

Outlook for Japanese Bond Market

~View Based on Global Economic Conditions~

December 2012

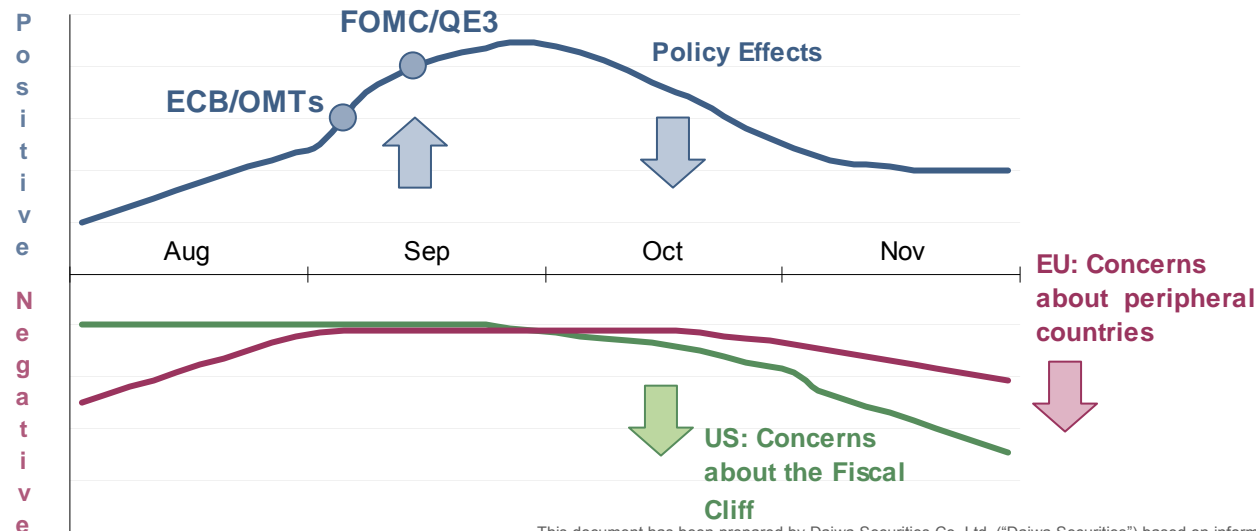
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Fixed Income, Currency and Commodities Research Dept.

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Shift Toward Risk-off Mode

- **US: Concerns about the fiscal cliff**
Downtrend in US stocks
- **Europe: Concerns about peripheral countries**
Slowdown in fundamentals
- **China: Concerns about medium- and long-term growth**
Falling Chinese stocks
- **Japan: Concerns about external factors**
Economic slowdown led by external demand, despite relatively stable domestic demand

Change in Market Sentiment (image)



Fading Policy Effects (1)

FOMC

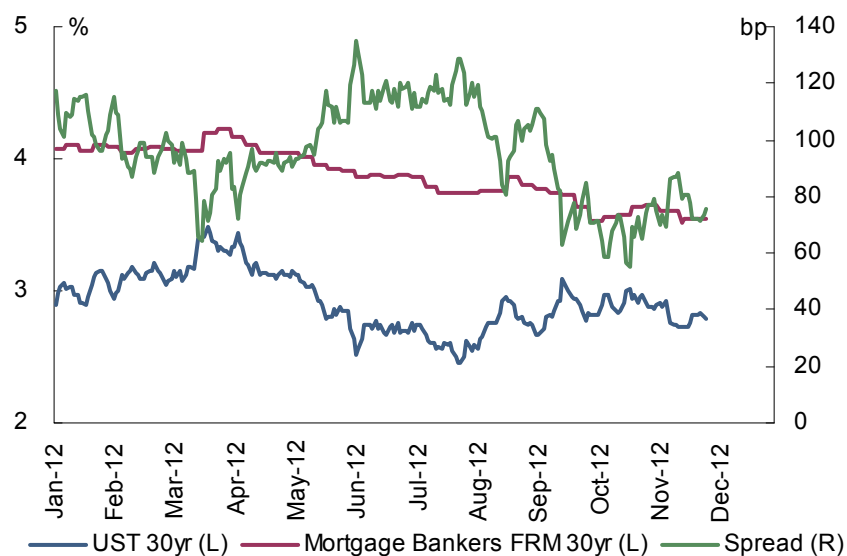
Intends to continue easing until “substantial and sustainable” growth is realized

QE3: Implementation of “open-ended” asset purchases



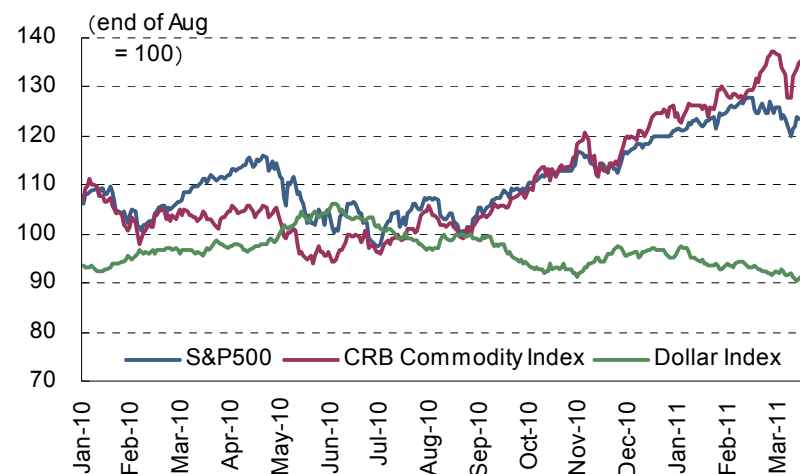
- Not resulting in higher stock/commodity prices or weaker dollar
- Limited decline in mortgage loan interest rates

30Y US Treasury Yield and Mortgage Loan Rate



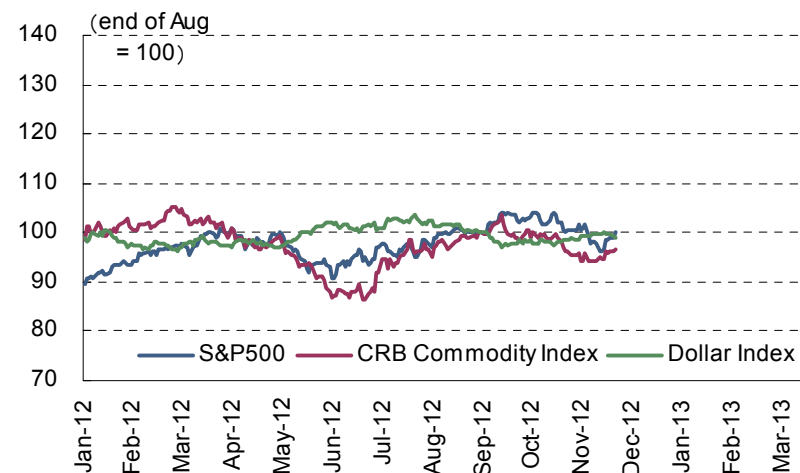
Source: Mortgage Bankers Association, Bloomberg

QE2 (2010)



Source: Bloomberg

QE3 (2012)



Source: Bloomberg

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Fading Policy Effects (2)

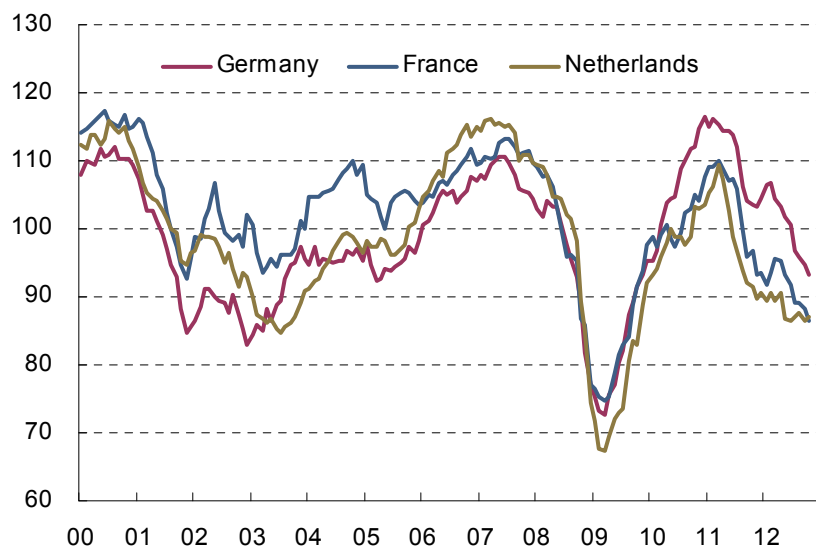
■ ECB

Ready to do whatever it takes to preserve euro
OMTs: Purchases of bonds (with maturity of up to 3 years) issued by Eurozone member-states under certain conditions



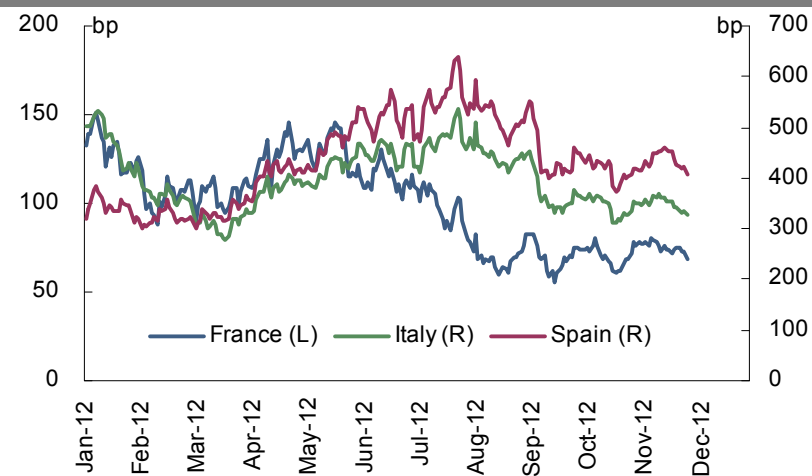
- Slowdown in fundamentals of core countries
- Winding down of spread tightening in peripheral countries

