

JGB Insight

JGBis Update / BOJ's JGB Purchase

- ✓ Take a buying stance for JGBis, centering on JBI22, which can be the best investment option with the highest expected return.
- ✓ On June 14, the BOJ trimmed buying of JGBs in the 3-5Y zone. Under Gov. Kuroda's leadership, that was the first adjustment done on the first day of the monetary policy meeting.
- ✓ Although an annual increase in BOJ's JGB holdings in 2018 is estimated at less than 38 trillion yen, lower than the 50 trillion yen target at the time of the QQE introduction, the BOJ will continue to reduce JGB purchases without hesitation.

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All existing JGBis in the market are now new-type (principal-guaranteed) JGBis

JGBis Update: JBI22 as the best investment option

JGBi trading has been relatively active in recent days. Especially on June 13 when the BOJ conducted purchase operation for JGBis, all JGBi issues were quoted and all issues, except for JBI19, traded. This appears the most active condition since October 2013 when the issuance of new (principal-guaranteed) JGBis was resumed. The background could be improvement in investor sentiment to JGBis since the beginning of June on the back of (1) a pause in the downtrend of crude oil prices and (2) a rebound of the US BEI reflecting relatively strong inflation indicators. Another notice on JGBis particularly this week is that JBI16, the last old-type JGBi issue (without principal guarantees) was redeemed on June 10. After the redemption, all existing JGBi issues (JBI17-23) in the market are new JGBis with over 5 to 10 years left to maturity. In this report, we would like to think of relative value among issues based on the JGBi yield curve and other factors.

Shape of JGBi yield curve is upward sloping, just like nominal JGB yield curve

First, we check the JGBi yield curve (Chart 1). The shape of the curve is currently upward sloping, just like the nominal JGB yield curve. The shape of the JGBi curve around six months ago was also similarly upward sloping. In other words, we can expect a yield decline due to shorter duration, i.e. rolling effect, on the JGBi yield curve. Another notable point is that JBI18 appears cheap and JBI19 looks expensive constantly. This is probably because trading in the JGBi secondary market has been limited most likely as the base of participants has been quite narrow due to very low liquidity to date.

JBI22 expected to generate the highest return

Here, we compare the total return of JBI17-23 over the next six months (Chart 2a), assuming that JGBis will also have rolling effect based on our index ratio forecasts (Charts 3-4) derived from our nationwide core CPI forecasts. While return from JBI22 is expected to be the highest, that from JBI19 is projected to be the lowest at below 0.1%. Compared with total return of nominal JGBs, which are counterparts of JBI17-23, we found that JGBis (excluding JBI19) are expected to generate higher return than nominal JGBs with the same remaining maturities (Chart 2b).

Index ratio is on uptrend despite sluggish CPI growth

We check the environment surrounding JGBis. The growth rate of the nationwide core CPI in April, announced on May 18, was +0.7% y/y, 0.2 percentage points lower than the +0.9% in March. In addition, the core CPI for the ward-area of Tokyo in May, announced on May 27, grew only 0.5% y/y. It was lower than the market consensus (similar to April) and 0.1 percentage point lower than the April reading. These data cast dark clouds on the future development of inflation. As crude oil prices have been moving at a high level, energy prices are expected to boost prices. On the other hand, it appears difficult for the core CPI to exceed the 1.0% y/y growth level due to sluggish growth of prices of durable consumer goods (such as mobile phones) and general service prices (foods/services). If we estimate the index ratios based on our inflation forecasts, however, it is highly possible that the ratios will mostly rise toward around March 2019 (Chart 4). This means that positive return can be expected even if market prices of JGBis are unchanged during the investment horizon. Caution remains about investor sentiment, which may not improve because ongoing weakness in the observed inflation may curb a rise in inflation expectations, but we can

expect support from the external environment such as crude oil prices and the US TIPS BEI. All in all, we think that the environment surrounding JGBis is not bad at the moment.

