

Outlook for 20Y JGB Auction

Average primary sales expected at 0.49-0.5% level

- ✓ The BOJ's "full-scale discussion to abate the side effects from the prolonged large-scale monetary easing" should be paid close attention. As uncertainty remains strong about measures to be used, however, the JGB market would not factor in it in the immediate future.
- ✓ Average primary sales are expected for new 20Y JGBs at the 0.49-0.50% level.
- ✓ We think of switching out from 30Y JGBs with the same duration with new 20Y JGBs. In addition, we would like to pay attention to demand for asset swaps at the Yen LIBOR-9bp level.

Strategic Memorandum DSTE253
FICC Research Dept.

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Auction Details

Auction Date:	July 12, 2018
Issue Date:	July 13, 2018
Maturity Date:	June 20, 2038
Offering Amount:	About 1.0 trillion yen

* New 20Y JGBs, JL165, will likely carry a 0.5% coupon.

** On July 11, JL164 traded at 0.480% (+0.5bp v. previous day's close) and closed at 0.480% (+0.5bp). WI barely traded and closed at 0.495% (+0.5bp v. previous day's close).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Average primary sales expected at 0.49-0.50% level

After the previous 20Y JGB auction went poorly at the 0.500-0.505% level on June 26, the on-the-run JL164 yield declined from 0.505% to 0.470% on an intraday basis amid the firmness of JGBs partly supported by the trend of lower stock prices/higher bond prices in the overseas markets. While such a trend seems to have let up, the yield is moving at the 0.470-0.480% range for the past several days. Key points to think about the bidding level at tomorrow's auction are as follows:

- ✓ Market positions currently look neutral around the 20Y sector;
- ✓ The 20Y sector is currently not attractive on the curve or against swaps;
- ✓ As JL165 will be new series of 20Y JGBs, which are generally popular among investors in terms of carry or expected return, expectations on demand from them may grow for this new issue more strongly than for reopened issues;
- ✓ By the next 20Y JGB auction to be held on August 21, the BOJ is expected to conduct six purchase operations in the zone over 10Y, in which new 20Y JGBs (JL165) will be included in the purchase list (three scheduled for July and we forecast three in August);
- ✓ Speculations on a cut in the BOJ's offer amount in the zone over 10Y are lingering. However, unless the BOJ trims it on July 19, there would be no chance in July;

In overseas markets, caution is growing about national security, in addition to trade friction

Let's check the environment surrounding 20Y JGBs. In the overseas markets, the risk-off sentiment, which grew in June, let up, and for the past several days, we have seen unwinding activities. However, caution about national security in Europe and the US appears to be increasing, in addition to the US-China/EU trade friction because (1) on July 10, the US announced an additional tariff list on Chinese products worth about \$200bn and (2) President Trump is expected to threaten European nations to increase spending on national defense at the NATO summit meeting to be held on July 11. Given such external factors, we think the possibility of a major collapse in JGBs is slim in the near term.

The BOJ is reported to consider measures to abate the side effects from monetary easing, but...

In Japan, the BOJ-related factors would attract attention as its Monetary Policy Meeting (MPM) is to be held on July 30-31. The BOJ is expected to revise down its inflation outlook in the July Outlook for Economic Activity and Prices report, which will be announced at the MPM. On the other hand, the BOJ is likely to maintain the current monetary policy to achieve the 2% price stability target, assuming that inflation momentum has been maintained. Up to now, the JGB market appears to have somewhat factored in the possibility that the BOJ will continue on the YCC policy over the relatively long term in a matter-of-fact stance, without making a step toward normalization or additional easing.

In such an environment, it was reported last night (July 10) that "the BOJ will start considering measures to abate the side effects from the prolonged large-scale monetary easing." However, it can be difficult for the Bank to discuss, for example, a hike of the target level of long-term interest rates at their stage of revising the inflation outlook down under the 2% price stability target. It is even more so, if we think of the impact on FX and stock markets by such a hike. Although more drastic reduction in the offer amount for long-term JGBs and/or a change in the purchase scheme could be discussed, immediate actions are unlikely to be taken as the 10Y JGB yield has been moving stably at around 0.03%. As measures to abate the side effects look quite limited at the moment, the JGB market would not factor in such a speculation in the immediate future. Market participants are likely to wait for the next MPM.

Switching out from 30Y JGBs with the same duration expected with JL165

Given all above, we would like to think about placing our bids to buy the necessary amount of new 20Y JGBs at the 0.49-0.50% level, assuming the JL165 yield will move in the 0.470-0.500% range until the next 20Y JGB auction. Relative-value wise, we think of switching out from 30Y JGBs with about same duration expected with that of JL165 (with around 22 years left to maturity), which are expected to carry lower total return than JL165 (Appendix 5). The fact that the 20Y sector is not overvalued against the 22Y sector (Appendix 3b and 6) helps the idea as well. In addition, we would like to pay attention to demand for asset swaps at the Yen LIBOR-9bp level (Appendix 4a).