Eurozone Economic Sentiment



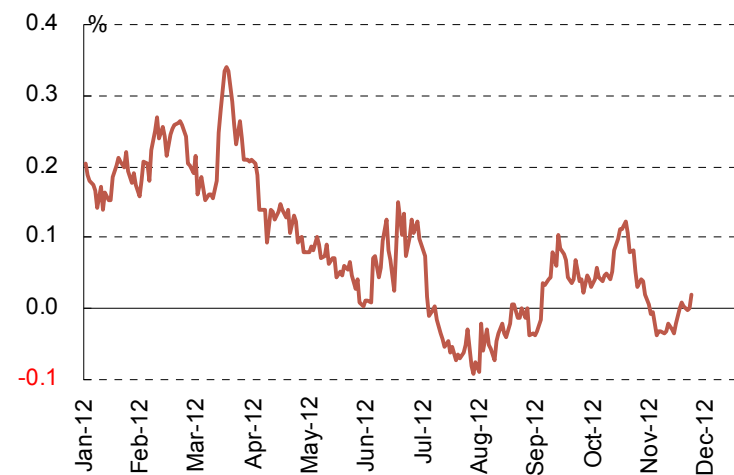
Source: European Commission

Spread of European Nations over Germany (10Y)



Source: Bloomberg

German Government Bonds (2Y)



Source: Bloomberg

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Fading Policy Effects (3)

■ BOJ

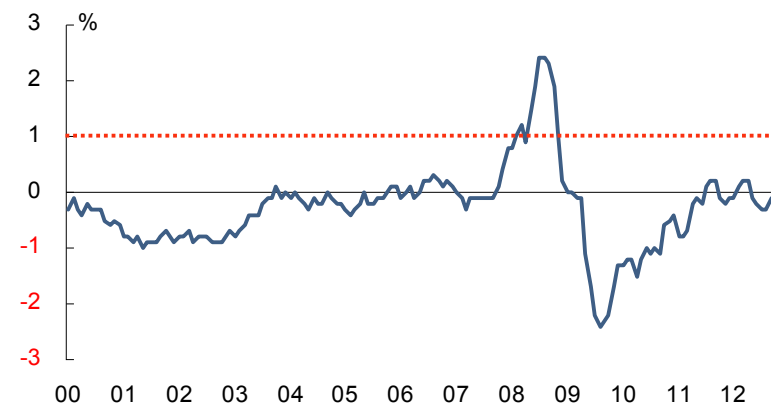
BOJ will continue with this powerful easing until it judges the 1 percent (CPI) goal to be in sight

- * Increased size of asset purchase program for two months in a row
- * Establishment of framework for fund-provisioning measure to stimulate bank lending
- * Measures aimed at overcoming deflation (joint statement with government)



- Problem is slowdown in demand for funds in private sector
- Limited effects from monetary policy

Japan CPI Nationwide Ex. Fresh Food (y/y)



Source: Ministry of Internal Affairs and Communications Japan

Increase in Asset Purchase Program

(Trillion yen)																
	Program size at the time of establishment (Oct.10-)	After 1st increase (Mar.11-)	After 2nd increase (Aug.11-)	After 3rd increase (end Oct.11-)	After 4th increase (Feb.12-)	After 5th increase (end Apr.12-)		Revision of Components (Jul.12-)		After 6th increase (Sep.12-)			Recent program size (Oct.12-)			progress**
Asset Purchases	5	10	15	20	30	35	40	40	45	40	50	55	40	53	66	35 53%
JGBs	1.5	2.0	4.0	9.0	19.0	24.0	29.0	24.0	29.0	24.0	29.0	34.0	24.0	31.5	39.0	21.6 55%
TDBs	2.0	3.0	4.5	4.5	4.5	4.5	4.5	9.5	9.5	9.5	14.5	14.5	9.5	14.5	19.5	7.4 38%
CPs	0.5	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	→	2.2	1.7 78%
CBs	0.5	2.0	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	→	3.2	2.9 90%
ETFs	0.45	0.9	1.4	1.4	1.4	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	→	2.1	1.4 69%
J-REITs	0.05	0.1	0.11	0.11	0.11	0.12	0.12	0.12	0.12	0.12	0.12	0.12	0.12	→	0.13	0.11 85%
Funds-supplying*	30	30	35	35	35	30	30	25	25	25	25	25	25	25	25	29 117%
3M term	20	20	20	20	20	20	20	-	-	-	-	-	-	-	-	-
6M term	10	10	15	15	15	10	10	-	-	-	-	-	-	-	-	-
Total	35	40	50	55	65	65	70	65	70	65	75	80	65	78	91	64 71%
will be completed by:	End-Dec.11	End-Jun.12	End-Dec.12	End-Dec.12	End-Dec.12	End-Dec.12	End-Jun.13	End-Dec.12	End-Jun.13	End-Dec.12	End-Jun.13	End-Dec.13	End-Dec.12	End-Jun.13	End-Dec.13	

US: Concerns About the Fiscal Cliff

- US presidential election ended with reelection of President Barack Obama
- Market interest shifted to the fiscal cliff
 - How “divided congress” will cope with the fiscal cliff
 - How much the cliff will have the impact
 - Concerns about higher taxes on capital gains and dividends

Fiscal Cliff

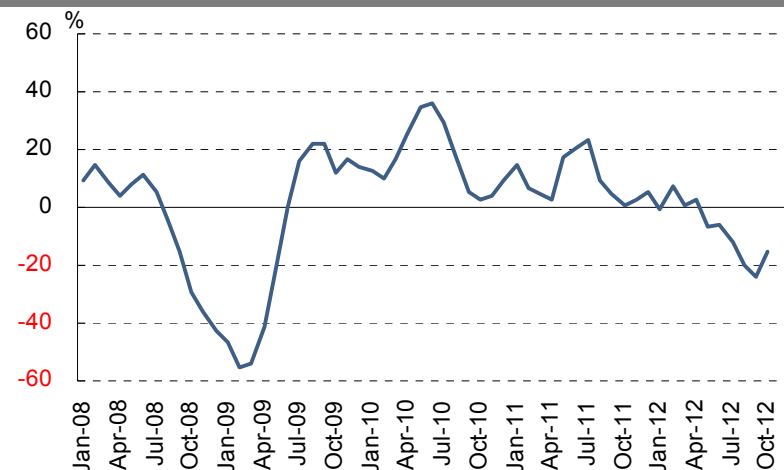
(\$ Bln)	FY2013 Oct.2012~ Sep.2013	CY2013 Jan.2013~ Dec.2013
<u>Changes in Specified Revenue Policies</u>		
Income Tax, Estate and Gift Tax Provisions	221	295
Payroll Tax	95	127
Other Tax Provisions	65	87
Taxes from the Affordable Care Act	18	24
Subtotal	399	532
<u>Changes in Specified Spending Policies</u>		
Control Act of 2011	65	87
Benefits	26	35
Doctors	11	15
Subtotal	103	137
Miscellaneous	105	140
Total	607	809

Source: US Congressional Budget Office

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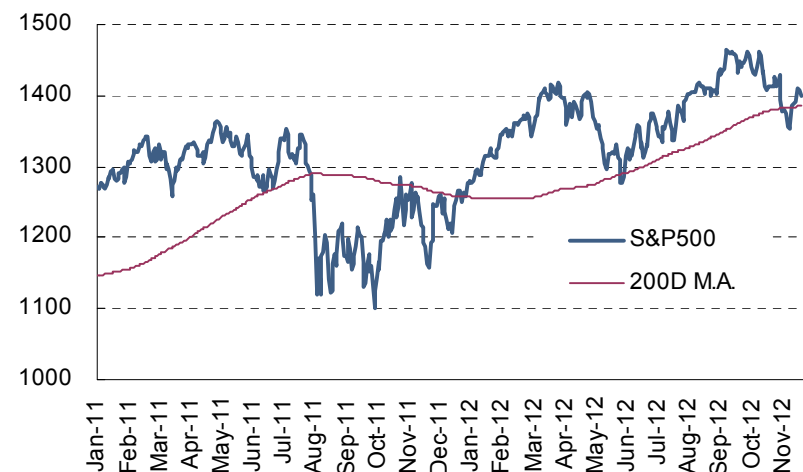
Fiscal cliff may drag
down GDP by 4%

Core Capital Goods Orders (3M MA annualized)



Source: US Commerce Department

S&P 500



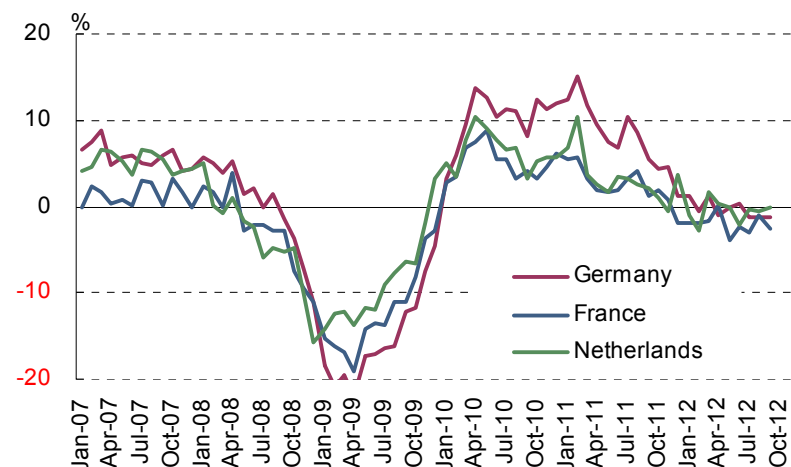
Source: Bloomberg

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Europe: Negative Feedback Loop to Emerge Again ?

