

Outlook for 10Y JGBi Auction

Expecting BEI to be supported around 45bp

- ✓ Following the MPM, the JGB market has been volatile. It will take some time before the market calms down. As the JGBi auction is to be held in such an environment, primary dealers will likely take a cautious bidding stance.
- ✓ However, the environment surrounding JGBis does not look so bad. What the BOJ tightens its grip on the YCC policy will serve as a good support for JGBis as well.
- ✓ We would like to place our primary bids around 45bp as of BEI with the target of 58-60bp by the next JGBi auction in November.

Strategic Memorandum DSTE258
FICC Research Dept.

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Auction Details

Auction Date:	August 7, 2018
Issue Date:	August 8, 2018
Maturity Date:	March 10, 2028
Offering Amount:	About 400 billion yen
Auction Method:	Dutch auction on a no-inflation-adjusted price with the increment of 0.05 yen
Base CPI:	100.7 (December 2017)
Ref. CPI:	100.994 (August 8)
Index ratio:	1.00292 (August 8)

* New 10Y JGBis will be the first reopening of JBI23 carrying a 0.1% coupon.

** On August 3, JBI23 barely traded, and closed at 105.20 yen (-0.10 yen v. previous day's close). JBI23 BEI was 52.0bp (-1.9bp v. previous day's close).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Key points in thinking about the bidding level

Since the previous JGBi auction went well in May, JGBis have been lacklustre. There are some reasons we think of for the poor performance. The US TIPS BEI plunged as crude oil prices turned to fall in late May. In early June, speculations grew that the BOJ was considering a downward revision to its inflation projections. In addition, a series of media articles was released saying that the Bank would discuss measures to curb side effects from the prolonged monetary easing. Those BOJ policy related talks most likely brought caution about a possible weakening of the BOJ's commitment to achieve the price stability target and dampened the market sentiment of JGBis.

Key points in thinking about the bidding level at the auction are as follows:

- ✓ The nationwide core CPI growth rate (y/y) is expected to remain at about 1.0% toward around September;

- ✓ After this auction, the index ratio will likely remain flat until September, and then post an uptrend toward around March 2019;
- ✓ Under the assumption that the current purchase pace continues, the BOJ and MOF are expected to purchase JGBis worth at least around 170 billion yen in total by the next JGBi auction to be conducted in November 2018;
- ✓ The BOJ strengthens its commitment to achieve the “price stability target” by forward guidance on policy interest rates. Considering the expected impact from the consumption tax hike scheduled for October 2019, the Bank reinforces the sustainability of the YCC policy;
- ✓ The BOJ decided to double the operational target range of the long-term interest rate, -0.1 to 0.1%, to about -0.2 to 0.2%.

Index ratio is on an uptrend, despite sluggish inflation at around 1%

Let's check the environment surrounding JGBi. On July 27, it was announced that the core CPI in Tokyo's 23 wards rose by 0.8% y/y in July, which exceeded the market consensus. Based on the Tokyo-area readings, we forecast July nationwide core CPI would rise by around 0.9% y/y, higher than the 0.8% growth in June. As witnessed by the trend, we can say that concerns over a slowdown in the growth rate, which mounted around May to June, are now diminishing. Looking ahead into the near future, we expect the core CPI growth rate to remain at around 1% as contribution from a rise in energy prices would boost it. If we estimate the index ratio of JBI23 based on our inflation forecast, it is highly possible that the ratio will remain flat during the period after the upcoming auction toward September and mostly rise toward around March 2019 after that (Chart 5). That means, during that period, even if JBI23 price remains unchanged, a positive return is expected from JBI23 (Chart 6). As the observed inflation is expected to stay at around 1%, the investor sentiment for JGBis is unlikely to improve strongly. That being said, it would not serve as a factor to trigger further selling, either. This is all the more so, as crude oil prices and the US TIPS BEI have been moving stably. Going forward, we think that the environment surrounding JGBis will not be bad compared to the period from the May auction to date.

