

Outlook for 5Y JGB Auction

Buy at -0.08 - -0.07% level

- ✓ Tomorrow's auction is likely to go in a trouble-free manner as the current yield level would not discourage primary dealers from buying new 5Y JGBs. We would like to buy at the -0.08 - -0.07% level.
- ✓ Relative-value wise, we think of switching out from the 2Y sector or 20Y JGBs with around 3 years left to maturity.

Strategic Memorandum DSTE210
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Auction Details

Auction Date: January 16, 2018
Issue Date: January 18, 2018
Maturity Date: March 20, 2022
Offering Amount: About 2.2 trillion yen

* New 5Y JGBs will be the first reopening of JS134 carrying a 0.1% coupon.

** On January 15, JS134 traded at -0.080% (+0.5bp v. previous day's close) and closed at -0.080% (+0.5bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Buy at -0.08 - -0.07% level

After the previous 5Y JGB auction went well on December 12, the 5Y JGB yield declined to -0.115% at one point. Subsequently, however, the yield temporarily rose to -0.075% last week amid the softness of Treasury Discount Bills (or TDBs) and long-dated JGB futures. Over the past several days, the yield has been in the -0.085 - -0.080% range.

Key points for tomorrow's auction are as follows:

- Partly due to the recent adjustment in the absolute yield level, the current 5Y JGB yield level would not discourage primary dealers from buying new 5Y JGBs;
- The 5Y sector appears noticeably undervalued vs. the 2Y sector (Appendix 3);
- It is highly possible that the BOJ will conduct six purchase operations by the next 5Y JGB auction to be held on February 14 (four more operations are scheduled in January and at least two operations expected in February);
- The uptrend in yields of TDBs and 2Y JGBs may lose momentum partly because of the steady result of the BOJ's TDB purchase operations (offered on January 12), for which the purchase amount was substantially raised compared to the previous operation.

Let's look at the environment surrounding the JGB market. The 10Y US Treasury yield appears to be recently edging up, as witnessed by a rise in inflation expectations partly on higher crude oil prices. However, the yield appears to lack the momentum for a continuous rise at above 2.6%. Relative to US yields, the 10Y JGB yield has been moving stably under the BOJ's yield curve control policy.

Although last week's BOJ's trimming in purchase operations for JGBs with over 10 years left to maturity surprised market participants in terms of its timing as well as reactions in the FX market and overseas bond markets, it was not a move to imply or signal any change in the central bank's current monetary policy stance. Regarding the nomination of the next BOJ Governor, many JGB market participants expect current Governor Haruhiko Kuroda (whose term will end in April) to get his second term. Although the nomination has not been confirmed yet, either Mr. Kuroda or someone, who will succeed the current monetary policy stance, is most likely to be chosen. Under the Abe administration, the yield curve control policy is unlikely to change substantially in the near term with the inflation rate having been failing to reach even 1%. The BOJ is expected to continue to buy JGBs under the framework of the yield curve control policy by paying close attention to the yield level, the shape of the yield curve, and the supply/demand balance in JGBs. However, as the latest trimming triggered substantial appreciation of the yen, the BOJ would hesitate to trim the purchase amount in the near term, unless it find any big changes or movements in those three factors. Looking at the 3-5Y zone, we find that the supply/demand condition is not tight in an excessive way at the moment. We thus think that the purchase amount in the zone will be likely unchanged in the near term.

All in all, we would like to buy new 5Y JGBs at the -0.08 - -0.07% level at tomorrow's auction in anticipation of steady support at around -0.07% level, although caution remains for upside resistance of JGB futures. Relative-value wise, we think of switching out from the 2Y sector (such as 2Y JGBs with around 2 years left to maturity; Appendix 3) or 20Y JGBs with around 3 years left to maturity in terms of the total return and the gap between curves (Appendix 8-9).