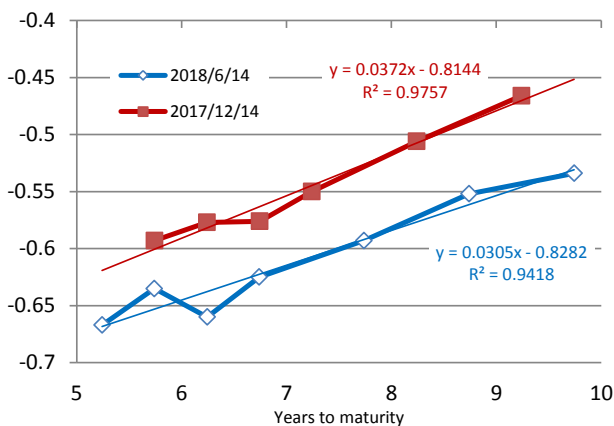
YCC policy is expected to continue over the relatively long term, which should support JGBis

At its Monetary Policy Board meeting held on June 15 (second day), the BOJ voted 8 to 1 to stick with its current stance for policy operations, similar to recent meetings. Meanwhile, the central bank lowered its assessment of actual inflation to “in the range of 0.5-1.0%” (from previous “around 1%”) in its written statement. However, the fact that the BOJ did not change its policy, despite the downward revision, means that its assessment that “momentum to achieve the 2% price target is maintained” is unchanged. This implies that the BOJ will continue on the YCC policy over the relatively long term in a matter-of-fact stance. In theory, as the YCC policy was introduced to achieve the 2% price stability target, it should raise inflation expectations and consequently boost the BEI to some extent. Under the YCC policy, the upside potential of nominal JGB yields from the current levels appears limited. However, if JGBi trading becomes more active, distortion of the supply/demand balance and liquidity may improve. We thus think these factors, including the BEI level, would not discourage investors from buying JGBis.

Take a buying stance for JGBis, centering on JBI22

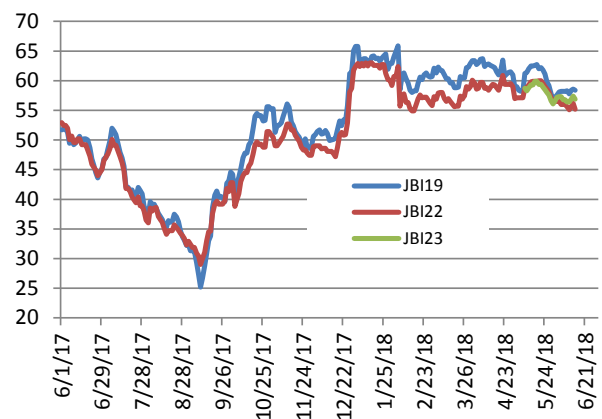
Given the aforementioned factors, we would like to take a buying stance for JGBis, centering on JBI22. For example, as the BEI of JBI22 is at around 55bp, a lower end of the existing range, it would be worth considering buying the issue in terms of the BEI as well.

Chart 1: JGBi Curve (%)



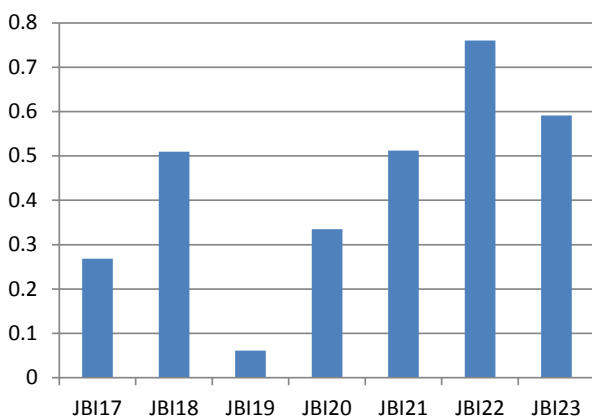
Source: Daiwa Securities

Appx.: JGBis BEI (bp)



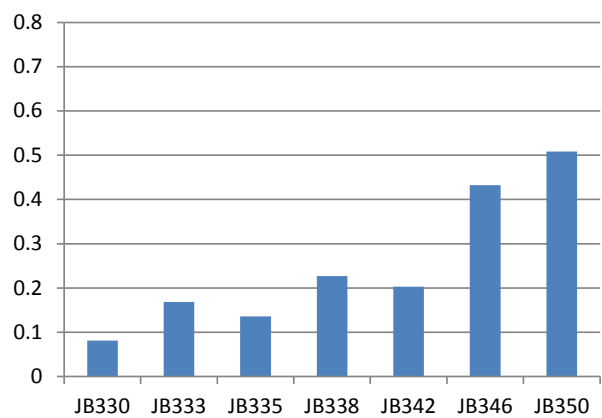
Source: Daiwa Securities.

