

Outlook for 5Y JGB Auction

Aggressive bidding unlikely around -0.115%

- ✓ It is highly possible that the 5Y JGB yield will remain in the existing range (-0.125 - -0.095%) in the near term. Unless pre-auction adjustment goes to the -0.110 - -0.100% level, primary dealers would hesitate to have an aggressive stance for tomorrow's auction.
- ✓ Relative-value wise, it would be worth considering switching out from the 7-10Y sector into the 5Y sector.

Strategic Memorandum DSTE247
FICC Research Dept.

Senior JGB Strategist
Keiko Onogi
+813 5555 8788
keiko.onogi@daiwa.co.jp
Daiwa Securities Co. Ltd.

Auction Details

Auction Date: June 21, 2018
Issue Date: June 22, 2018
Maturity Date: March 20, 2023
Offering Amount: About 2.0 trillion yen

* New 5Y JGBs will be the third (and final) reopening of JS135 carrying a 0.1% coupon.

** On June 20, JS135 traded at -0.115% (+0.5bp v. previous day's close) and closed at -0.115% (+0.5bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Aggressive bidding unlikely around -0.115%

Since the previous 5Y JGB auction went smoothly at the -0.105 - -0.100% level on May 17, the 5Y JGB yield has been moving in the -0.125 - -0.095% range on an intraday basis. On June 14, the BOJ reduced the offer amount of JGBs in the 3-5Y zone from the previous 330 billion yen to 300 billion, but this has not brought a major correction to 5Y JGBs. For the past few days, the JGB market has been performing solidly amid growing risk-off sentiment in the overseas markets due to caution about escalation of US-China trade friction. Partly because of this, the 5Y JGB yield has been moving at -0.120 - -0.115% on a close basis, a lower end of the range since the May auction. Key points to think about the bidding level at tomorrow's auction are as follows:

- ✓ Short-covering for JS135 is not as deep as it was at the previous auction in May;
- ✓ On the JGB yield curve, the 5Y sector is currently noticeably overvalued vs. the 2-3Y, while it is undervalued vs. the 7-10Y sectors (Appendix 3). Around the 5Y sector, there are no notable yield gaps between 5Y JGBs and 10Y and 20Y JGBs with about 5 years left to maturity (Appendix 9);
- ✓ By the next 5Y JGB auction scheduled on July 10 (new 5Y JGBs will belong to new maturity basket to be redeemed in June 2023), the number of BOJ's JGB purchase operations in the 3-5Y zone is expected to be five, or only four in some cases (three scheduled for June and one to two may be conducted in July)

✓ JGB yields in the 0-3Y zone have been stabilized around -0.130%

We check the environment surrounding 5Y JGBs. 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 policy statement. However, at the post-meeting press conference, BOJ Governor Haruhiko Kuroda repeated that “I think that momentum to achieve the 2% price target is maintained.” He also stated that “the current framework of ‘Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control’ is sustainable” and “I think that there is no need to conduct another comprehensive assessment.” In addition, the decisions at the ECB Governing Council meeting held in the same week (indication that a rate hike is unlikely before the summer of 2019, though the quantitative easing will be extended and ended at end-December 2018) did not provide strong pressure on at least normalization to the BOJ. Given those together, we forecast that the BOJ will continue on the YCC policy over the relatively long term in a matter-of-fact stance. Under the current framework of the YCC, the 5Y JGB yield is unlikely to show upside breakout from the existing range in the near term from the viewpoint of monetary policies. At the moment, on the other hand, it is also difficult to assume downside breakout. Recently, risk-off mode has been increasing in the overseas markets amid escalating US-China trade friction. That may continue to support JGBs. However, downside of the 5Y JGB yield from the current level appears to be limited partly because, in addition to interest rates in the money market having been losing volatility at the current level, the short to intermediate zone has been flattening at the moment (Appendix 11) as well.

