Daiwa's View

Has the process of correcting the overshoot started?

- ‘Negative impact on real economy’ is a key point when considering actions by BOJ

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.

Has the process of correcting the overshoot started?

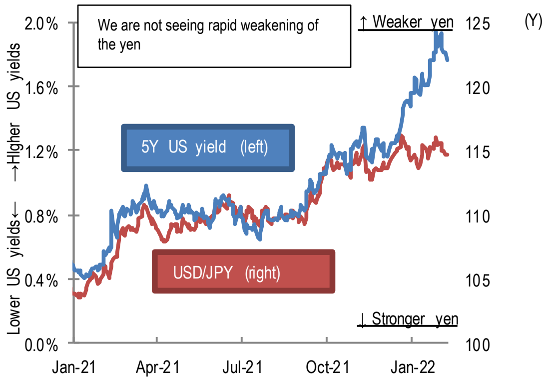
‘Negative impact on real economy’ is a key point when considering actions by BOJ

Currently, the USD/JPY exchange rate is at the Y114.8 level. The yen’s strength is partially caused by escalating tensions in the Ukraine. However, if nothing else, one objective assessment of the situation is that we are not seeing the rapid weakening of the yen due to fixed-rate purchase operations by the BOJ that the media and some market participants had feared (anticipated?).

This point appears to be important when thinking about the yen bond market, as well. This is because we should be seeing a rapid weakening of the yen if (1) the sharp rise in JGB yields, which have underperformed European and US yields since late January, signified a change in the ‘rational midpoint’ reflecting a rise in the underlying inflation rate in Japan, and (2) the BOJ were forcefully constraining that change (fixed-rate purchase operations aren’t ‘firing blank shots,’ and will easily attract bids from investors). Conversely, given that it is very likely that the reason the yen did not eventually experience rapid weakening after all was because the amount of the bid from investors in fixed-rate purchase operations was zero, we increasingly suspect that the surge in JGB yields since late January has largely reflected an overshoot factor in line with a decline in market liquidity, and not just a change in the ‘rational midpoint.’

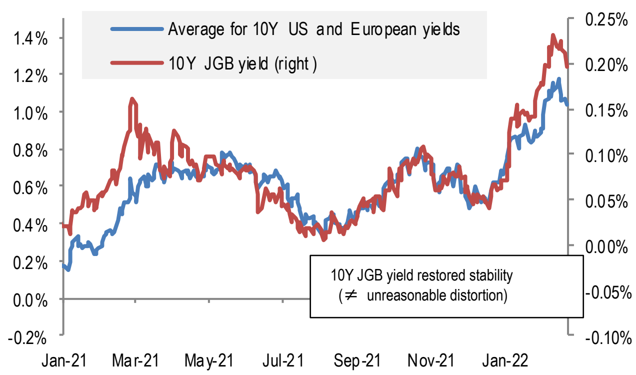
If so, then when interpretating possible factors behind the restored stability in the 10-year sector (in which fixed-rate purchase operations were conducted) ahead of other sectors, the opinion often heard in the news that distortions are being caused by ‘suppression by the power of the BOJ’ seems less likely. Rather, our interpretation is that as fixed-rate purchase operations eliminated downward volatility in the 10-year sector, market sentiment recovered from a frozen level only in that sector, ahead of other sectors, resulting in a recovery of market liquidity in that sector.

5Y US Yield, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa Securities.

10Y JGB Yield, Average for US and European 10Y Yields

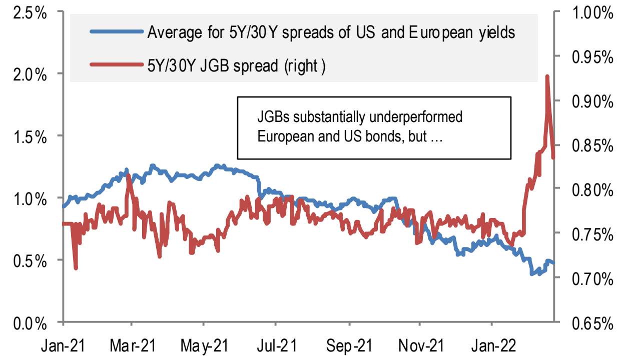


Source: Bloomberg; compiled by Daiwa Securities.

If this interpretation is correct, provided investors regain their calm due to communications by the BOJ, the overshoot in zones other than the 10-year sector will also likely be corrected in line with a recovery of market liquidity. With superlong yields having already declined for two consecutive days (last Friday and yesterday), the 30-year JGB yield dropped to around 0.89% from its recent peak of 0.99%, logged around the time of the 20-year JGB auction. Based on the above-mentioned standpoint, it is possible that the process of correcting the overshoot has started.

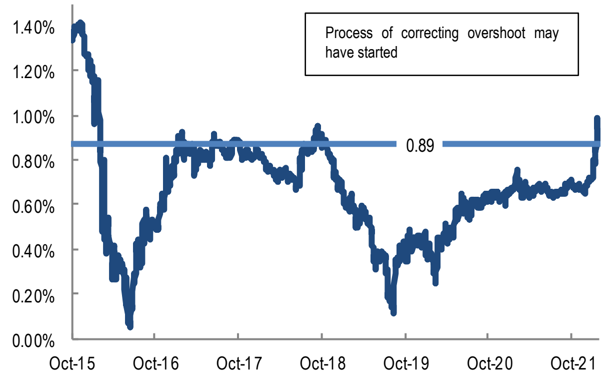
Meanwhile, we think it unrealistic to assume a return to the levels at the end of 2021, given speculation about policy revisions by the BOJ and a possible rise in inflation expectations, which may be created in an 'adaptive' (backward-looking) manner by a temporary rise in the actual inflation rate. Regardless of the sector (10-year or superlong), it is highly likely that the market's thresholds with respect to the rational midpoint have risen compared to the previous ones. Accordingly, the market is expected to try to find a new point of reference for the rational midpoint in the near term, while correcting the overshoot. (Refer to our past report regarding our estimates for superlong yields.)

5Y/30Y Spread: JGBs vs. Average for US and Europe



Source: Bloomberg; compiled by Daiwa Securities.

30Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Also, if we assume that the base interest rate is in the process of restoring stability after the end of an overshoot, we will very likely see a recovery in the Japanese credit market, which is experiencing confusion (such as cancellations of bond issuance) because of a lack of market liquidity similar to (more than) JGBs, with appropriate yield guidelines having been lost due to sharp fluctuations in the base interest rate. Of course, I leave assessments of the credit market to credit specialists. However, as our chief credit analyst Toshiyasu Ohashi repeatedly points out, the recent decline in function in the yen credit market and higher yields were likely led by liquidity premium in line with destabilization of the base interest rate, rather than by a full-scale proper movement of the Japanese credit cycle. If so, it is very possible that the restored stability of the base interest rate will become a big step towards stabilization of the corporate bond market.

Needless to say, we shouldn't welcome continuous, unrestrained market interventions by the central bank. However, when we are seeing a decline in (lack of) market function, particularly in the current situation in which the dysfunction has induced confusion in the real economy (incl. the corporate bond market), actions to constrain volatility can be said to be appropriate. In our view, the 'negative impact on the real economy' is a key point when considering actions by the BOJ (incl. those in the future).

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