Chart 2a: JGBi Total Return (6M, %)



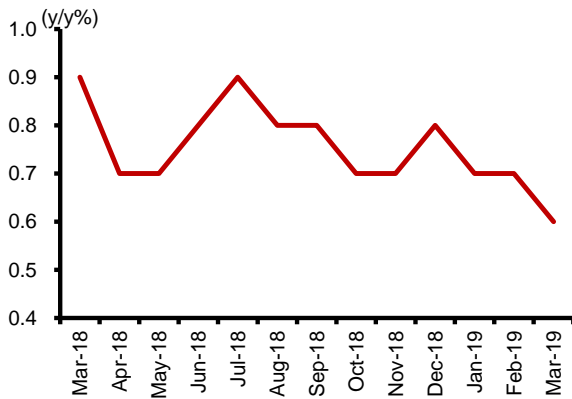
Source: Daiwa Securities

Chart 2b: Nominal JGB Total Return (6M, %)



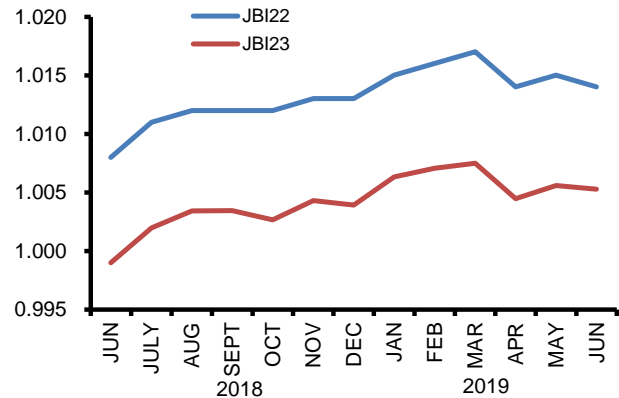
Source: Daiwa Securities

Chart 3: Nationwide Core-CPI Growth Outlook



Note: actual for Mar.-Apr. 2018
Source: Daiwa Securities.

Chart 4: Index Ratio Forecast on JBI22 and New (JBI23)



Note: based on Chart 3; actual for June and July 2018
Source: Daiwa Securities

Table 1: JGBs Outstanding etc. (est.)

(billion yen)

	Issue Size	MoF Buyback	BoJ Outright Purchase	Market Outstanding
JBI17	646.7	22.0	226.3	398.4
JBI18	821.7	15.9	145.7	660.1
JBI19	1,091.8	7.2	68.5	1,016.1
JBI20	2,139.4	64.1	275.5	1,799.8
JBI21	1,727.2	98.1	305.5	1,323.6
JBI22	1,760.4	73.5	448.9	1,238.0
JBI23	447.1	0.0	2.3	444.8
TOTAL	8,187.2	280.8	1,470.4	6,436.0
%	100.0%	3.4%	18.0%	78.6%

(As of June 8)

Source: Ministry of Finance, Bank of Japan, Daiwa Securities

Table 2: BOJ Purchase and MOF Buyback Results

	Previous Day's Close (Yen)	Pro-rata Price Spread (Yen)	Average Successful Price Spread (Yen)	Allotment on Pro-rata (%)	B/C	Close Price (Yen)
1/9/18	106.60	-0.120	-0.159	86.7	5.92	106.50
1/29/18	106.20	-0.170	-0.198	80.6	6.80	106.00
2/7/18	105.65	0.090	0.028	4.3	5.22	105.80
2/13/18	105.75	-0.170	-0.211	80.8	5.77	105.75
2/26/18	106.00	-0.060	-0.101	28.2	7.02	106.05
3/2/18	106.00	0.040	0.028	89.8	6.18	105.95
3/23/18	106.25	0.000	-0.230	93.5	3.86	106.30
4/2/18	106.35	-0.060	-0.115	53.3	5.88	106.35
4/11/18	106.35	-0.060	-0.082	80.6	5.55	106.35
4/23/18	106.25	-0.160	-0.166	42.8	5.82	106.10
5/11/18	106.50	-0.100	-0.132	100.0	7.58	106.50
5/25/18	106.50	-0.160	-0.182	26.4	6.16	106.50
6/1/18	106.40	-0.180	-0.195	45.5	4.94	106.35
6/13/18	106.25	0.010	-0.006	45.0	4.79	106.30

Note: Previous Day's Close and Close Price are based on JBI22 until April 23 and JBI23 from May 11 and beyond; buybacks by the Ministry of Finance on February 13 and April 11, 2018