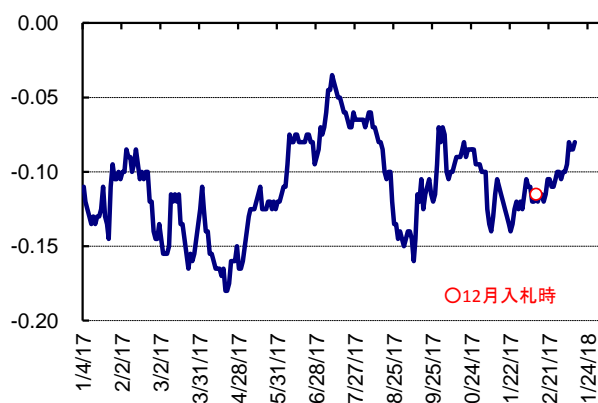
5Y JGB Auction Results

Auction Date	Issue #	Maturity Date	Coupon %	Issue Size (trillion yen)	B/C	Average Price	Lowest Price	Price Tail (yen)	Average Yield	Highest Yield	Yield Tail (%)	Allotment (%)	
1/16/18	134R*	12/20/22	0.1	2.2**									
12/12/17	134	12/20/22	0.1	2.5	4.38	101.03	101.02	0.01	-0.104	-0.102	0.002	83.4736	Good
11/14/17	133R	9/20/22	0.1	2.5	4.19	101.01	101.00	0.01	-0.107	-0.105	0.002	53.5278	Avg
10/19/17	133R	9/20/22	0.1	2.5	4.24	100.90	100.90	0.00	-0.082	-0.082	0.000	88.7951	Good
9/12/17	133	9/20/22	0.1	2.2	4.07	101.06	101.03	0.03	-0.110	-0.104	0.006	47.7913	Poor
8/17/17	132R	6/20/22	0.1	2.3	4.46	100.89	100.88	0.01	-0.083	-0.081	0.002	69.6951	Avg
7/11/17	132R	6/20/22	0.1	2.5	4.85	100.67	100.66	0.01	-0.035	-0.033	0.002	81.8127	Avg
6/8/17	132	6/20/22	0.1	2.4	4.71	100.83	100.82	0.01	-0.065	-0.063	0.002	83.4769	Good
5/16/17	131R	3/20/22	0.1	2.3	3.59	101.06	101.04	0.02	-0.117	-0.113	0.004	41.5877	Avg
4/18/17	131R	3/20/22	0.1	2.3	3.28	101.29	101.25	0.04	-0.160	-0.152	0.008	50.9655	Poor
3/9/17	131	3/20/22	0.1	2.4	2.86	101.10	101.06	0.04	-0.118	-0.110	0.008	83.8513	Poor
2/14/17	130R	12/20/21	0.1	2.8	4.26	100.92	100.90	0.02	-0.089	-0.085	0.004	26.2248	Avg
1/19/17	130R	12/20/21	0.1	2.4	3.66	101.07	101.01	0.06	-0.116	-0.104	0.012	84.3630	Poor
12/13/16	130	12/20/21	0.1	2.5	4.48	100.82	100.79	0.03	-0.063	-0.057	0.006	53.0841	Avg

* Daiwa forecast (as of Jan. 15) ** Amount the MOF plans to issue

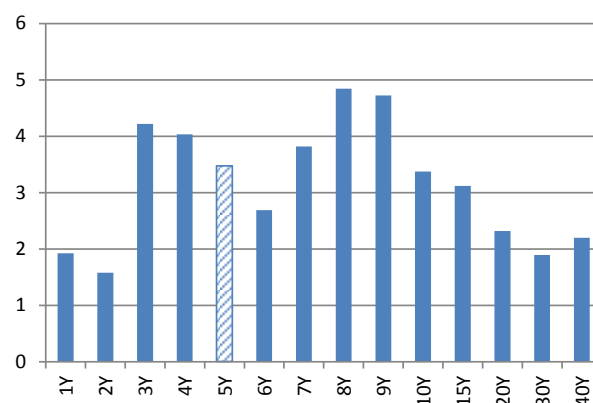
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 5Y JGB Yield (%)