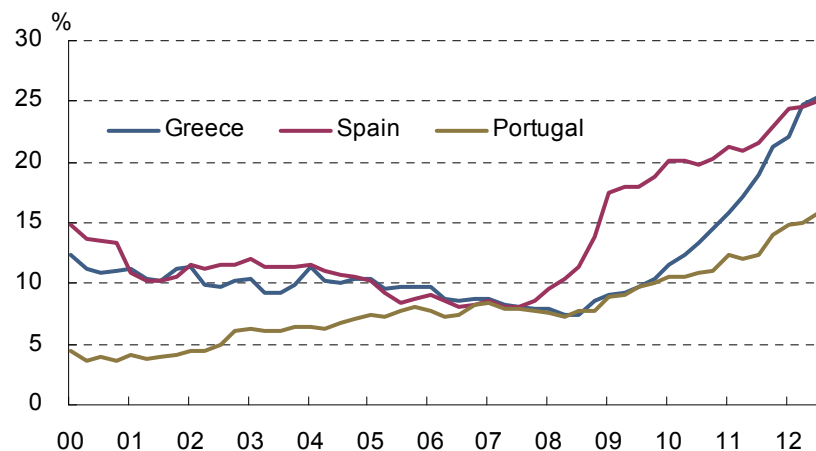
- Slowdown in fundamentals
Although tail risk diminished significantly thanks to ECB's OMTs, there is no panacea for real economy
 - ECB
"Euro area unemployment rate remains deplorably high"
"Growth momentum in Eurozone would remain weak in 2013"
- ↓
- Policy measures such as OMTs are working as backstop, but limited ripple effects in real economy revealed

Industrial Production in Core European Nations



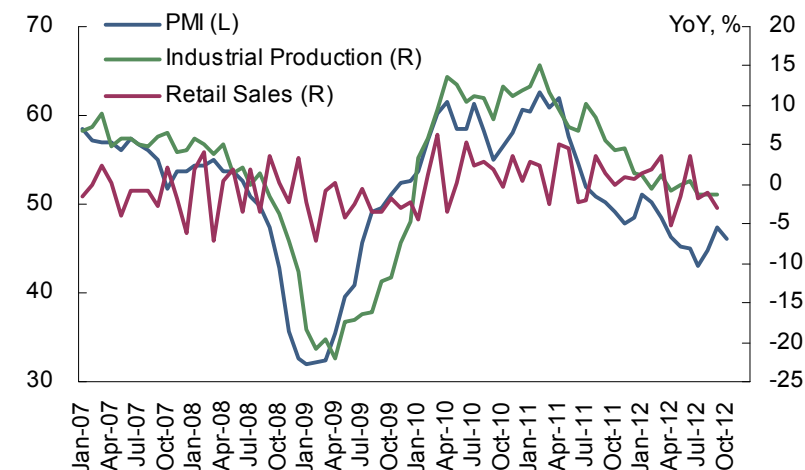
Source: German Economics Ministry, French Statistics Office, Dutch Statistics Office

Unemployment rate in peripheral Countries



Source: National Statistical Service of Greece, Spanish Labour Ministry, Portugal Statistics Institute

German Economy

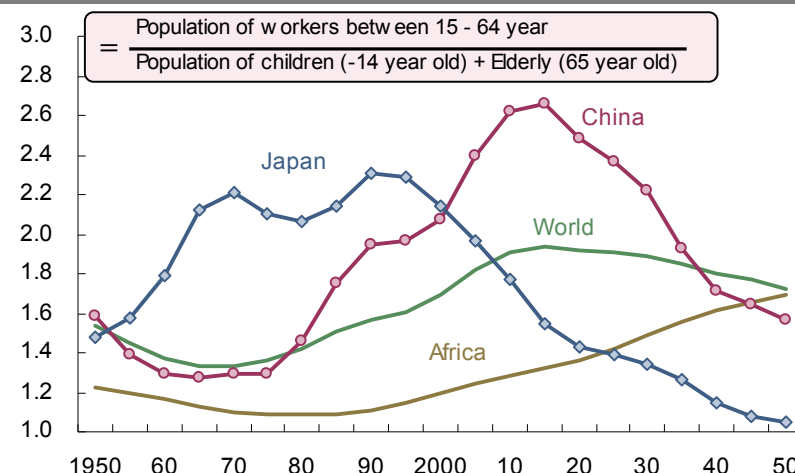


Source: Markit, German Economics Ministry, German Federal Statistics Office

China: Concerns About Medium- and Long-term Growth

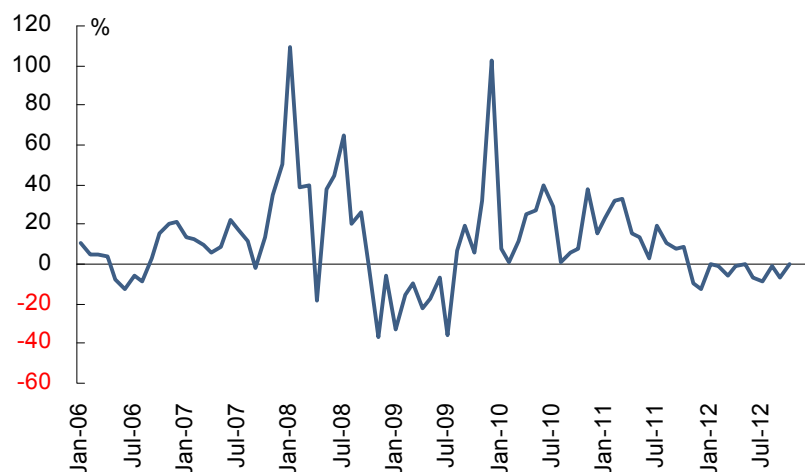
- From a medium and long-term viewpoint, China's demographic dividend is expected to hit peak in mid-2010s. Thus, growth trend to decline in not-so-distant future in terms of demographics
 - BOJ: "Challenge is to whether soft landing (from high to medium growth) is realized, amid adjustment of two factors over short term: (1) population transfer from farming villages to the cities and (2) decline in working-age population in a few years"
 - RBA: "Looking ahead, the peak in resource investment is likely to occur next year, and may be at a lower level than earlier expected"

Demographics in China



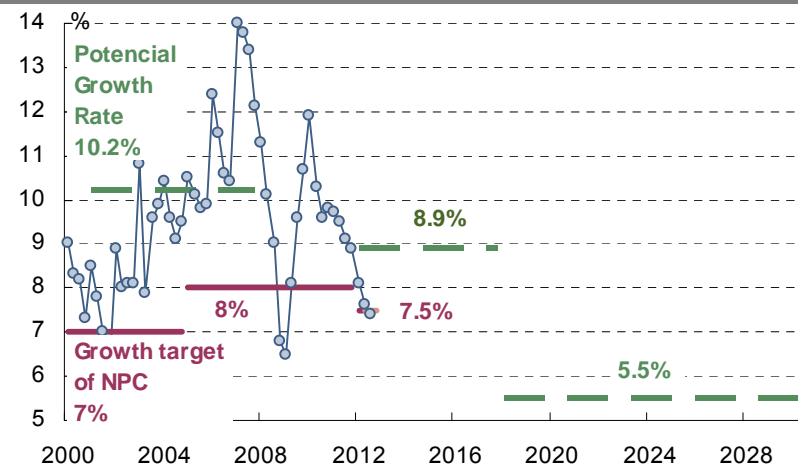
Source: World Population Prospects, the 2010 Revision

FDI Foreign Capital Actually Utilized (y/y)



Source: National Bureau of Statistics of China

Growth Rate in China



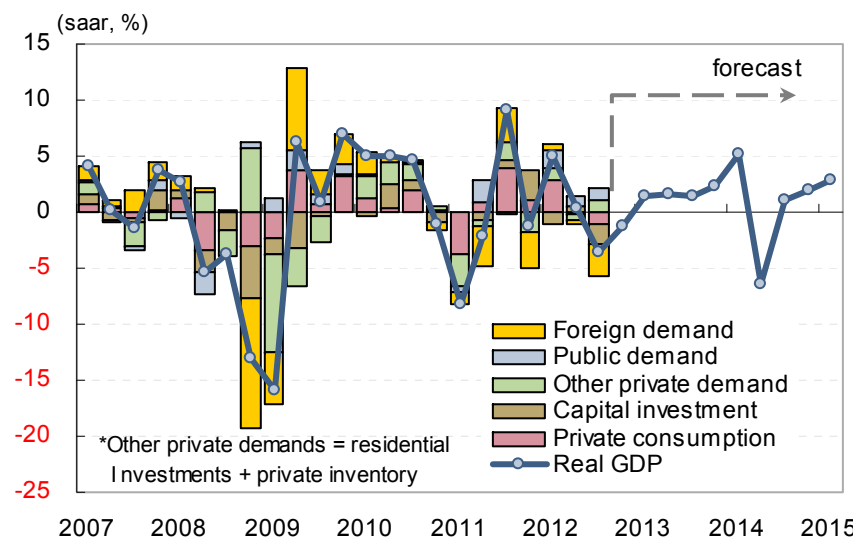
Source: OECD, National Bureau of Statistics of China

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Japan: Economy Entered Recessionary Phase?

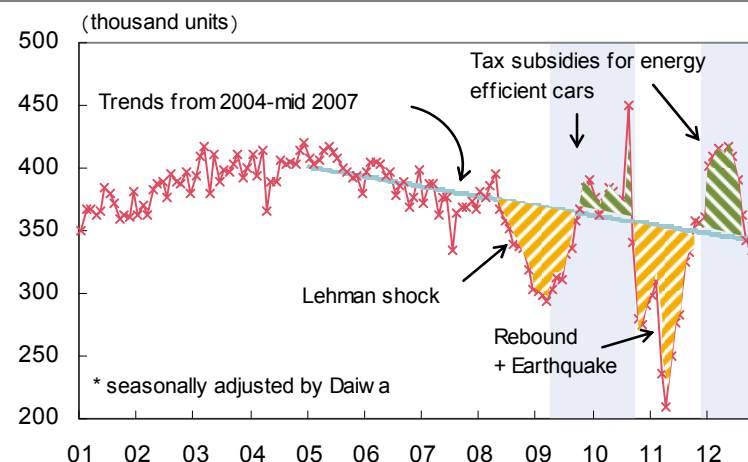
- Domestic demand has been relatively stable, but reconstruction demand and boosts from government's subsidy program for environmentally friendly vehicles (both of which supported steady domestic demand) gradually diminished
- Exports plunged due to slowdown in overseas economy, negatively affecting production
- Worsened Sino-Japan relationship caused by the Senkaku islands dispute brought further damage
- Tumble in Jul-Sep real GDP
As real GDP likely to remain negative growth in Oct-Dec, Japan's economy appears to have entered recession