The BOJ strengthens its commitment to realize the “price stability target”

The BOJ decided to strengthen its commitment to realize the “price stability target” by introducing forward guidance on policy interest rates at the Monetary Policy Meeting (MPM) on July 30-31. The Bank intends to maintain “the current extremely low levels of short- and long-term interest rates for an extended period of time,” given the uncertainties regarding economic activity and prices including the impact by the consumption tax hike scheduled to take place in October 2019. As the BOJ lowered its inflation projections through FY20, the time frame for achieving the “price stability target” has extended. That being said, the reinforcement of the Bank's commitment to achieve its price stability target is a positive factor for JGBi.

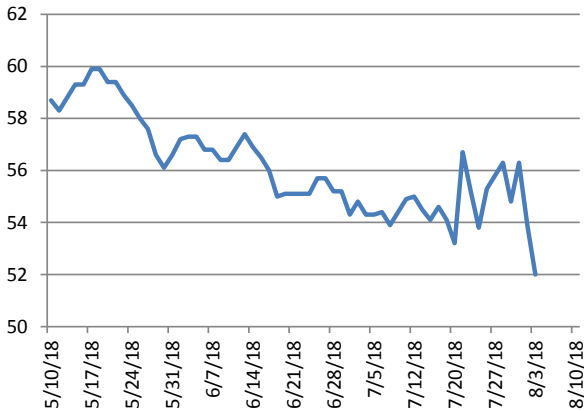
The BEI range could shift upward as the operational target range of the long-term interest rate has been widened

In addition, the Bank roughly doubled the operational target range of the long-term interest rate from the previous range of about -0.1 to 0.1% (that is, to about -0.2 to 0.2%). The expansion of the target range may boost the upside potential of the BEI. Following the MPM, JGBi yields followed the rise in nominal interest rates most likely because (1) market participants disfavored the extension of the time frame for reaching the price stability target and (2) the upcoming auction came in sight. As a result, the BEI has remained roughly flat at around 55bp. However, we think that the BEI range could shift upward as the market would understand and digest more the “Strengthening the Framework for Continuous Powerful Monetary Easing” decided at the latest MPM.

Cautious bidding stance: betting on supopr around 45bp

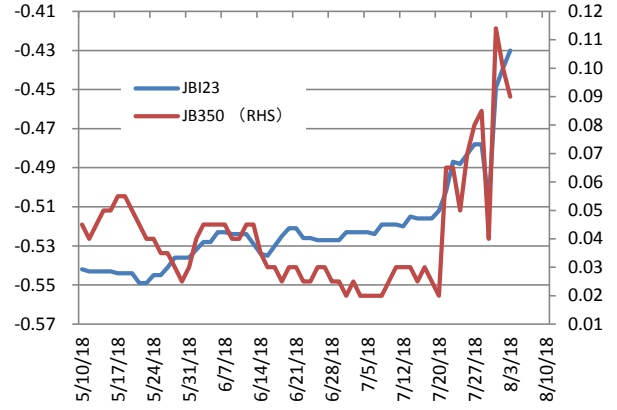
Following the MPM, the JGB market has been volatile. It will take some time before the market calms down. As the JGBi auction is to be held in such an environment, primary dealers will likely take a cautious bidding stance. However, (1) JGBis have been facing selling pressure alongside nominal JGBs, (2) it is easy to forecast the upside potential of JGBis, rather than downside potential, as the BOJ tightens its grip on the YCC policy, and (3) investor sentiment may improve at the time of next auction (slated for November) as the consumption tax hike in October 2019 becomes more likely, despite doubt among some observers. All in all, we would like to place our primary bids around 45bp as of BEI with the target of 58-60bp by the next JGBi auction in November.

