Daiwa's View

Are markets 'selling Asia,' rather than selling Japan?

- There's increasing evidence that focus of selling is shifting to Asia

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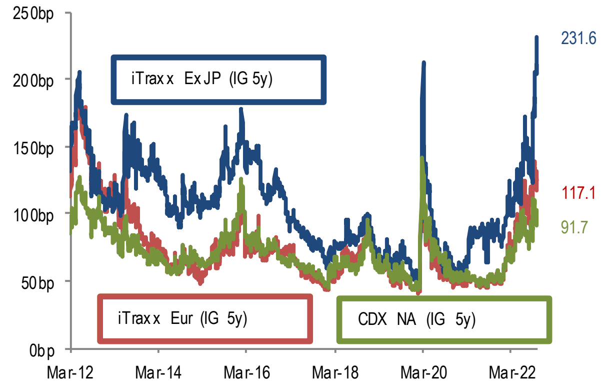
◆ Extraordinary deterioration of Asian CDS

Yesterday, the iTraxx Asia ex-Japan CDS Index, which covers Asian entities excluding Japan, rapidly widened to 231bp against the tightening of European and US indices. The index reached a new high, exceeding the levels reached during the European debt crisis in 2012, the China shock in 2015-16, and the COVID-19 pandemic in 2020 (left-hand chart below). The sovereign bond market is also facing an extraordinary situation. In several *Daiwa's View* reports in the past, we have reported about signs of moves to sell assets in Asia and emerging nations. As of the writing of those reports, the dollar-denominated Chinese sovereign 5-year CDS Index had stood at 86bp on 4 July and 112bp on 12 October, but the index widened to 135bp yesterday. The level of the Chinese index has now exceeded that of the Malaysian Index (120bp, right-hand chart below).

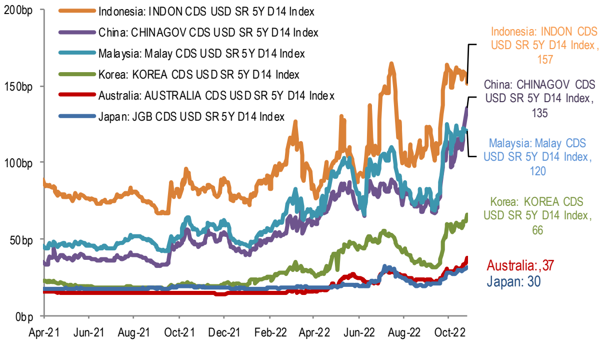
Needless to say, China is the world's second largest economic power, and, therefore, the possibility of it actually going into default is naturally low. Currently, the Chinese sovereign CDS Index is widening, underperforming indices of other Asian nations. The iTraxx Asia ex-Japan CDS Index is also widening rapidly, diverging from indices in Europe and the US. These conditions suggest the possibility that hedging allowances (credit valuation adjustments: CVAs) against Asian risk assets are increasing, including in the context of counterparty exposure management. While moves to sell European assets have let up amid the appearance of favorable factors for the UK financial market, the target of selling may be shifting to the Asian region.

CDS Index in US, Europe, Asia (5-year)



Source: Bloomberg; compiled by Daiwa Securities.

Dollar-denominated Sovereign 5-year CDS Index

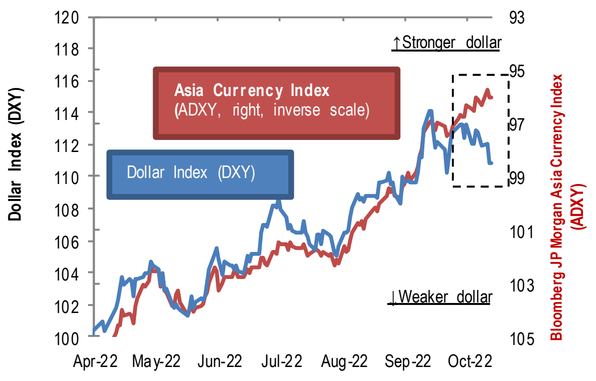


Source: Bloomberg; compiled by Daiwa Securities.

◆ Is currency market also 'selling Asia?'