Real GDP Trend



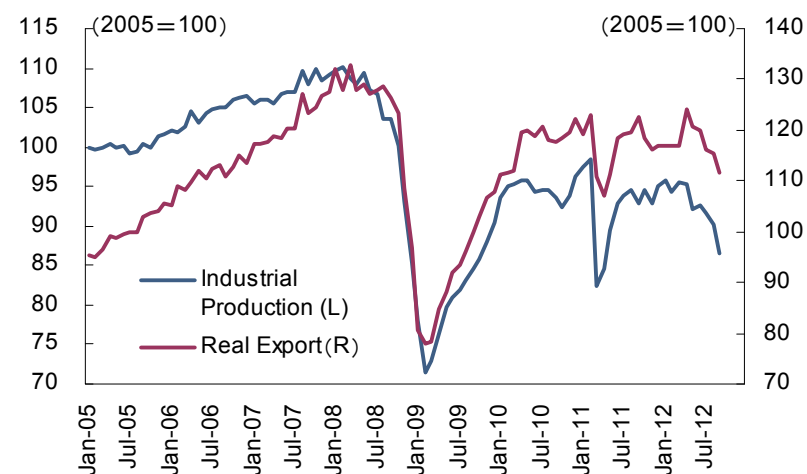
Source: CAO, Daiwa Securities

New Car Sales in Japan



Source: Japan Automobile Dealers Association, Japan Mini Vehicles Association, Daiwa Securities

Industrial Production and Real Export



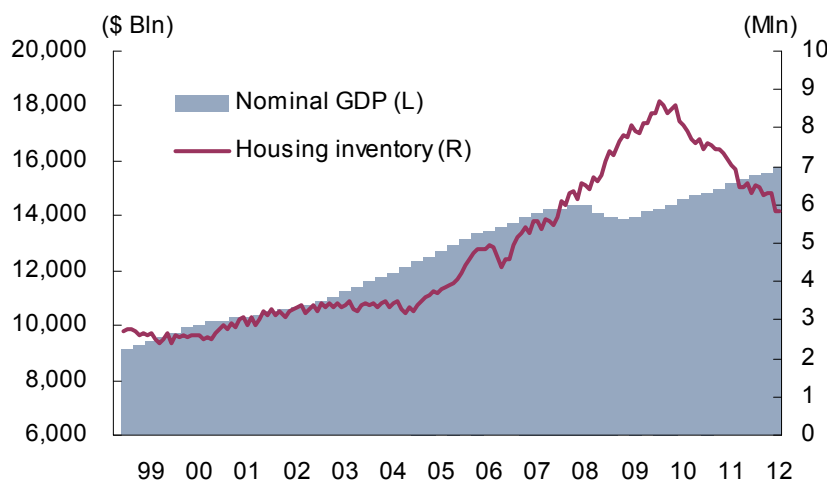
Source: Ministry of Economy, Trade and Industry Japan, BOJ

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US: Expectations for Economic Recovery (1)

- Ongoing recovery of housing market
NAHB Housing Market Index recovered to the 2006 level
Housing inventories declined to reasonable level
- Continuous increase in bank lending
- Steady personal spending
University of Michigan Consumer Sentiment Index rebounded to the 2007 level
- Solid employment
Unemployment rate lowest since President Obama takes the reins

Housing Inventories and US GDP



Source: US Commerce Department, National Association of Realtors, Mortgage Bankers Association; compiled Daiwa Securities

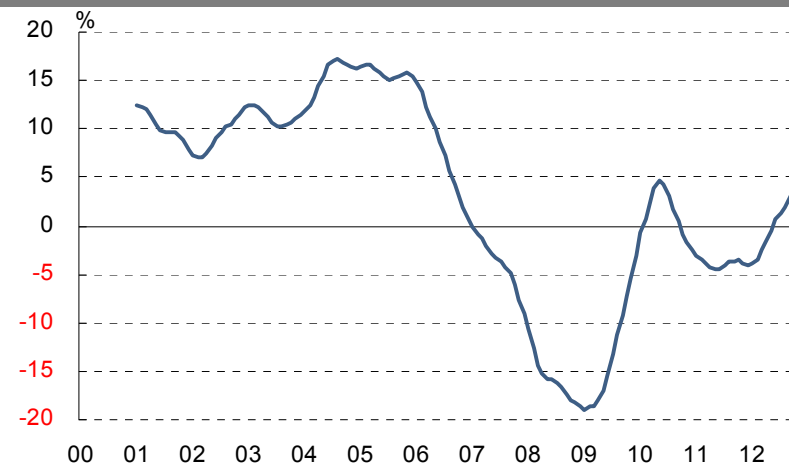
Note: Housing inventory = Available for sale (Existing-Home) + Shadow Inventory Estimates

NAHB Homebuilders Index



Source: National Association of Home Builders

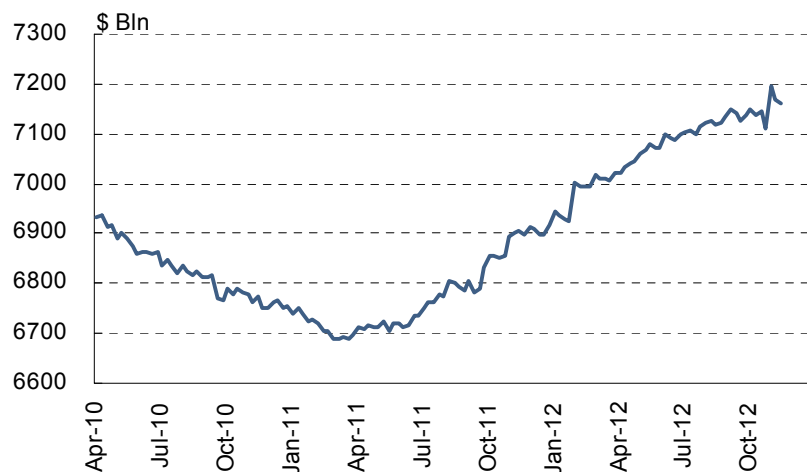
S&P/Case-Shiller Home Price Index (20-city, y/y)



Source: S&P/Case-Shiller

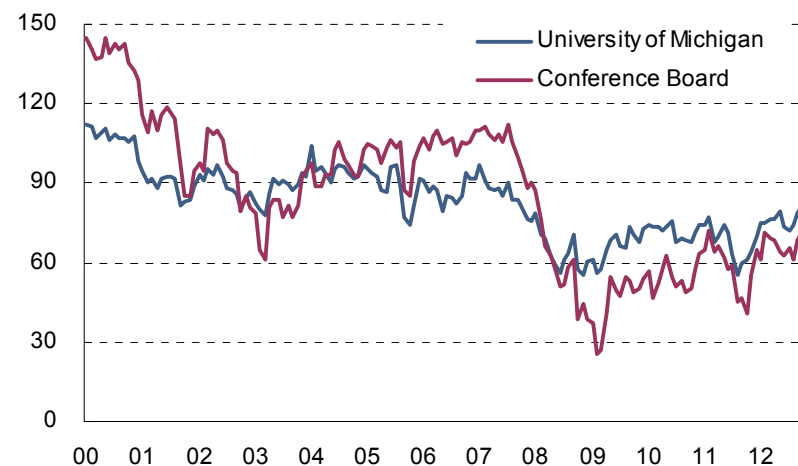
US: Expectations for Economic Recovery (2)

Lending at US Commercial Banks



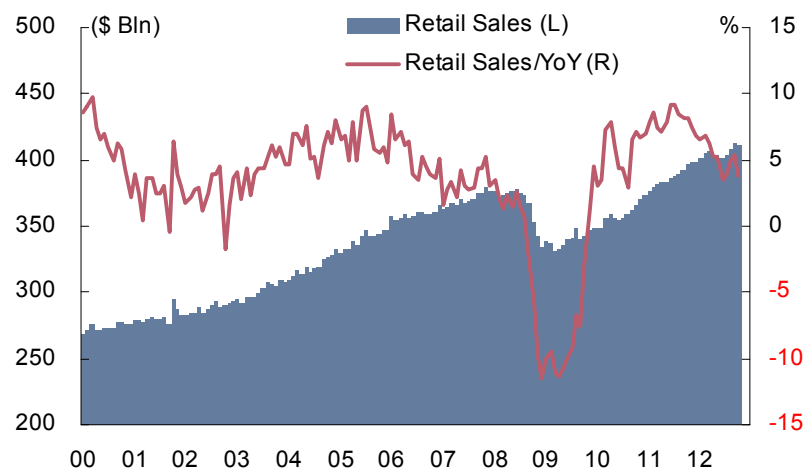
Source: FRB

Consumer Confidence



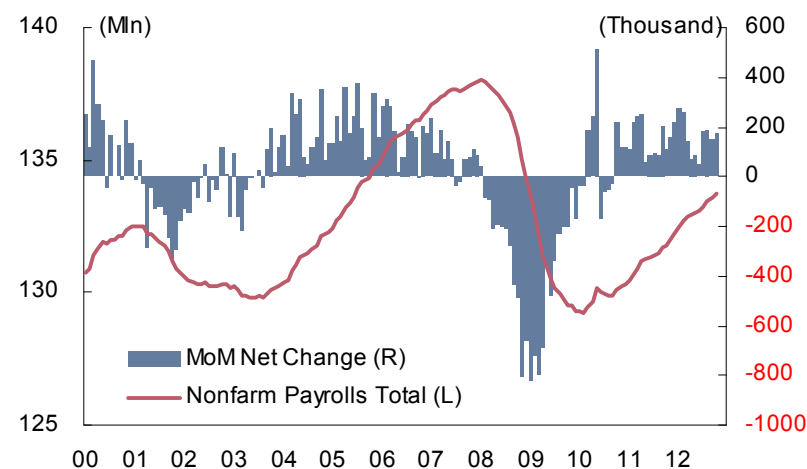
Source: University of Michigan, Conference Board