Chart 1: BEI of JBI23 (bp)



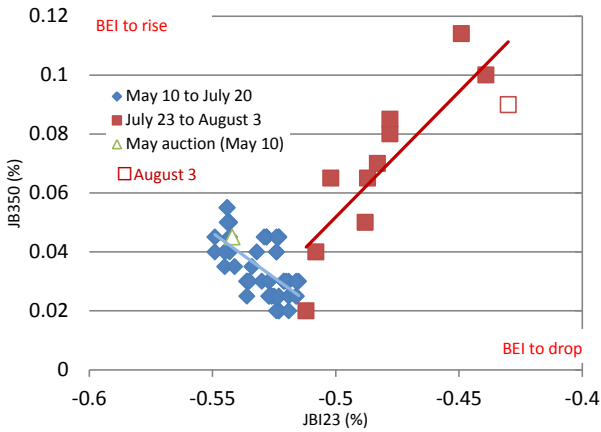
Source: Daiwa Securities

Chart 2: JBI23 and JB350 Yields (%)



Source: Daiwa Securities.

Chart 3: Correlation between JBI23 and JB350 (%)



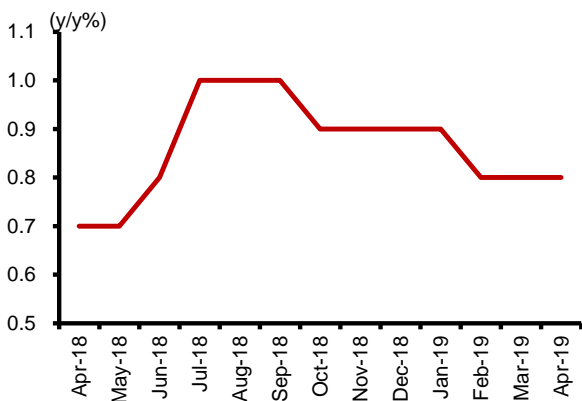
Source: Daiwa Securities

Table 1: 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
6/20/18	106.20	-0.080	-0.114	8.1	8.15	106.20
7/2/18	106.25	-0.060	-0.069	44.6	7.77	106.20
7/17/18	106.10	-0.130	-0.157	36.6	7.44	106.10

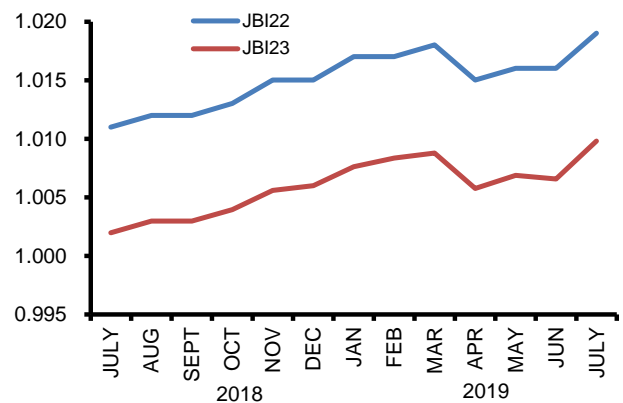
Source: Bank of Japan, Ministry of Finance, Daiwa Securities

Chart 4: Nationwide Core-CPI Growth Outlook



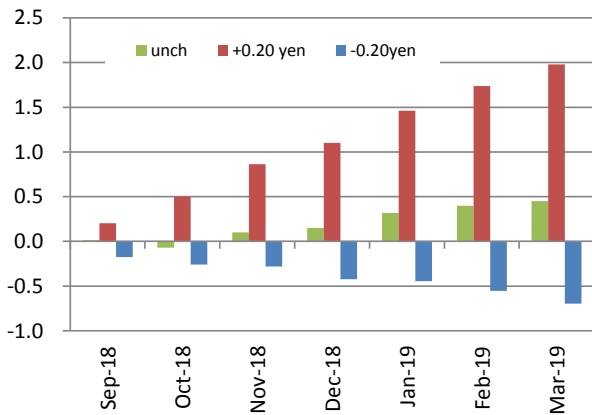
Note: actual for April to June 2018
Source: Daiwa Securities.