All in all, it is highly possible that the 5Y JGB yield will remain in the existing range (-0.125 - -0.095%) in the near term, we think. As of 14:00 today (June 20), JS135 trades at -0.115% (+0.5bp vs. previous day's close). Unless pre-auction adjustment goes to the -0.110 - -0.100% level, primary dealers would hesitate to have an aggressive stance for tomorrow's auction. On the other hand, the 5Y sector is currently undervalued vs. the 7-10Y sector on the curve (Appendix 3). It would be worth considering switching out from the 7-10Y sector into the 5Y sector because speculations that the BOJ will cut its offer amount in the 5-10Y zone again would rise if the 10Y JGB yield falls below 0.03%.

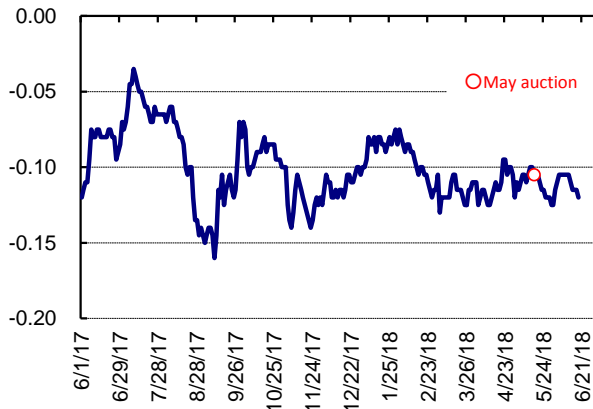
5Y JGB Auction Results

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 (%)
6/21/18	135R*	3/20/23	0.1*	2.0**								
5/17/18	135R	3/20/23	0.1	2.0	4.22	100.99	100.98	0.01	-0.103	-0.101	0.002	33.7643
4/17/18	135R	3/20/23	0.1	2.0	4.40	101.09	101.08	0.01	-0.120	-0.118	0.002	95.5045
3/13/18	135	3/20/23	0.1	2.2	4.18	101.05	101.04	0.01	-0.108	-0.106	0.002	67.4216
2/14/18	134R	12/20/22	0.1	2.5	4.67	100.94	100.94	0.00	-0.093	-0.093	0.000	91.9530
1/16/18	134R	12/20/22	0.1	2.4	5.24	100.91	100.90	0.01	-0.084	-0.082	0.002	8.9750
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
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
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
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
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
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
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
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

* Daiwa forecast (as of June 20) ** Amount the MOF plans to issue

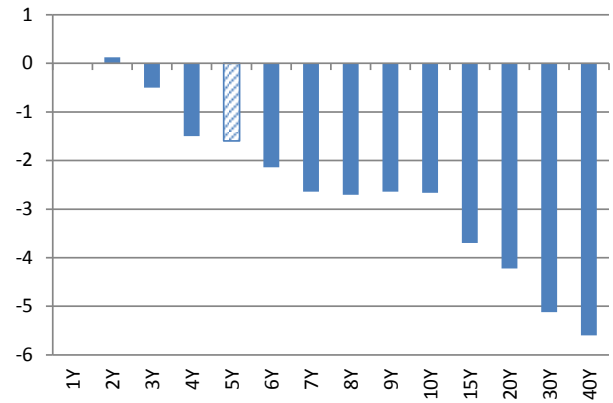
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 5Y JGB Yield (%)



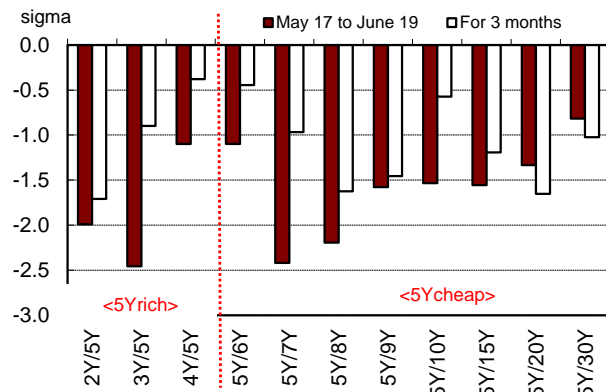
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (May 17 v. June 19; bp)