Retail Sales



Source: US Commerce Department

Nonfarm Payroll Employment



Source: US Labor Department

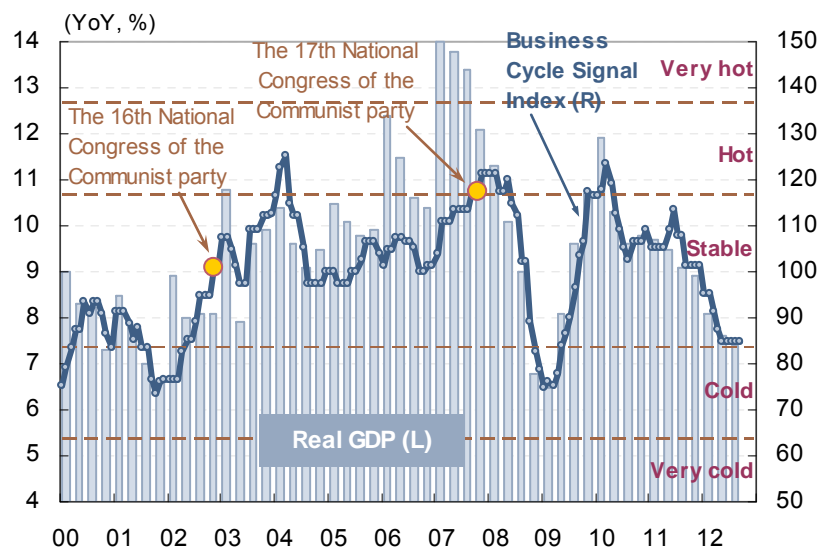
China: Signs of Economic Bottom

- Prolonged economic slowdown
- Signs of economic bottom from short-term viewpoint
- Slowdown in CPI



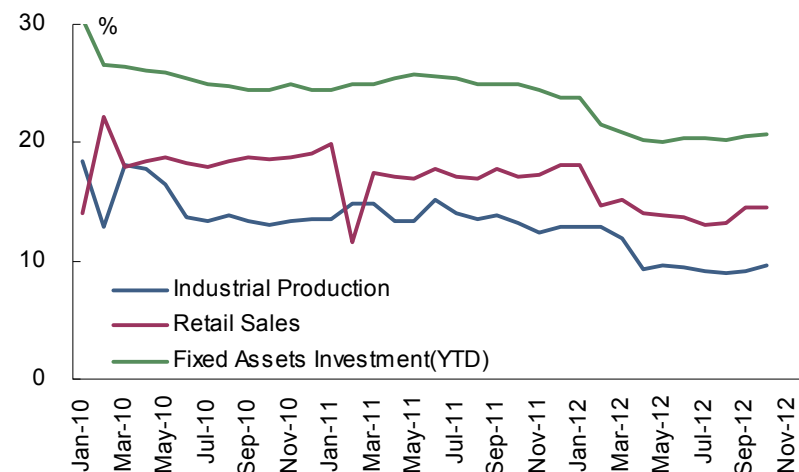
- Expectations for additional easing
- Expectations for fiscal spending by new regime

China's Economic Trend



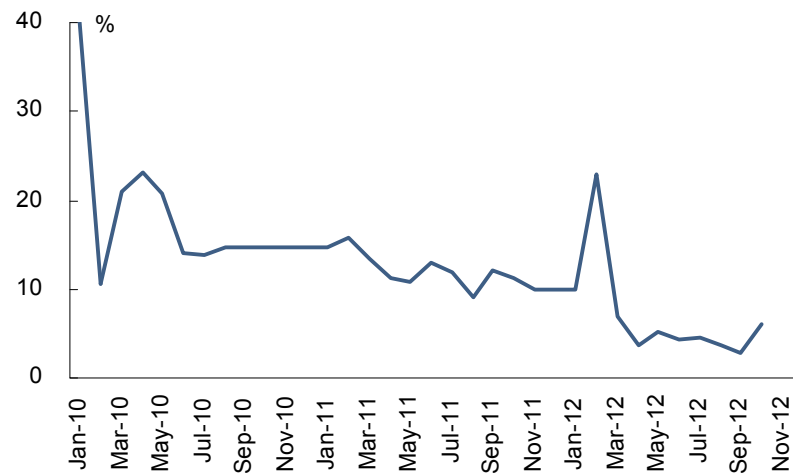
Source: National Bureau of Statistics of China

Industrial Production, Retail Sales, Fixed Assets Investment (y/y)



Source: National Bureau of Statistics of China

Electricity Consumption (y/y)

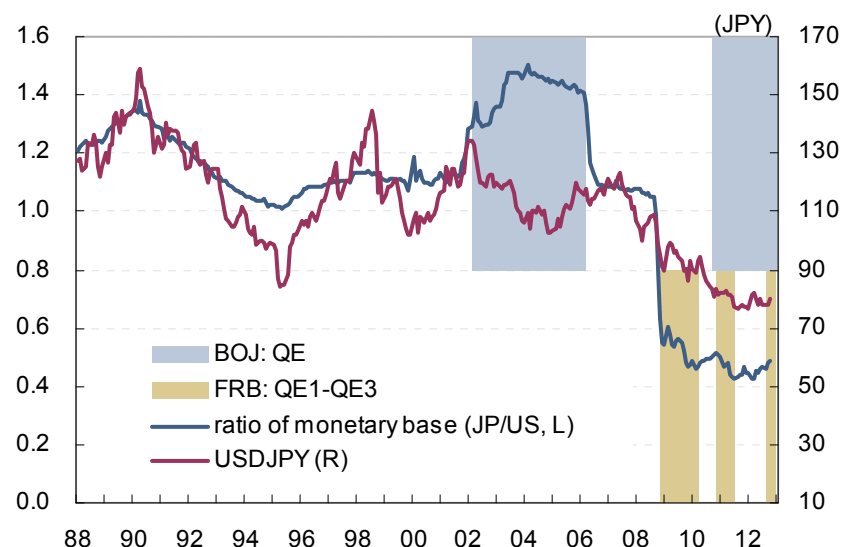


Source: China National Energy Administration

Japan: Expectations for Weaker Yen

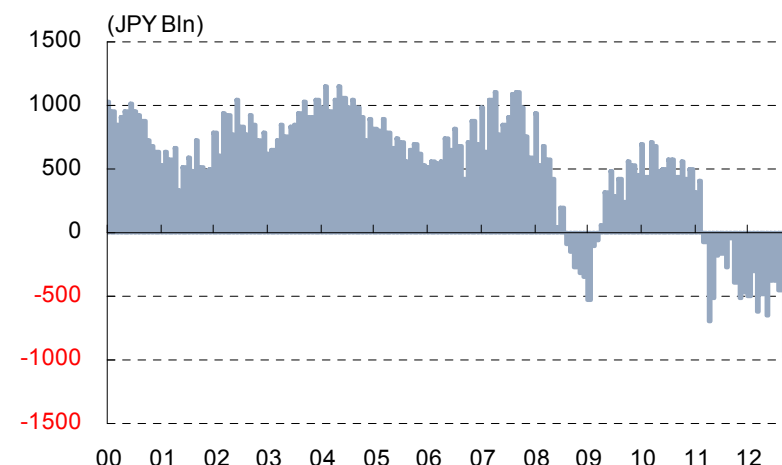
- Unwinding of flight-to-quality trade
- Widening gap in interest rates between Japan/US
- Prolonged trade deficit
- Stimulating Bank Lending Facility newly launched by BOJ
 - BOJ: "Discussion on foreign bond purchases by BOJ is nearly breaking rules internationally. However, even if yen carry trade under this framework causes yen depreciation, such trade does not break rules. This is because the reaction on the forex market is simply a result of monetary easing."

Solos Chart



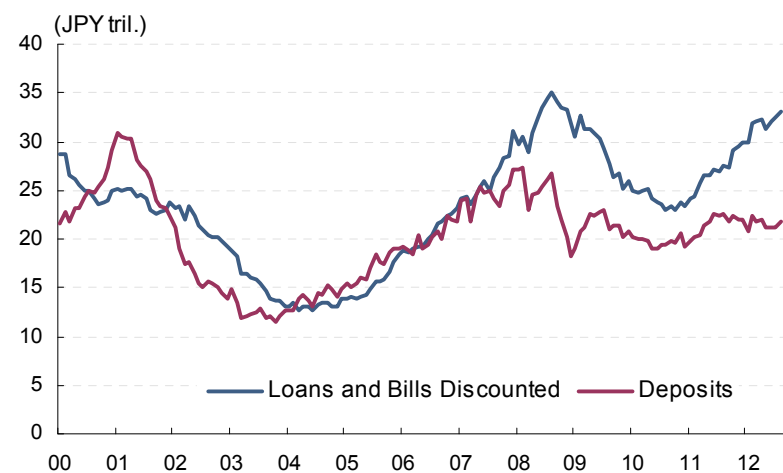
Source: BOJ, FRB

Trade Balance (Seasonally adjusted)



Source: Ministry of Finance Japan

Loans and deposits of overseas branches of Japanese city banks

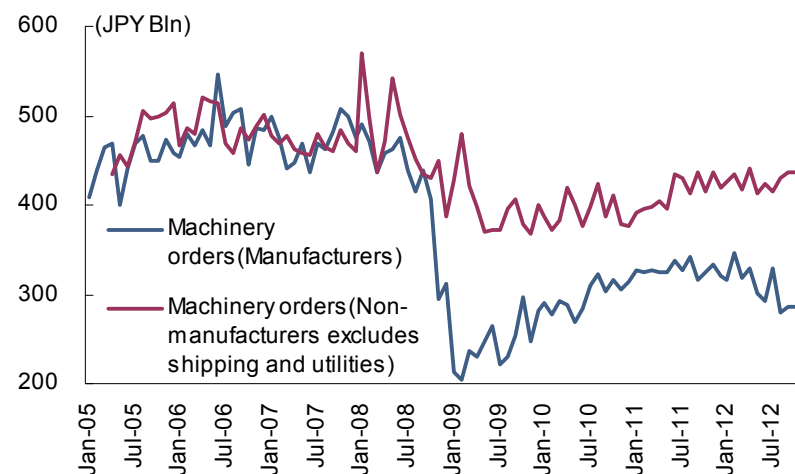


Source: BOJ

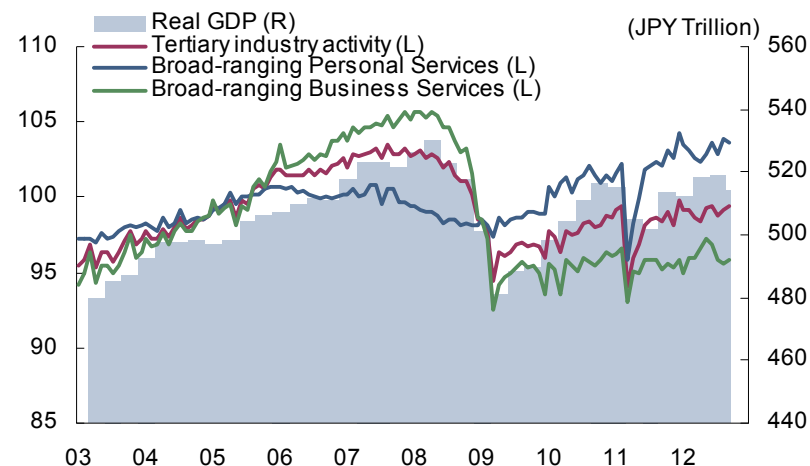
Japan : Expectations for Economic Recovery