Chart 5: Index Ratio Forecast on JBI22 and New (JBI23)



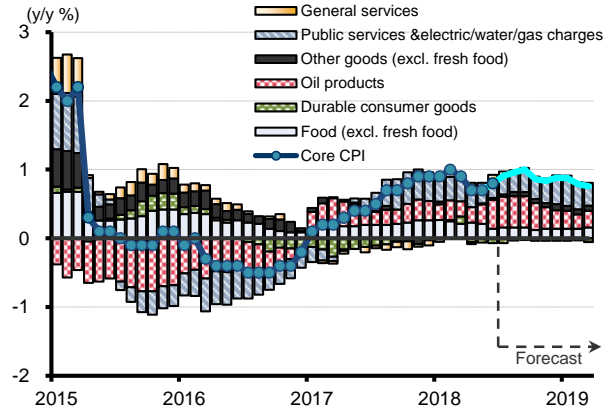
Note: based on Chart 4; actual for July to September 2018
Source: Daiwa Securities

Chart 6: Nationwide Core-CPI Growth Outlook



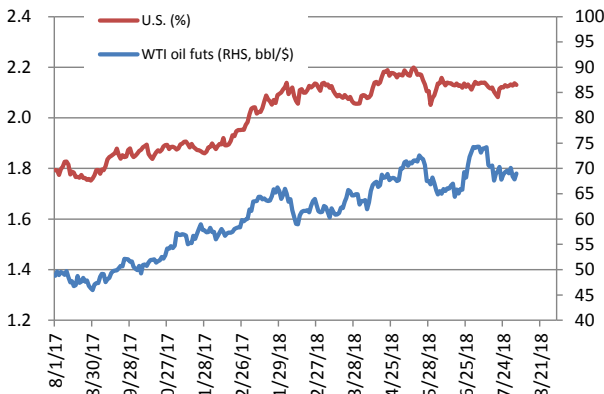
Notes: Return by scenario is estimated based on the index ratio in Chart 5. Price during each holding period from August 8 (as on settlement day) is unchanged under "the scenario 1", up 0.20 yen every month under "the scenario 2", and down 0.20 yen every month under "the scenario 3."
Source: Daiwa Securities

Chart 7: Nationwide Core-CPI Growth Outlook



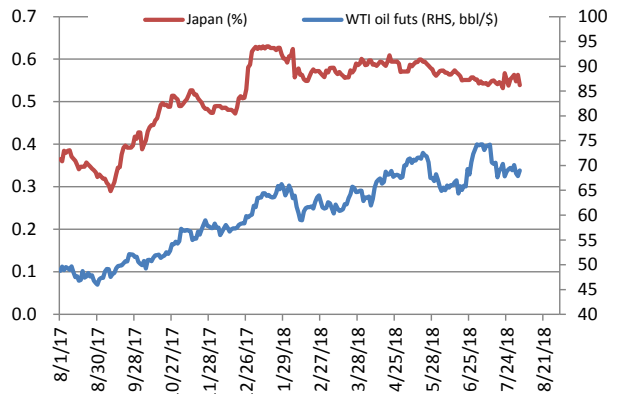
Source: Ministry of International Affairs and Communications; Daiwa Securities

Chart 8a: US BEI and Oil Price



Source: Bloomberg

Chart 8b: Japan BEI and Oil Price



Source: Bloomberg, Daiwa Securities.