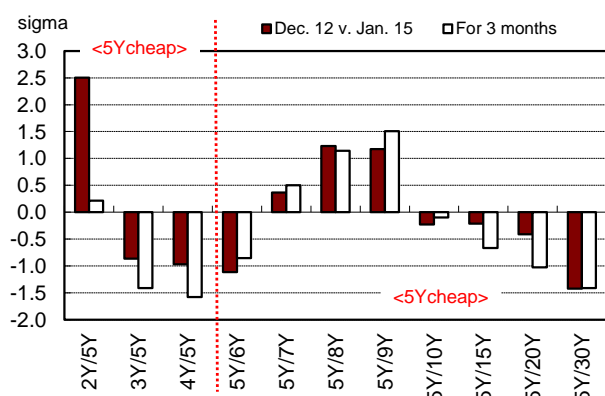
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (Dec. 12 v. Jan. 15; bp)



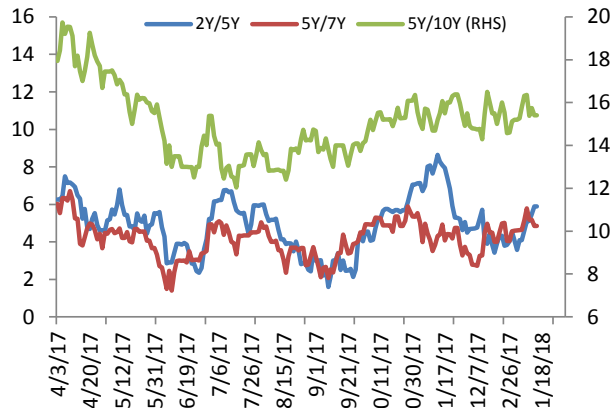
Source: Daiwa Securities.

Appendix 3: Z-scores of JGB Yield Spreads



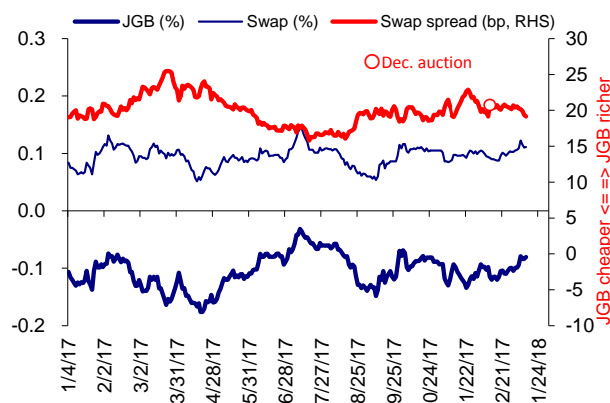
Source: Daiwa Securities.

Appendix 4: JGB Yield Spreads (bp)



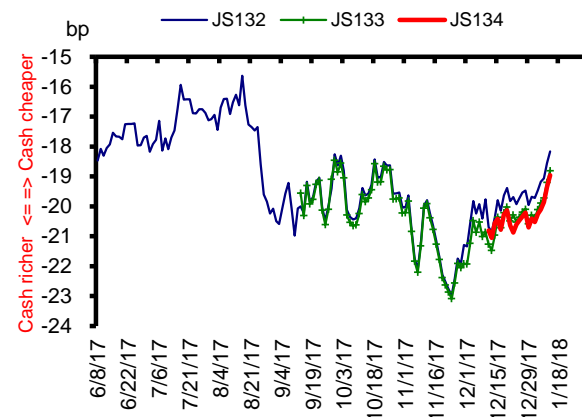
Source: Daiwa Securities.

Appendix 5a: 5Y Swap Spread



Source: Daiwa Securities.