- Somewhat slowdown in manufacturing sector due to high dependence on overseas economy
- Non-manufacturing sector manages to remain flat; growth is likely in FY2013
 - Growth should strongly depend on external demand, but there are signs of recovery in US and China
- Expectations for new administration led by Shinzo Abe
 - “Intention to implement bolder policies than those under former LDP administrations”
 - “The market does not react unless an unlimited easing policy is taken with inflation target of 2% or 3%”
 - “BOJ should cut overnight call rate to zero or negative rate in order to strengthen pressure to lend.”
 - Public investment worth Y200 trillion over ten years? “Basic bill to strengthen national land” submitted based on prior disaster prevention strategy (4 June 2012) Infrastructure investment of Y200 trillion (incl. private fund) over ten years
 - Revision to Bank of Japan Act? Term of BOJ Governor Masaaki Shirakawa to end in Apr 2013 Term of Deputy Governor Hirohide Yamaguchi and Kiyohiko Nishimura to end in Mar 2013

Machinery Orders



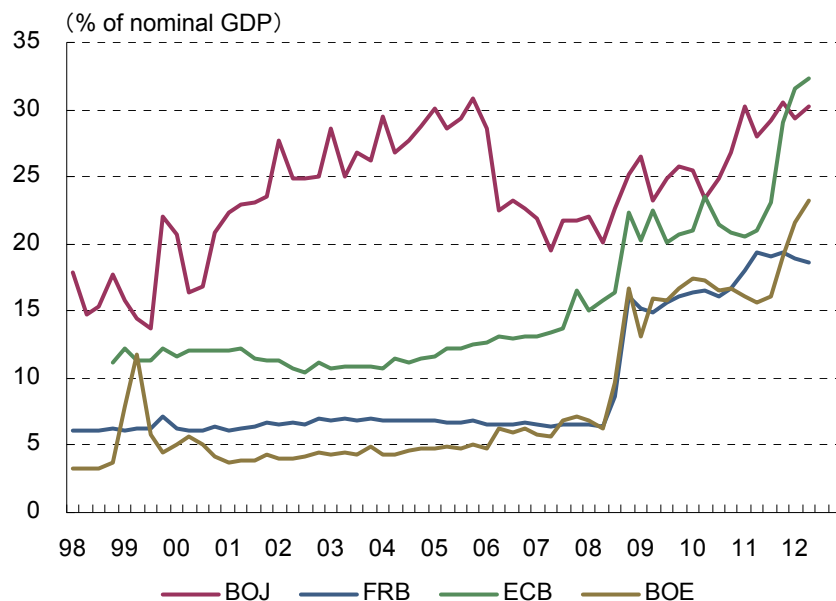
All Industry Activity



Overflowing Money (1): Further Expansion in Balance Sheet at Central Banks

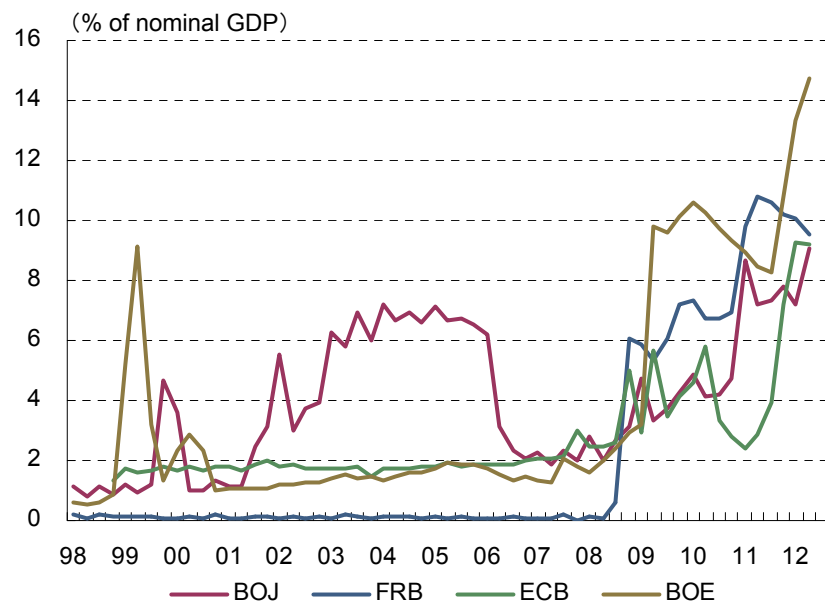
- Central banks in Japan, US, Europe continuing monetary easing measures, further expanding balance sheet at central banks
 - BOJ : Continuing easing without a break as current inflation rate falls far short of the goal of 1%
 - FRB : Continuing easing until “substantial and sustainable” growth is realized
 - ECB : Purchasing bonds (with maturity of up to 3 years) issued by Eurozone member-states via OMTs program

Size of Balance Sheet (BOJ, FRB, ECB and BOE)



Source: BOJ, FRB, ECB, BOE; Compiled by Daiwa Securities

Size of Current Deposit (BOJ, FRB, ECB and BOE)

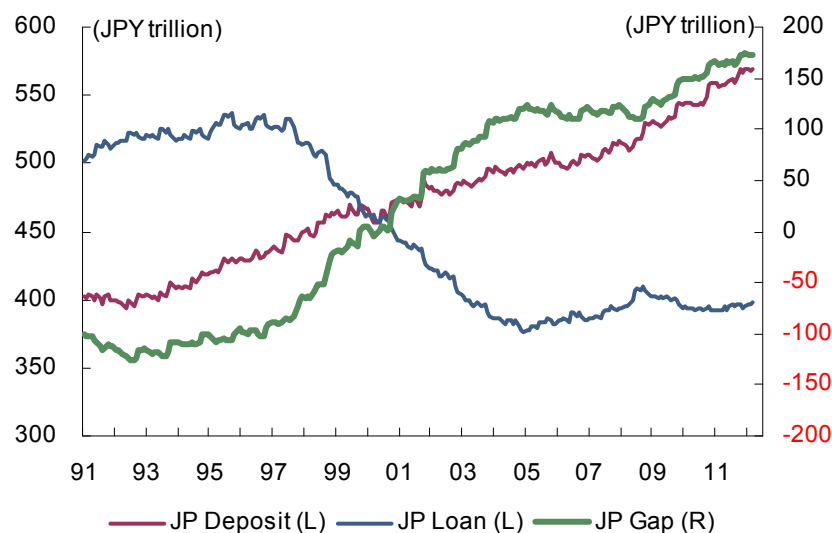


Source: BOJ, FRB, ECB, BOE; Compiled by Daiwa Securities

Overflowing Money (2): Widening Deposit - Loan Gap

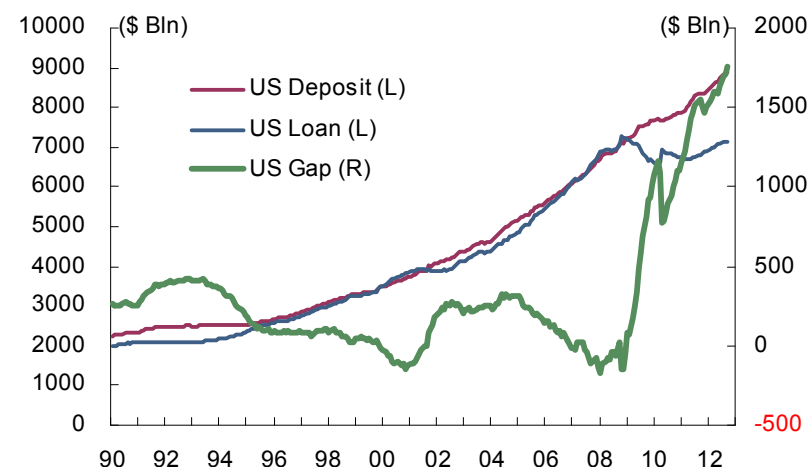
- Deposit-loan gap is widening reflecting excessive supply of funds from central banks
- Limited inflow to real economy mainly due to insufficient bank lending
- Overflowing money shifting to investment in government bonds, common factor both in Japan and US

Deposit and Loan Balance in Japan



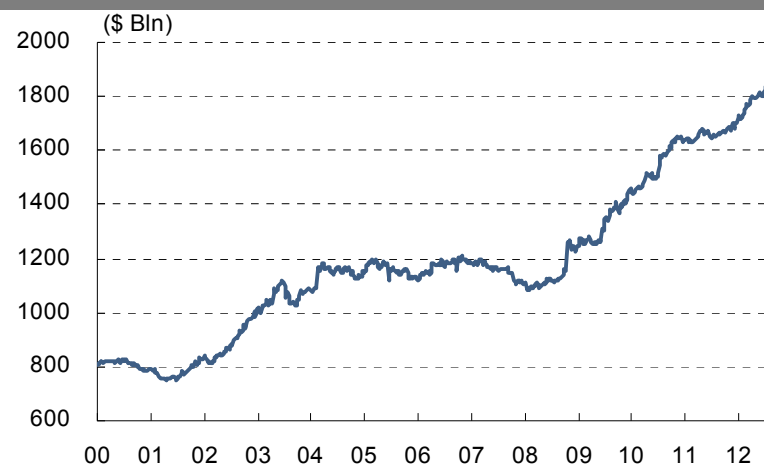
Source: BOJ

Deposit and Loan Balance in the US



Source: FRB

US Commercial Bank Assets US Treasury and Agency Securities



Source: FRB

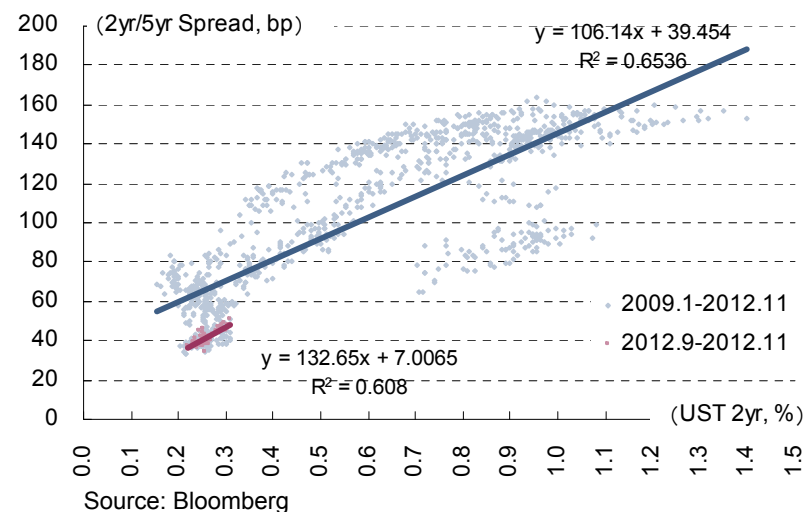
Interest Rates Likely Low and Stable (1)