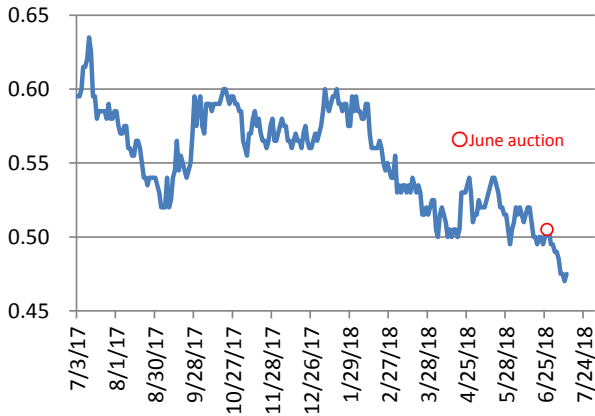
20Y JGB Auction Results

Auction Date	Issue #	Coupon (%)	Maturity Date	Issue Size (billion yen)	B/C	Average Accepted Price (Yen)	Lowest Accepted Price (Yen)	Tail (Yen)	Average Accepted Yield (%)	Highest Accepted Yield (%)	Tail (%)	Allotment (%)	Rating
7/12/18	165	0.5*	6/20/38										
6/26/18	164R	0.5	3/20/38	999.3	4.23	99.93	99.85	0.08	0.503	0.508	0.005	5.5369	Poor
5/22/18	164R	0.5	3/20/38	998.9	4.12	99.42	99.40	0.02	0.532	0.533	0.001	87.1182	Avg
4/19/18	164R	0.5	3/20/38	999.1	3.69	100.00	99.90	0.10	0.500	0.505	0.005	3.4926	Poor
3/15/18	164	0.5	3/20/38	1,126.7	4.47	99.22	99.20	0.02	0.543	0.544	0.001	83.3690	Good
2/22/18	163R	0.6	12/20/37	1,145.9	4.44	100.68	100.65	0.03	0.561	0.563	0.002	56.8524	Avg
1/25/18	163R	0.6	12/20/37	1,068.9	4.17	100.14	100.10	0.04	0.592	0.594	0.002	55.9271	Avg
12/14/17	163	0.6	12/20/37	1,138.6	4.56	100.48	100.45	0.03	0.573	0.574	0.001	60.4234	Good
11/16/17	162R	0.6	9/20/37	1,042.9	4.13	100.48	100.45	0.03	0.573	0.574	0.001	80.8990	Avg
10/17/17	162R	0.6	9/20/37	1,084.2	4.05	100.17	100.15	0.02	0.590	0.591	0.001	91.5000	Good
9/14/17	162	0.6	9/20/37	1,075.9	4.15	100.71	100.65	0.06	0.560	0.563	0.003	67.8513	Avg
8/22/17	161R	0.6	6/20/37	1,069.1	4.48	100.88	100.85	0.03	0.550	0.552	0.002	63.1797	Good
7/13/17	161R	0.6	6/20/37	1,128.1	4.19	99.88	99.80	0.08	0.606	0.611	0.005	34.8784	Avg
6/13/17	161	0.6	6/20/37	1,135.7	3.98	100.30	100.25	0.05	0.583	0.586	0.003	64.9734	Good

* Daiwa forecast as of July 11 ** Amount the Ministry of Finance plans to issue

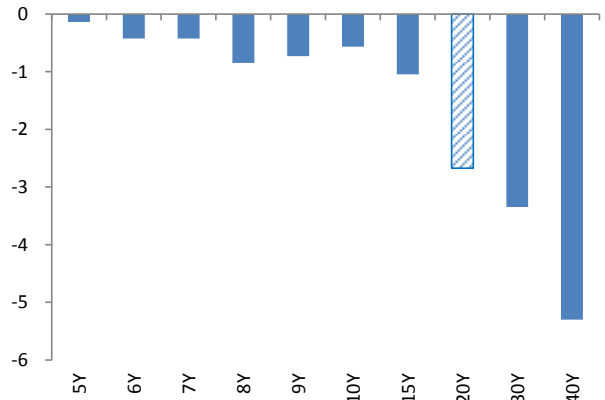
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 20Y JGB Yield (%)