Source: Ministry of Finance, Bank of Japan, Daiwa Securities

BOJ's JGB Purchases

Reduction in offer amount in 3-5Y zone

In JGB purchase operations offered on June 14, the BOJ trimmed buying of JGBs in the 3-5Y zone from the previous 330 billion yen to 300 billion yen. This is the second adjustment to JGB purchase operations in June, following the reduction in the 5-10Y zone on June 1. Since Haruhiko Kuroda became BOJ governor, this is the first adjustment to the offer amount in its purchase operation conducted on the first day of the Monetary Policy Meeting. We think that the background factors for the reduction are as follows:

- ✓ As witnessed by decline in repo rate in negative territory, the Bank expected the supply/demand balance for 5Y JGBs to tighten;
- ✓ Offer amount in 3-5Y zone could be good reduction target for BOJ partly because it has been around upper end of offer range (or higher than median: Chart 1) since central bank raised it on January 31.

First reduction in 3-5Y zone since Sep 1, 2017 when 10Y JGB yield on downtrend

This is the first reduction in the offer amount in the 3-5Y zone since September 1, 2017. At that time, the amount was cut from 330 billion yen to 300 billion yen as the 10Y JGB yield moved at around 0.0% amid the yield downtrend since July, in addition to the tight supply/demand condition in the intermediate zone. 5Y JGBs (JS132) posted the highest price at -0.140% and closed at -0.140% on the previous trading day, and closed at -0.150% on the day. Meanwhile, 10Y JGBs (JB347) logged the highest price at 0.0% and closed at 0.0% on the previous trading day, and closed at -0.050% on the day. The latest

reduction can be regarded as a move just to cope with a tighter supply/demand condition in the intermediate zone because the offer amount was reduced amid stable movement of the 10Y JGB yield at 0.040-0.050% since the trimming in the 5-10Y zone on June 1.

BOJ will continue to trim offer amount without hesitation, but cut in zone over 10Y could be seen from July

After the notice of the latest trimming, we saw an increase in selling JGB futures alongside yen appreciation. However, both were temporary. With respect to the stock market, we can say that there was almost no reaction. Following the reduction on June 1, reactions to the latest trimming on the currency and stock markets were limited, which would keep the BOJ comfortable and easy to trim the offer amount in upcoming purchase operations. The JGB market is likely to continue to be attentive to the BOJ's cut in the offer amount. In particular, speculations could linger on reduction in the 5-10Y zone, in which the offer amount continues to be higher than the median of the offer range. This would increase if the 10Y JGB yield approaches 0.03%. As the impact of the latest trimming appears to have played out instantaneously, further reduction in the 3-5Y zone is also possible if the supply/demand condition in the intermediate zone remains tight. On the other hand, for the zone over 10 years, the BOJ plans to conduct only two purchase operations in the zone in the rest of June (on days following 20Y and 30Y JGB auctions). The BOJ is thus likely to lower the offer range to be announced at the end of this month first, and then trim the offer amount in July and beyond.

If we assume that the pace of BOJ's JGB purchases as of June 14, which takes into account the latest reduction, remains the same until the end of this year, the annual increase in the BOJ's JGB holdings in 2018 (vs. end-Dec 2017) is estimated to be slightly less than 38 trillion yen (Table 2). The amount is expected to be much lower than the 58 trillion yen increase from end-2016 to end-2017. Assuming that the reduction will continue going forward, we think that the annual increase in the amount outstanding of BOJ's JGB holdings will be scaled down further. If we recall that the target for the annual increase in JGB holdings at the time of the introduction of quantitative and qualitative monetary easing (QQE) was around 50 trillion yen, it appears that the BOJ is already not taking account of "quantity" at all. Before the introduction of the QQE, the annual increase was only slightly above 20 trillion yen. As reactions to the BOJ's adjustments to the offer amount in JGB purchase operations have been increasingly limited in the financial market, the BOJ will continue to trim the offer amount without hesitation.

Table 1: BOJ JGB Purchase and MOF Issuance

(Yen billions)

		Offer size per operation*		Number of Offers (per month)	Offer size**	Monthly Total exp.	MOF issuance per month in FY2018***
			Mid				
JGBs ex Linkers and Floaters							
Up to 1 year		About 10-100	55	2	50	100	-
Over 1 to 5 years	Over 1 to 3 years	About 200-300	250	6	250	1,500	2,247-2,647
	Over 3 to 5 years	About 250-350	300		300	1,800	2,140
Over 5 to 10 years		About 300-500	400	6	430	2,580	2,954
Over 10 years	Over 10 to 25 years	About 150-250	200	5	190	950	1,070-1,320
	Over 25 years	About 50-150	100		70	350	999 - 1,177**
Linkers		About 25	-	2	25	50	428***
Floaters (in even months)		About 100	-	1	100	100	-

* Scheduled by BOJ as of end-May 2018 ** As of June 14 *** Including the 2nd Non-competitive (est.) and AELs (est.). Per-issuance size for Linkers, which are issued quarterly

Source: Bank of Japan, Ministry of Finance, compiled by Daiwa Securities

Table 2: BOJ Cash Flow in JGBs (exp.)

