Daiwa's View

10-year UST yield above 4% and JGB reversion

- Conditions more likely to encourage JGB reversion compared to last year

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.

I am pleased to announce that I was awarded first place in the 2023 Nikkei Veritas Analyst Rankings (Fixed Income Analyst Category). Allow me to express my deepest gratitude to everyone for their support.

10-year UST yield above 4% and JGB reversion

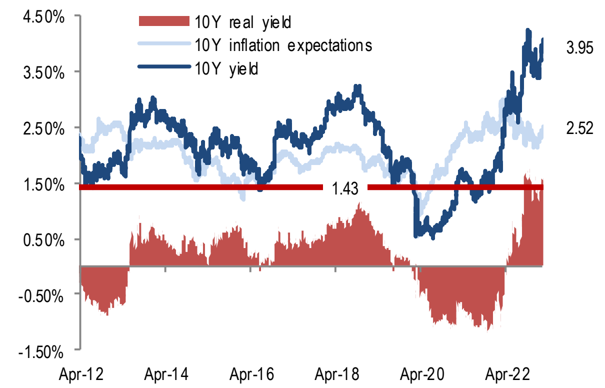
Conditions more likely to encourage JGB reversion compared to last year

Nikkei Veritas ranked me as the top fixed income analyst in its rankings for 2023. I want to thank everyone for their support. This honor of receiving the top ranking for the first time is especially moving for me as it coincides with the (planned) appointment of Kazuo Ueda, who was a professor at the University of Tokyo when I was an undergraduate there. Since the end of World War Two, it has been customary to fill the post of BOJ Governor with someone from the BOJ or MOF. However, this year will be one of change beyond such unwritten rules of the past. We feel that Ueda's appointment symbolizes that Japanese finance, which had become stuck in a certain sense, has reached an inflection point in terms of steering its course in a direction that places more emphasis on academic approaches. In order to further evolve our reports so that they are more appropriate for a new era of monetary policy, we will continue to provide information with a greater emphasis on data.

◆ <u>10-year UST yield briefly tops 4% on higher terminal rate</u>

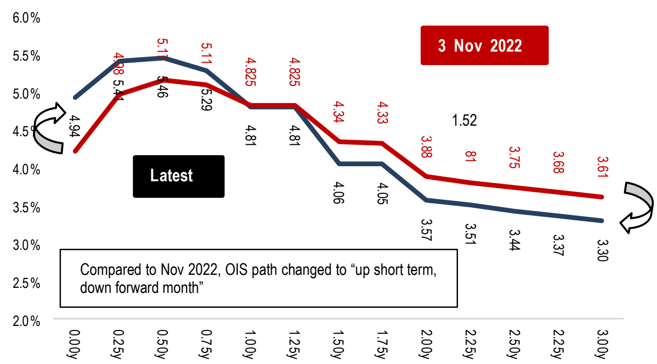
Meanwhile, the 10-year US Treasury yield briefly topped 4% over the past week. The main factor was the change in the trajectory for US interest rate hikes. Even compared to 3 November, when the 10-year US Treasury yield was above 4%, a rise in the expected terminal interest rate (point at which Fed stops raising rates) of about 30bp (from 5.17 to 5.46%) was factored in. The higher expected terminal rate is likely due to a change in perception of the economic situation and the resulting expectations for dot chart changes (hike) at the March FOMC meeting.

10Y US Yield



Source: Bloomberg; compiled by Daiwa Securities.

OIS 3-month Forward Rates



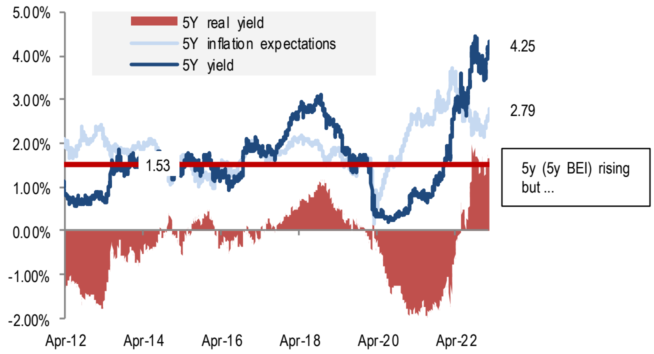
Source: Bloomberg; compiled by Daiwa Securities.