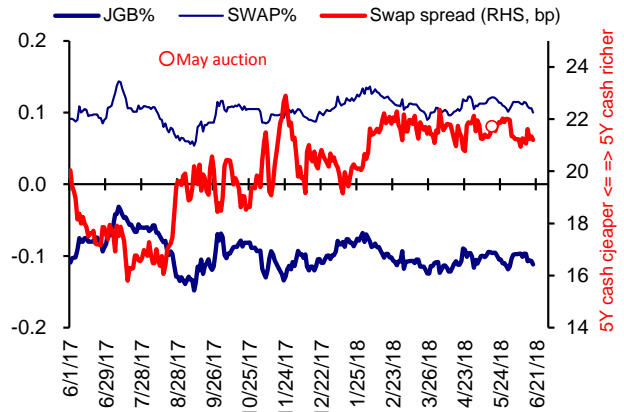
Source: Daiwa Securities.

Appendix 3: Z-scores of JGB Yield Spreads



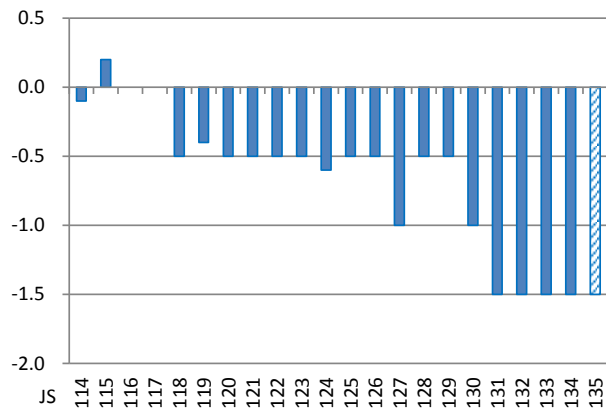
Source: Daiwa Securities.

Appendix 4: 5Y Swap Spread



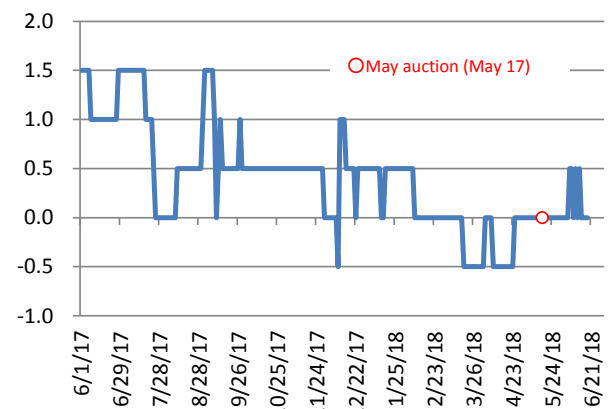
Source: Daiwa Securities.

Appendix 5: JS Yield Change (bp): May 17 v. June 19



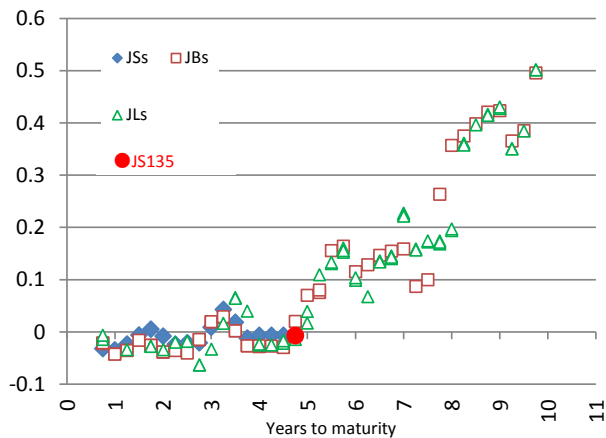
Source: Daiwa Securities.

Appendix 6: JS On-the-run and Off-the-run Spread (bp)



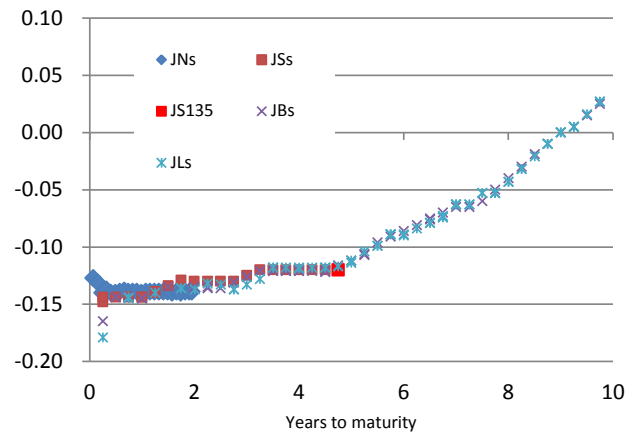
Source: Daiwa Securities.