- Extraordinary low federal fund rate likely to be justified at least until mid-2015
- Fed to continue easing until “substantial and sustainable” growth is realized
- QE3: Implementation of “open-ended” asset purchases
- QE3 may add US Treasury purchases at Dec FOMC

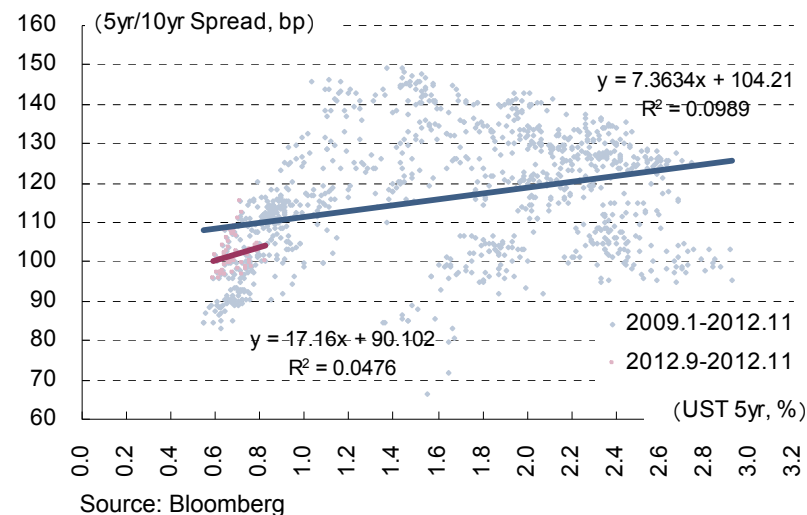
2Y US Treasury Yield



2Y US Treasury Yield and 2Y/5Y Spread



5Y US Treasury Yield and 5Y/10Y Spread



Interest Rates Likely Low and Stable (2)

- Continue with this powerful easing until BOJ judges the 1 percent (CPI) goal to be in sight

- Inflation goal of 1% unlikely to be achieved even in FY2014

* BOJ's Forecasts of the Majority of Policy Board Members:
CPI (all items less fresh food)

	as of Apr 2012	as of Jul 2012	as of Oct 2012
FY 2012	0.3	0.2	-0.1
FY 2013	0.7	0.7	0.4
FY 2014			0.8

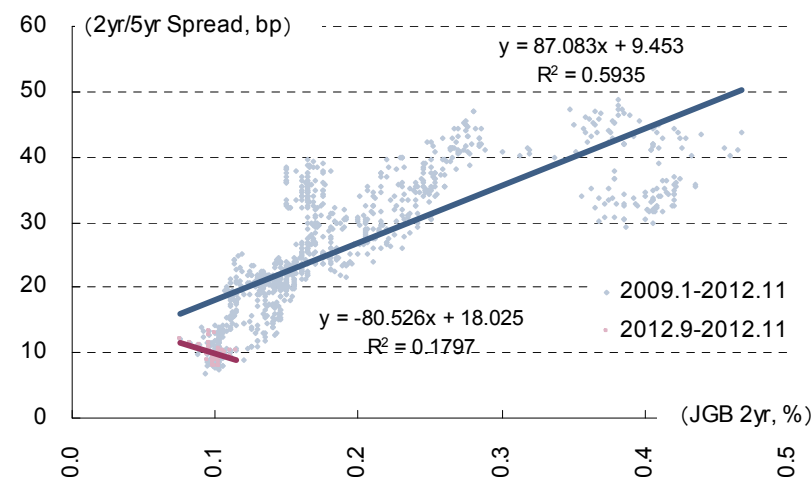
Source: BOJ

2Y JGB Yield



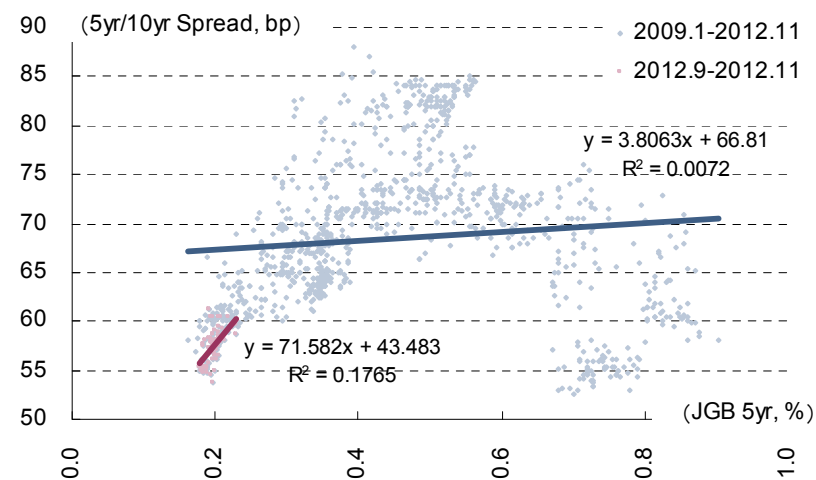
Source: Bloomberg

2Y JGB Yield and 2Y/5Y Spread



Source: Bloomberg

5Y JGB Yield and 5Y/10Y Spread

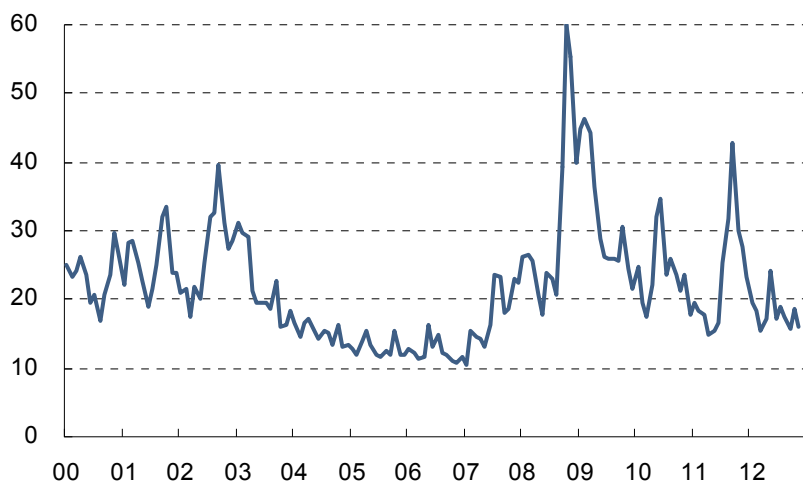


Source: Bloomberg

Low and Stable Volatility

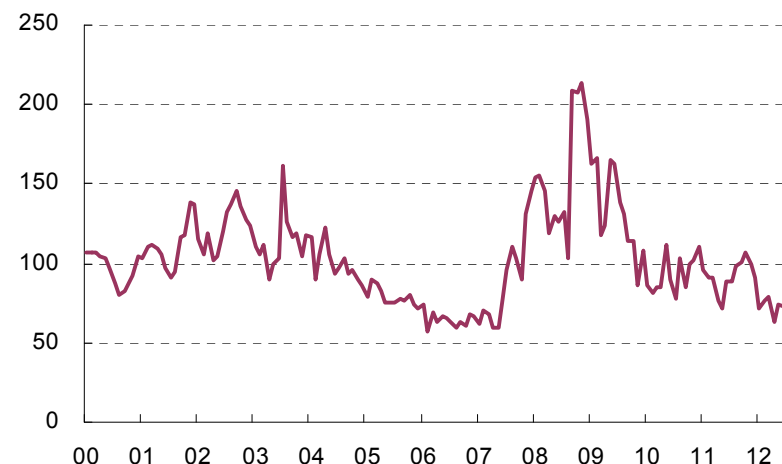
- Significant decline in tail risk on aggressive measures by each central bank
- Worldwide low and stable volatility of stocks, bonds, currencies
- Low volatility environment = Low risk premium environment
Funds forced to flow into risk assets

VIX (US stock volatility)



Source: Bloomberg

MOVE (US Treasury volatility)