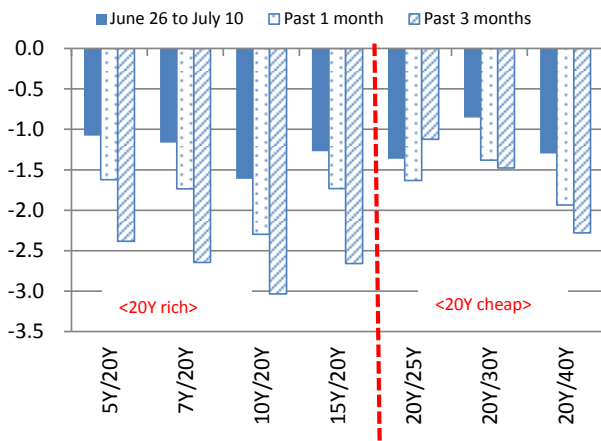
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (June 26 v. July 10, bp)



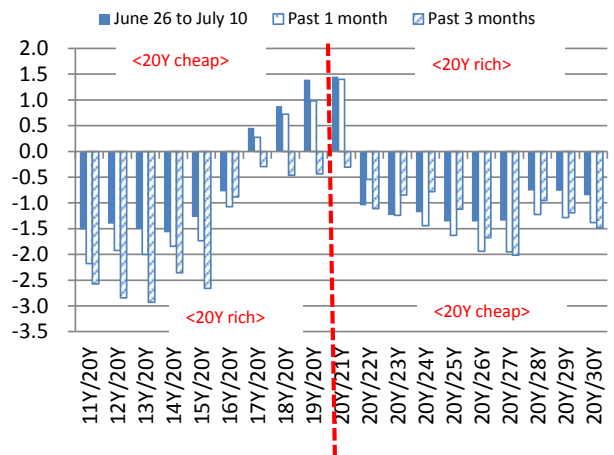
Source: Daiwa Securities.

Appendix 3a: Z-score I



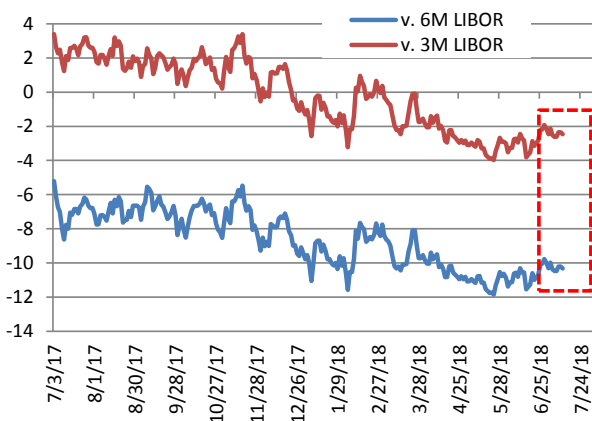
Source: Daiwa Securities.

Appendix 3b: Z-score II



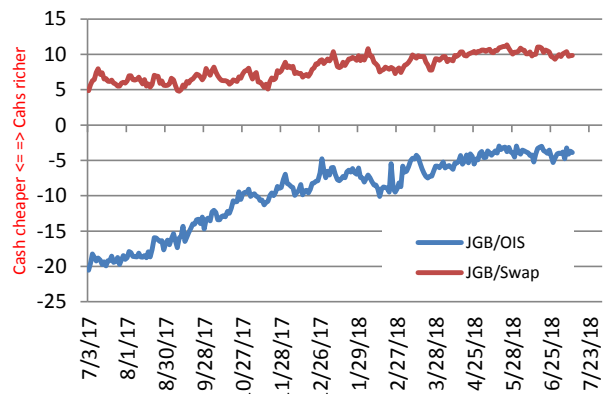
Source: Daiwa Securities.

Appendix 4a: 20Y JGB Asset Swap Spread (bp)



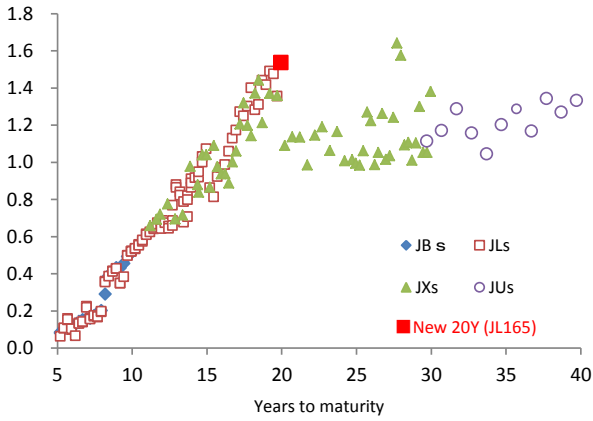
Note: since the May auction
Source: Daiwa Securities.