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



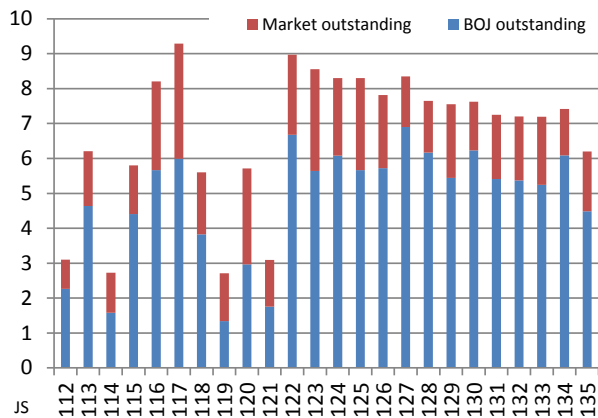
Note: Based on JB, JS and JL yield curves on June 19, respectively; Assuming that those yield curve shapes do not change and factoring roll-down effect etc.
Source: Daiwa Securities.

Appendix 9: JGB Yield Curve (%)



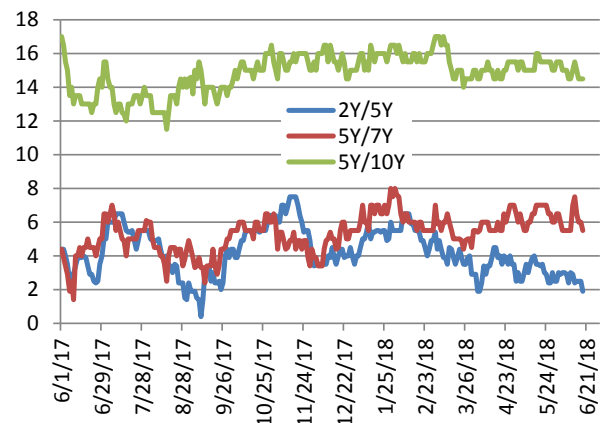
Note: as of June 19
Source: Daiwa Securities.

Appendix 10: BOJ and Market Outstanding of JSs (Yen trillions)



Note: as of June 8
Source: Ministry of Finance, Bank of Japan, Daiwa Securities.

Appendix 11: JGB Yield Spread (bp)



Note: as of June 19
Source: Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

■ The Significance of Registration

Registered Credit Rating Agencies are subject to the following regulations:

- 1) Duty of good faith.
- 2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
- 3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
- 4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")

The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (<http://www.standardandpoors.co.jp/unregistered>) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (<http://www.standardandpoors.co.jp>)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of March 7th, 2017, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of S&P Global Ratings Japan Inc. (<http://www.standardandpoors.co.jp>)

[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service, Inc. ("MIS")

The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moody.com/pages/default_ja.aspx))

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings are Moody's Investors Service, Inc.'s ("MIS") current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. MIS defines credit risk as the risk that an entity may not meet its contractual, financial obligations as they come due and any estimated financial loss in the event of default. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk, or price volatility. Credit ratings do not constitute investment or financial advice, and credit ratings are not recommendations to purchase, sell, or hold particular securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information, is given or made by MIS in any form or manner whatsoever.

Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of May 13th, 2016, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Moody's Japan K.K. (https://www.moody.com/pages/default_ja.aspx)

[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")

The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (<https://www.fitchratings.co.jp/web/>)

Assumptions, Significance and Limitations of Credit Ratings

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

For the details of assumption, purpose and restriction of credit ratings, please refer to "Definitions of ratings and other forms of opinion" on the website of Fitch Rating Japan Limited.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of May 13th, 2016, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Fitch Rating Japan Limited (<https://www.fitchratings.co.jp/web/>)

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.

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 (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.

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