Source: Bloomberg

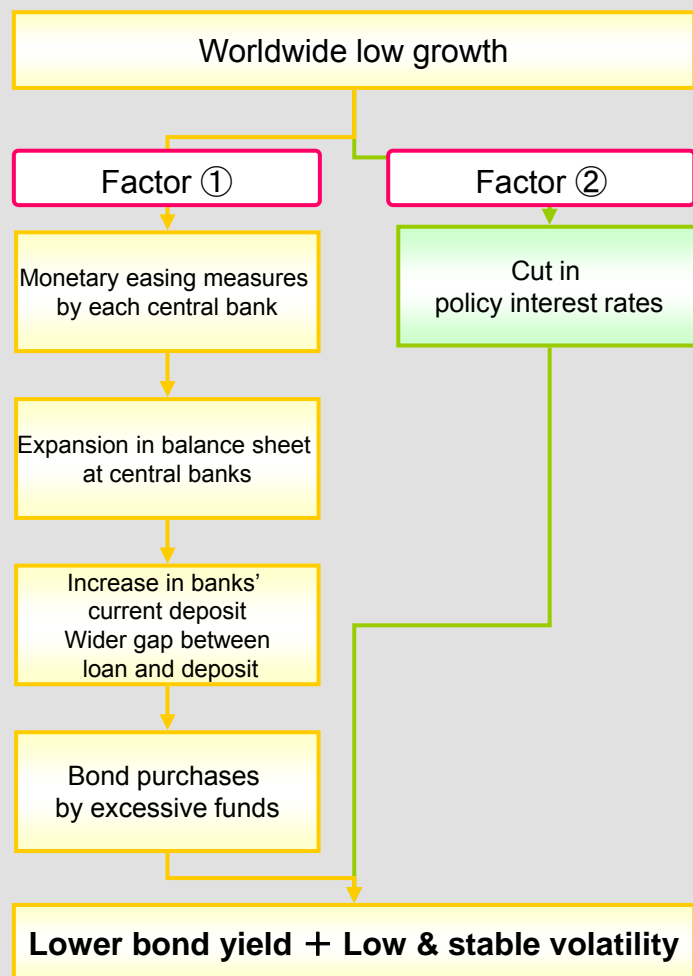
Dollar/yen volatility (1Y)



Source: Bloomberg

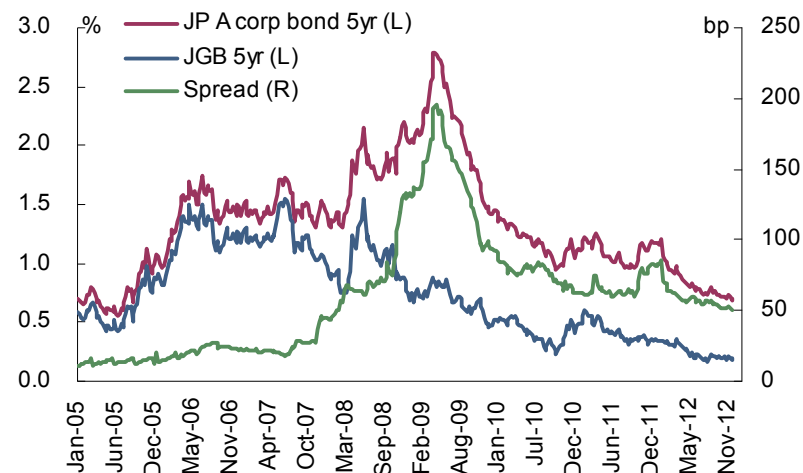
Change in Money Flow: Sharp Decline in Credit Yield

【Summary】



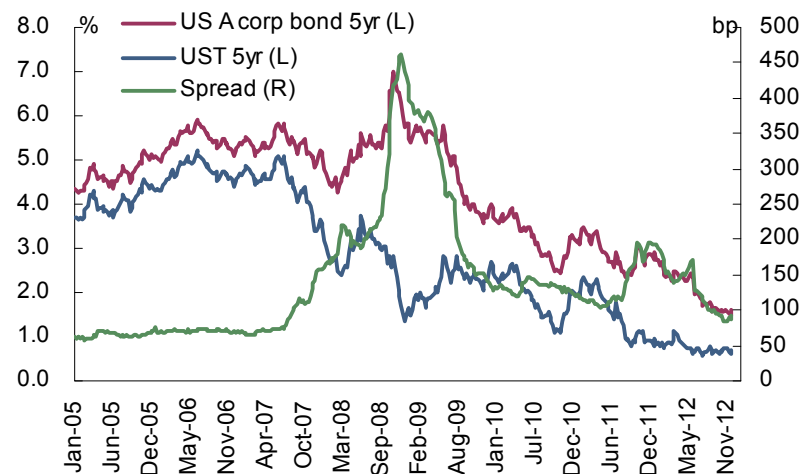
Given future policies by central banks,
current conditions to continue over long term

Japan: Yield of JGBs and Corporate Bonds (5Y)



Source: Bloomberg

US: Yield of Treasuries and Corporate Bonds (5Y)



Source: Bloomberg

Expectations for Higher US Stock Prices

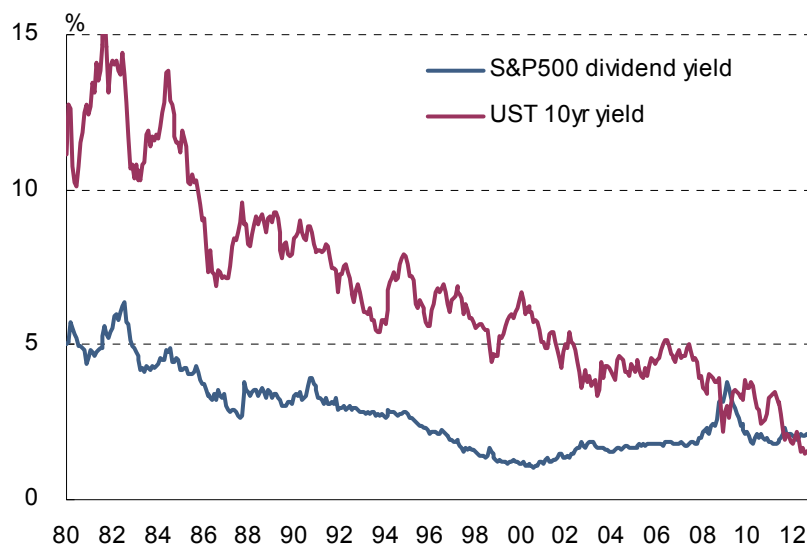
- Stock market factoring into tail risk associated with fiscal cliff

- Unclear outlook
- Higher taxes on capital gains and dividends



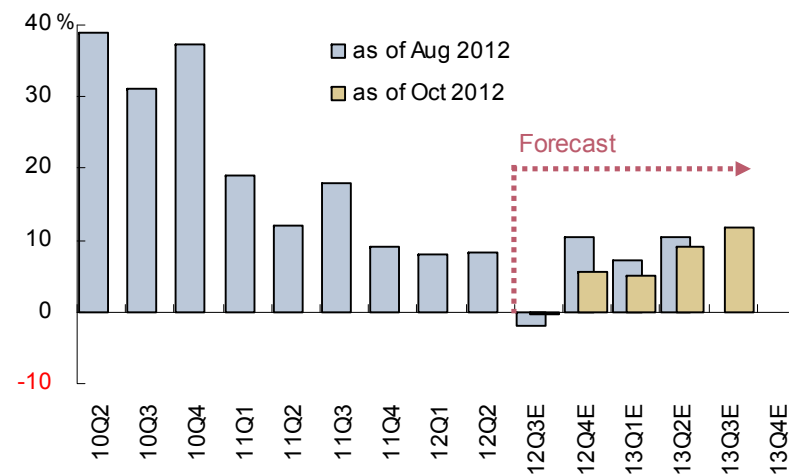
- Revision to EPS estimates
- Superior to US Treasuries

S&P 500 Dividend Yield and 10Y US Treasury Yield



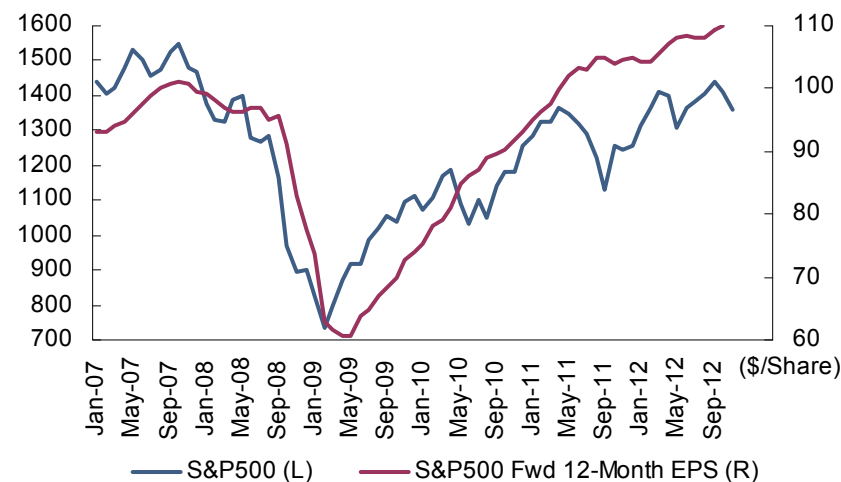
Source: Bloomberg

S&P 500: Profit Growth Rate (as of Oct 2012)



Source: Reuters

S&P 500 and 12-month Forward EPS



Source: Reuters

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Outlook for Japanese Bond Market

- It's always darkest before the dawn. Favorable environment is expected for risk assets in 2013.
- Yields are likely to rise moderately from late December in line with mild economic recovery.
Yields of 10Y US Treasury and 10Y JGBs to aim for 2.0% and 0.9%, respectively, toward March 2013.
- However, forward guidance is rock solid both in Japan and US, which should result in very limited rise in yields of bonds with maturities up to 5 years
- Although investor appetite may reach super long-term zone, worry about performance remains relative to other maturity zones
Lack of real demand from final investors, influence of concerns about increasing bond issuance in next FY

Interest Rates Forecasts (term-end)

	2012	2013		
	Q4	Q1	Q2	Q3
【Japanese Economy】				
GDP (QQAR)	-1.2%	1.4%	1.6%	1.4%
CPI excl. fresh food (YoY)	0.0%	-0.2%	-0.2%	0.1%
【Japanese Interest Rates】				
O/N Call Rate Target	0~0.1%	0~0.1%	0~0.1%	0~0.1%
5yr JGB Yield	0.20%	0.25%	0.28%	0.30%
10yr JGB Yield	0.80%	0.90%	0.95%	1.00%
【US Interest Rates】				
FF Rate Target	0.00~0.25%	0.00~0.25%	0.00~0.25%	0.00~0.25%
2yr UST Yield	0.25%	0.30%	0.35%	0.40%
10yr UST Yield	1.75%	2.00%	2.25%	2.50%

Source: Daiwa Securities

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(Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law)

If you decide to enter into a business arrangement with our company based on the information described in materials presented along with this cover letter, 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 (including tax) 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.

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.

Financial instruments firm: chief of Kanto Local Finance Bureau (Kin-sho) No.108

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