Appendix 4b: JGB/Swap and JGB/OIS Spreads (bp)



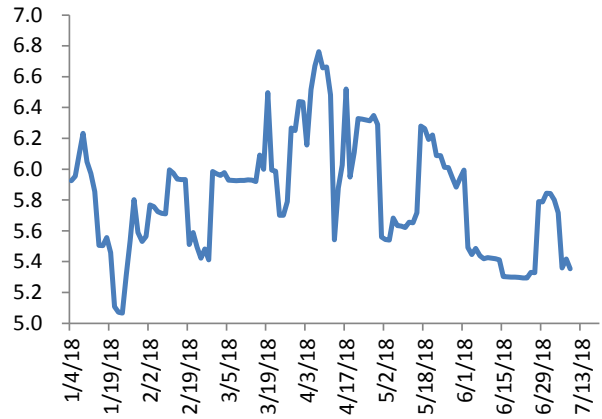
Source: Daiwa Securities.

Appendix 5: JGB Total Return Curve (6M, %)



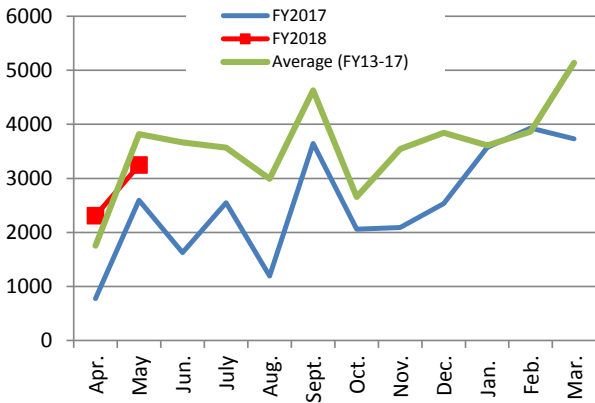
Note: Based on the July 10 curve; factoring in roll-down effect etc.; new 20Y (JL165) is calculated by assuming that the coupon is 0.5% and the spread to JL164 is 1.5bp.
Source: Daiwa Securities.

Appendix 6: JGB 20Y/22Y Spread (bp)



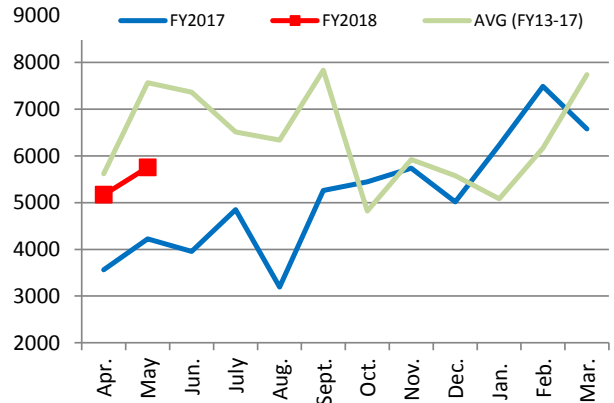
Source: Daiwa Securities.

Appendix 7a: Net Purchase of Superlong JGBs by Life- and Non-life Insurers (Yen billions)



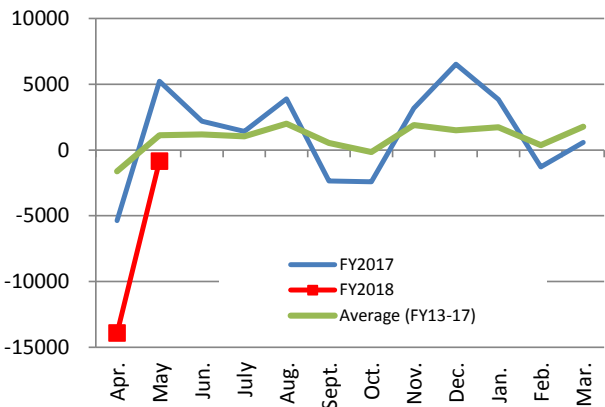
Source: JSDA.

Appendix 7b: Gross Purchase of Superlong JGBs by Life- and Non-life Insurers (Yen billions)



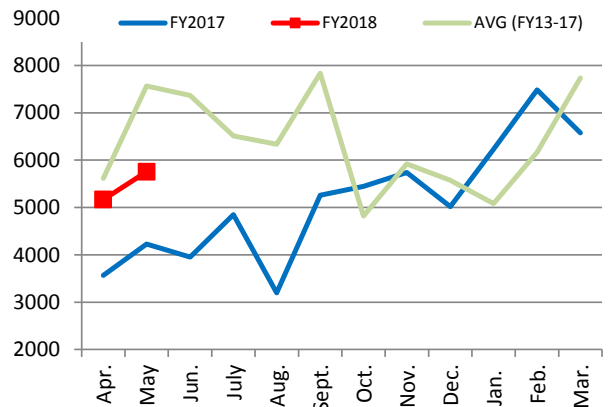
Source: JSDA.

Appendix 8a: Net Purchase of Superlong JGBs by Major Banks (Yen billions)



Source: JSDA.

Appendix 8b: Gross Purchase of Superlong JGBs by Major Banks (Yen billions)



Source: JSDA.

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[Standard & Poor's]

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

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May 2018

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- 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.
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* 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.

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