10Y JGBi Auction Results

Auction Date	Issue #	Coupon (%)	Maturity Date	Issue Size (billion yen)	B/C	Lowest Accepted Price/Issue Price (Yen) (Note 1)	Highest Accepted Yield (%)	Issue Price Before Multiplied by Index Ratio (Note 2)	Allotment (%)	BEI Before Auction (Note 3)	BEI on Auction Day (bp) (Note 3)	Change from p.d. (bp) (Note 3)	Market Expectation of Lowest Accepted Price (Yen) (Note 4)	Expected range	
8/7/18	23R	0.1	3/10/28	400.0*						52.0					
5/10/18	23	0.1	3/10/28	447.1	4.02	106.35	-0.513	-	32.0441	56.5	58.7	2.2	106.20	106.10-106.30	Good
2/6/18	22R	0.1	3/10/27	440.8	3.38	105.35	-0.464	-	5.0000	62.4	55.7	-6.7	106.25	106.00-106.30	Poor
10/5/17	22R	0.1	3/10/27	446.4	3.10	104.50	-0.361	-	55.6088	38.8	39.9	1.1	104.40	104.30-104.50	Good
8/3/17	22R	0.1	3/10/27	419.3	3.19	104.55	-0.358	104.048	69.4877	36.0	38.5	2.5	104.45	103.70-104.50	Good
4/11/17	22	0.1	3/10/27	453.9	3.64	105.00	-0.385	105.210	50.5643	44.0	46.7	2.7	104.80	104.65-105.00	Good
2/7/17	21R	0.1	3/10/26	412.2	2.61	105.10	0.439	105.406	25.7142	62.9	58.2	-4.7	105.30	105.00-105.50	Poor
10/6/16	21R	0.1	3/10/26	425.1	3.21	104.80	-0.391	105.316	40.0537	30.9	37.1	6.2	104.75	104.50-104.90	Good
8/4/16	21R	0.1	3/10/26	454.3	2.85	104.20	-0.324	104.509	72.0520	30.0	31.0	1.0	103.80	103.40-104.05	Good
4/12/16	21	0.1	3/10/26	435.6	2.84	104.90	-0.376	105.629	80.0000	35.0	36.7	1.7	104.70	104.30-105.40	Good
1/13/16	20R	0.1	3/10/25	542.9	2.47	104.40	-0.364	104.088	20.5882	57.5	52.8	-4.7	104.35	104.00-104.55	Avg
11/10/15	20R	0.1	3/10/25	501.6	2.21	105.45	-0.459	105.240	96.8750	76.7	74.2	-2.5	105.50	105.00-105.65	Avg
7/7/15	20R	0.1	3/10/25	541.2	2.33	106.70	-0.555	106.593	20.0000	106.0	99.2	-6.8	106.80	106.60-107.00	Good
5/8/15	20	0.1	3/10/25	553.7	2.65	107.20	-0.589	107.847	4.4444	112.4	108.5	-3.9	106.95	106.20-107.20	Good

* Daiwa forecast as of May 8 ** Planned by MoF (Note 1) Inflation adjusted price until August 2017 and inflation unadjusted price from October 2017 (Note 2) Daiwa calculation (Note 3) Closing price; WI basis for new issues; as of Aug. 3 for the Aug. 2018 auction (Note 4) Bloomberg

Source: Ministry of Finance, Daiwa Securities

Image of Bidding Price at Auction

(Yen)

		Nominal bond yield (%、JB350)									
		0.070	0.075	0.080	0.085	0.090	0.095	0.100	0.105	0.110	0.115
BEI (bp)	51	105.29	105.24	105.19	105.14	105.09	105.04	104.99	104.94	104.89	104.84
	50	105.19	105.14	105.09	105.04	104.99	104.94	104.89	104.84	104.79	104.74
	49	105.09	105.04	104.99	104.94	104.89	104.84	104.79	104.74	104.69	104.64
	48	104.99	104.94	104.89	104.84	104.79	104.74	104.69	104.64	104.59	104.54
	47	104.89	104.84	104.79	104.74	104.69	104.64	104.59	104.54	104.49	104.44
	46	104.79	104.74	104.69	104.64	104.59	104.54	104.49	104.44	104.39	104.34
	45	104.69	104.64	104.59	104.54	104.49	104.44	104.39	104.34	104.29	104.24
	44	104.59	104.54	104.49	104.44	104.39	104.34	104.29	104.24	104.19	104.14
	43	104.49	104.44	104.39	104.34	104.29	104.24	104.19	104.14	104.09	104.04
	42	104.39	104.34	104.29	104.24	104.19	104.14	104.09	104.04	103.99	103.94
	41	104.29	104.24	104.19	104.14	104.09	104.04	103.99	103.94	103.89	103.84
	40	104.19	104.14	104.09	104.04	103.99	103.94	103.89	103.84	103.79	103.74
39	104.09	104.04	103.99	103.94	103.89	103.84	103.79	103.74	103.69	103.65	

Note: actual bidding with the increment of 0.05 yen; as on Aug. 7 with the Aug, 8 settlement
Source: Daiwa Securities

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[Standard & Poor's]

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May 2018

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