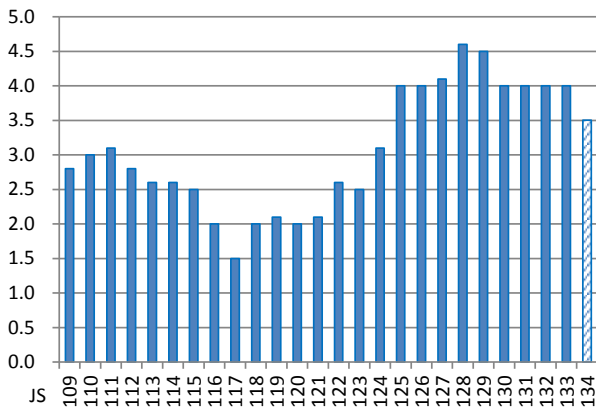
Appendix 5b: 5Y JGB Asset Swap Spreads



Note: against Yen LIBOR

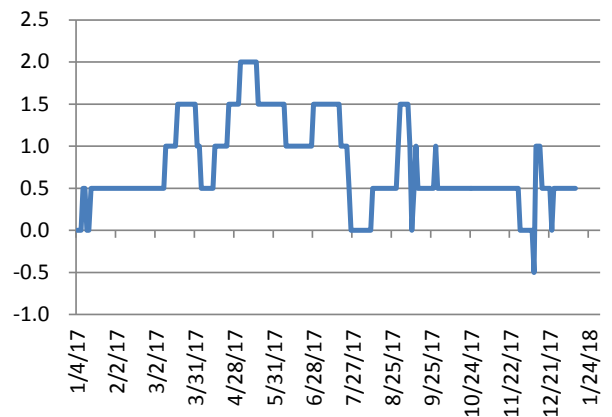
Source: Daiwa Securities.

Appendix 6: JS Yield Change (bp): Dec. 12 v. Jan. 15



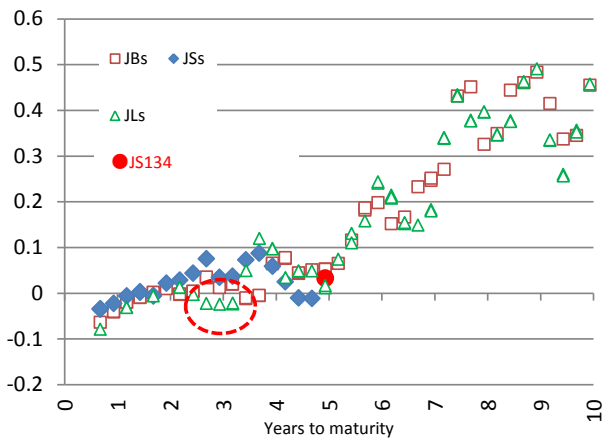
Source: Daiwa Securities.

Appendix 7: JS On-the-run and Off-the-run Spread (bp)



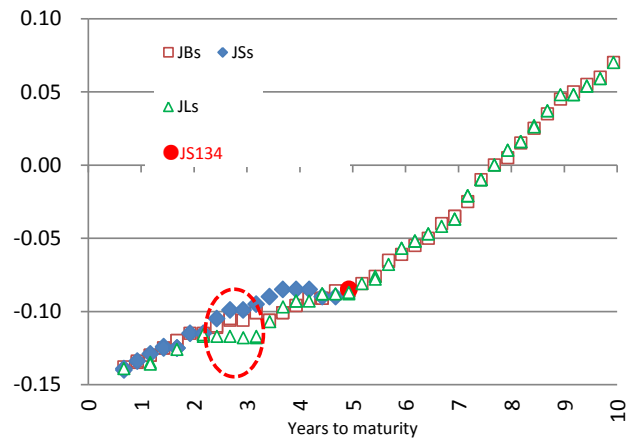
Source: Daiwa Securities.

Appendix 8: 6M Total Returns of JSs, JBs and JLs (%)



Note: Based on JB, JS and JL yield curves on Jan. 12, respectively; Assuming that those yield curve shapes do not change and factoring roll-down effect etc.
Source: Daiwa Securities.

Appendix 9: JGB Yield Curve (%)



Source: Daiwa Securities.

IMPORTANT

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- 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.

** 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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