	Purchase amount (face value) <A>	Redemption (face value) 	Redemption of JGBs purchased in 2017 (face value) <C>	Net purchase (face value) <A-B-C>	Outstanding (face value)	Outstanding (BOJ B/S)
Dec-2017					407.6	418.5
May-2018					429.4	439.9
Jun	7.50	11.3		-3.8	425.6	
July	7.33	1.2		6.2	431.8	
Aug	7.43	0.9	0.10	6.4	438.2	
Sept	7.33	9.6	0.10	-2.3	435.8	
Oct	7.43	0.9	0.10	6.4	442.2	
Nov	7.33	1.7	0.10	5.5	447.8	
Dec	7.43	9.5	0.10	-2.2	445.6	456.1
	Total redemption:		35.6	Annual increase:	38.0	37.5

Notes: "Purchase amount (face value)" is tentative under assumption that the purchase pace the BOJ announced on June 14 will be maintained for the rest of the year. "Redemption amount (face value)" is based on the amount outstanding of BOJ's JGB holdings by issue as of June 8 (start-day basis). "Redemption amount of JGBs purchased in 2017 (face value)" is tentative, based on average purchase term to maturity in 0-1Y zone during Jan-May 2017 of around 0.5 years. Regarding "Outstanding (face value)," figures on Dec. 2017 and May 2018 are actual, and those from June to December 2018 are estimates. With respect to "Outstanding (BOJ B/S)," figures on Dec. 2017 and May 2018 are actual, and the figure for December 2018 is estimated by adding gap between outstanding (face value) and outstanding (BOJ B/S) as of May 2018 (around 10.5 trillion yen) to outstanding (face value) on BOJ's balance sheet as of December 2017. "Total redemption" indicates the total of "Redemption (face value)" and "Redemption amount of JGBs purchased from June to December 2018."

Source: Daiwa Securities

BOJ JGB Purchase Schedule (as of June 15)

(Yen billions)

BOJ offer day / JGB auction day	(BOJ start day/ MOF settlement day)	Up to 1 year	Over 1 to 3 years	Over 3 to 5 years	Over 5 to 10 years	Over 10 to 25 years	Over 25 years	JGB Linker	JGB Floater
6/1/18	F 6/4/18	50.1			430.3			25.0	
6/4/18	M 6/5/18		250.2	330.4		191.3	70.6		
6/5/18	T 6/6/18	10Y JGB Auction							
6/6/18	W 6/7/18		250.5	330.5	431.2				
6/7/18	TH 6/8/18	AEL (for 20Y, 30Y and 40Y JGBs with over 15.5 to less than 39 years to maturity)							
6/8/18	F 6/11/18					190.4	70.4		100
6/11/18	M 6/12/18	AEL (for 10Y and 20Y JGBs with over 5 to 15.5 years or less to maturity)							
6/13/18	W 6/14/18	50.0			430.9			25.1	
6/14/18	TH -		250.8	300.5		191.0	70.4		
6/15/18	F -	BOJ MPM (Day 2)							
6/18/18	M 6/19/18								
6/19/18	T 6/20/18	30Y JGB Auction							
6/20/18	W 6/21/18				◎	◎	◎		
6/21/18	TH 6/22/18	5Y JGB Auction							
6/22/18	F 6/25/18		◎	◎	◎			○	
6/25/18	M 6/26/18	20Y JGB Auction							
6/26/18	T 6/27/18		◎	◎		◎	◎		
6/27/18	W 6/28/18	2Y JGB Auction							
6/28/18	TH 7/2/18		◎	◎	◎				
6/29/18	F 7/2/18		◎	◎	◎				

Note: ◎ Scheduled by BOJ, ○ Daiwa forecast; Figures are actual, decreased from previous operation in red; BOJ MPM (Day 1) on June 14 (in blue)

Source: Bank of Japan, Ministry of Finance, Daiwa Securities

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- 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