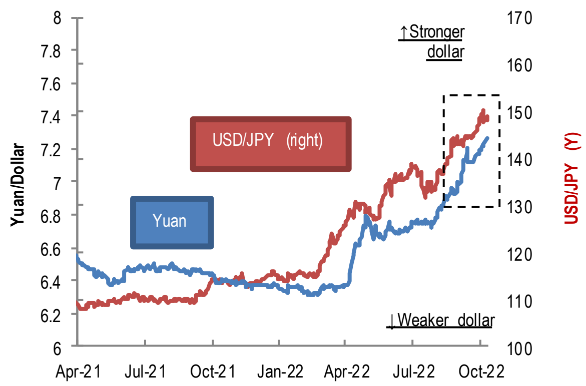
The situation for currencies appears to be similar. Until a short time ago, the topic of the day was the singular strength of the US dollar. However, with the yen recently weakening against the euro, as well, some think that it will only be the yen that weakens in the end, and that yen depreciation will not stop unless there are policy revisions by the BOJ. I don't deny that that is a possibility. However, a comparison of the Dollar Index and the Bloomberg JP Morgan Asia Currency Index (ADXY) indicates a shift from the singular strength of the dollar thus far towards 'selling Asian currencies' (left-hand chart below). The yuan is also continuing to weaken, even after the USD/CNY rate exceeded $7, apparently indicating a similar trend to that of the yen (right-hand chart below). Given this and the above-mentioned CDS developments, interpreting this in the context of 'selling Asia' feels like a better fit.

Dollar Index, Asia Currency Index



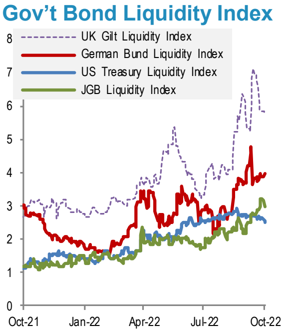
Source: Bloomberg; compiled by Daiwa Securities.

USD/JPY, Chinese Yuan



Source: Bloomberg; compiled by Daiwa Securities.

Gov't Bond Liquidity Index



Source: Bloomberg; compiled by Daiwa Securities.

Excessive focus on Japan-specific factors could cause us to trip up

This 'selling Asia' may be related to recent weak demand in the JGB market. Recently, the liquidity index of JGBs has been approaching that of European bonds, exceeding that of US bonds. Many people feel that stronger selling pressure and lower liquidity are caused by concerns about 'the singular weakness of the yen' and 'policy revisions by the BOJ.' While we can't deny that this could be the case, a global comparison and product comparison imply that something is happening on a much bigger scale. As our Chief Market Economist Mari Iwashita pointed out in yesterday's report, the BOJ is now more wary of the downside risks of overseas economies than higher-than-expected prices. If the risk of a 'storm' is increasing not only in US/Europe but also in the Asian region, we might trip up if we were to be overly focused on Japan-specific factors and/or make the mistake of thinking that global factors only consist of US/Europe factors.

A panicked mindset appears to be spreading due to an excessive decline in sentiment in the JPY bond market. Therefore, I have listed items on the next page that are a summary by Mr. Howard Marks of market cycle trends. The course of action that should be considered by investors (not speculators) in the current cycle (or phase) should be self-evident after confirming whether the current JPY bond market more closely resembles a situation in which "Investors should forget about the risk of losing money and worry only about missing opportunity" or a situation in which "Investors should forget about missing opportunity and worry only about losing money."

Items in Market Cycle Trends

Investors should forget about the risk of losing money and worry only about missing opportunity. This is the time to be aggressive!	Investors should forget about missing opportunity and worry only about losing money. This is the time for caution!
Media report only bad news.	Media carry only good news.
Securities markets weaken.	Securities markets strengthen.
Investors become worried and depressed.	Investors grow increasingly confident and optimistic.
Risk is seen as being everywhere.	Risk is perceived as being scarce and benign.
Investors see risk-bearing as nothing but a way to lose money.	Investors think of risk-bearing as a sure route to profit.
Fear dominates investor psychology.	Greed motives behaviors.
Demand for securities falls short of supply.	Demand for investment opportunities exceeds supply.
Asset prices fall below intrinsic value.	Asset prices rise beyond intrinsic value.
No one considers improvement possible. No outcome seems too negative to happen.	No one can imagine things going wrong. No favorable development seems improbable.
Everyone assumes things will get worse forever.	Everyone assumes things will get better forever.
Investors ignore the possibility of missing opportunity and worry only about losing money.	Investors ignore the possibility of loss and worry only about missing opportunities.
No one can think of a reason to buy.	No one can think of a reason to sell, and no one is forced to sell
"Don't try to catch a falling knife" takes the place of "buy the dips."	Investors would be happy to buy if the market dips.
Prices reach new lows.	Prices reach new highs.
The media fixate on this depressing trend.	Media celebrate this exciting event.
Investors become depressed and panicked.	Investors become euphoric and carefree.
Security holders feel dumb and disillusioned. They realize they didn't really understand the reasons behind the investments they made.	Security holders marvel at their own intelligence; perhaps they buy more.
Those who abstained from buying (or who sold) feel validated and are celebrated for their brilliance. Those who held give up and sell at depressed prices, adding further to the downward spiral.	Those who've remained on the sidelines feel remorse; thus they capitulate and buy
Implied prospective returns are sky-high.	Prospective returns are low (or negative).

Source: Excerpted from Mastering the Market Cycle *by Howard Marks.*

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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.

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** 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.

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