FICC

◆ Differences compared to last year's 10-year UST yield move over 4%

That said, there are some differences compared to the last time the 10-year US Treasury yield topped 4%, in November 2022. Comparing the 3-month forward overnight index swap (OIS) rate to 3 November 2022, the expected terminal rate rose by about 30bp, while the expected 3-year forward OIS yield has diverged downward by about -30bp. A similar phenomenon can be observed with the 5-year Treasury yield and the 5-year/5-year forward Treasury yield. While the 10-year US Treasury yield has moved above 4% and the 5-year yield has climbed to 4.25%, the 5-year/5-year forward yield remains in a 3-4% range at 3.62%. Even looking at the breakeven inflation (BEI) rate, the 10-year BEI rate rose to 2.52%, near the upper end of its range, but the 5-year/5-year forward BEI rate, which indicates long-term expectations, remained stable at 2.28%. Here, we can see that most of the increase was due to the 5-year BEI rate increase to 2.79%. Of course, the extent of inverted yields has certain limits, so if the terminal rate rises to some extent, the 10-year US Treasury yield would also rise in tandem. However, the current trend of rising US Treasury yields led by short/medium-term maturities suggests that the market remains confident that the 10-year US Treasury yield will return to the 3-4% range over the long term, even if it briefly tops 4%. This is a significant difference from the situation when the 10-year US Treasury yield rose last year.

5Y US Yields



Source: Bloomberg; compiled by Daiwa Securities.

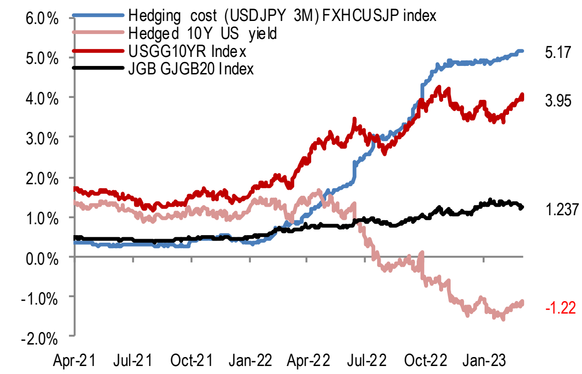
5Y5Y US Yields

Source: Bloomberg; compiled by Daiwa Securities.

◆ JGB reversion

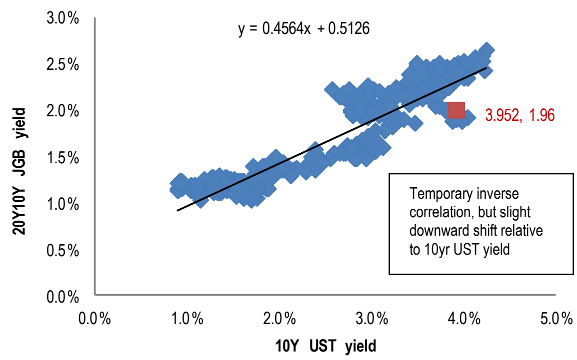
However, the Fed's higher rate hike trajectory is directly linked to expectations among investors in non-USD assets, including Japanese investors, that hedging costs will remain stuck at high levels. This is one factor likely to encourage Japanese investors to return to JGBs in the next fiscal year and beyond. Of course, the extreme inverse correlation between rising US Treasury yields and falling super-long JGB forward yields seen last week will not continue and a return to the normal relationship that is to some extent tied to the 10-year US Treasury yield seems likely. Still, there is the strong possibility that JGB yields have shifted slightly lower relative to the 10-year US Treasury yield. The future for JGB yields is expected to be a mix of upward pressure brought about by US Treasury yields and downward pressure brought about by investors returning JGBs due to higher hedging costs. This is probably another difference from situation when the 10-year US Treasury yield rose last year.

10Y US Yield, Hedging Cost, JGB Yields



Source: Bloomberg; compiled by Daiwa Securities.

10Y US Yield, 20Y10Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

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, Japan Security Token Offering Association