calming of the rate-hike frenzy is expected to mainly work on the slightly longer zone of JGBs in comparison to US and UK government bonds. The impact is likely to emerge as downward pressure on intermediate/long-term yields, rather than short-term yields.

Why? This is very obvious when observing the shape of the instantaneous forward rates in each nation and the policy rate spread. The longest maturity point, where the policy rate spread is maximized, in the US is the 2-year zone, while that in Japan is the 5 to 7-year zone (the 3 to 5-year zone in Europe). During the rate-hike frenzy to date, the marginal points were (excessively) above the instantaneous forward rates. Due to yesterday's decision by the BOE, this movement will reverse course.

Instantaneous Forward Rate (Japan, US)





Source: Bloomberg; compiled by Daiwa Securities.

Amid this rate-hike frenzy, I recommended buying JGBs for investors with a long-term horizon, as well as the combination of long positions of superlong JGBs and short positions of futures if delta hedging is applied. However, if the panicky rate-hike frenzy has played out, hedging through futures' short positions is unnecessary. For now, a simple outright long in the long-term sector is likely to work.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

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