

Outlook for 40Y JGB Auction

Solid bidding expected

- ✓ The 40Y JGB yield, which has declined below 1%, may discourage investors from purchasing 40Y JGBs in an aggressive stance. In the current bond-friendly environment, however, the current yield level can be as it is even by factoring in potential cut in the number of the BOJ offers to purchase superlong JGBs per month and tight issuance schedule over the next two weeks.
- ✓ Considering that the 40Y JGB yield may decline to 0.90-0.95% level by the next auction on a conventional yield basis, we would like to think about our bidding stance at the auction.

Strategic Memorandum DSTE280
FICC Research Dept.

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

Auction Details

Auction Date:	November 27, 2018
Issue Date:	November 28, 2018
Maturity Date:	September 20, 2058
Offering Amount:	About 400 billion yen
Auction Method:	Dutch auction on a compound yield with the increment of 0.5bp

* New 40Y JGBs will be the third reopening of JU11 carrying a 0.8% coupon.

** On November 26, JU11 traded at 0.965-0.975% (-0.5 - +0.5bp v. previous day's close: 0.943-0.951% on compound yield) and closed at 0.965% (-0.5bp: 0.943%).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

40Y JGB yield down below 1% on both conventional and compound yield bases

Since the previous 40Y JGB auction went well at the 1.060-1.065% level (or 1.023-1.027% on compound yield basis) on September 26, the market sentiment for superlong JGBs had been unfavorable as (1) the US long-term interest rate posted an uptrend, as witnessed by the 10Y UST yield's recovery to the 3.2% level, partly on a rate hike and (2) the BOJ revised its JGB purchase operation guideline at the end of September. In such an environment, the 40Y JGB yield temporarily rose to 1.115% (or 1.068% on compound yield basis) in early October. Since then, the JGB market has firmed up amid a plunge in crude oil prices and stock prices around the globe, leading the 40Y JGB yield down. Recently, the yield has been below 1% on both conventional and compound yield bases (Appendix 1). From the viewpoint of the absolute yield level, we are slightly worried about investor demand for 40Y JGBs.

In an environment where upward pressure on yields is unlikely to grow...

Let's look at the environment surrounding the JGB market. Amid entrenched worries over the economy weakening on the combination of a cyclical downturn in the global economy and US-China trade friction, the Fed Chair and Vice Chair pointed to the global economic slowdown in mid-November, thereby weakening expectations of accelerated pace of rate

hikes and apparently diminishing upward pressure on US long-term rates. In addition to ongoing downtrend in crude oil prices, stock prices remain lackluster both outside and inside of Japan, failing to show a big recovery after the plunge in October. In terms of external factors, it is difficult for market participants to expect JGB yields to show a strong uptrend in the near term.

The current yield level can be as it is even by factoring in potential cut in the number of BOJ offers in the zone over 10Y and tight JGB issuance schedule

In terms of domestic factors, market participants would pay attention especially to the BOJ's purchase stance. It seems that the market consensus has been already built for potential cut in the number of offers from five per month in November to five in December. In the current bond-friendly environment, the current 40Y JGB yield can be as it is even by factoring in the cut along with the tight JGB issuance schedule around the long end of the curve over the next two weeks, including tomorrow's 40Y JGB auction, the tap auction for JGBs with over 15.5 to 39 years to maturity on Dec. 6 and the 30Y JGB auction on Dec.11.

Thinking about our bidding stance at the auction in anticipation of a yield decline to 0.90-0.95% level

We expect tomorrow's 40Y JGB auction to go well also backed by some supportive factors—(1) the auction will be conducted in a yield-Dutch method, (2) decent short-covering is expected, (3) the issuance amount will be relatively small at about 400bn yen, and (4) the next 40Y JGB auction is scheduled in January, though the 40Y sector's richness on the curve can be a concern (Appendix 5). Considering that the 40Y JGB yield may decline to the 0.90-0.95% level on a conventional yield basis by the next auction scheduled for Jan. 29, we would like to think about our bidding stance at this auction.

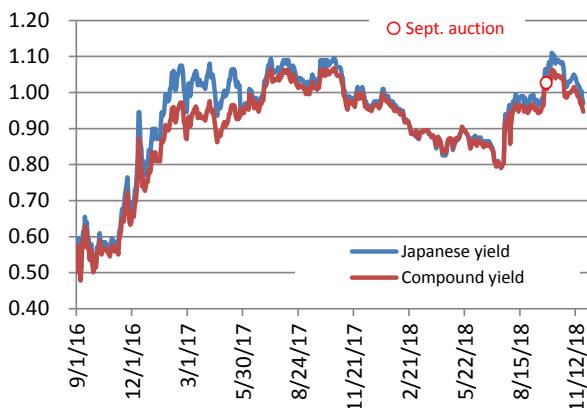
40Y JGB Auction Results

Offer Date	Issue#	Nominal Coupon (%)	Maturity Date	Issue Size (100M yen)	B/C	Highest Accepted Yield (%)	Allotment (%)	Issue Price (yen)	Yield on the previous day (%)**	30Y/40Y on the previous day (bp)**	Yield at close on the auction day (%)**	30Y/40Y at close on the auction day (bp)**	
11/27/18	11R	0.8	3/20/58	400.0*					0.947	12.0			
9/26/18	11R	0.8	3/20/58	399.2	3.24	1.025	66.5584	92.71	1.027	14.3	1.027	14.3	Good
7/24/18	11R	0.8	3/20/58	399.5	3.30	0.880	36.6400	97.33	0.896	12.8	0.921	13.1	Good
5/29/18	11	0.8	3/20/58	456.7	3.92	0.865	52.4978	97.81	0.890	15.0	0.857	13.5	Good
3/27/18	10R	0.9	3/20/57	566.1	3.19	0.885	20.6239	100.49	0.886	14.6	0.882	14.2	Good
1/12/18	10R	0.9	3/20/57	572.1	3.67	0.985	10.8072	97.24	0.995	15.9	0.982	15.5	Good
11/28/17	10R	0.9	3/20/57	534.1	3.00	1.005	63.8132	96.60	0.991	16.0	0.999	16.3	Poor
9/26/17	10R	0.9	3/20/57	556.2	3.24	1.015	1.4525	96.27	1.012	19.4	1.012	19.0	Good
7/25/17	10R	0.9	3/20/57	563.7	3.20	1.045	6.5217	95.30	1.046	18.8	1.033	18.8	Good
5/25/17	10	0.9	3/20/57	530.2	2.87	0.965	5.1671	97.86	0.945	14.5	0.956	14.7	Poor

* Issue amount planned by Ministry of Finance ** Based on WI for new JU series; as of Nov. 22 close for the Nov. 2018 auction

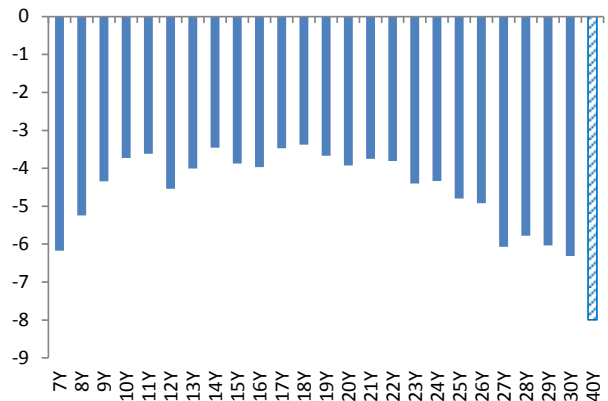
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 40Y JGB Yield (%)



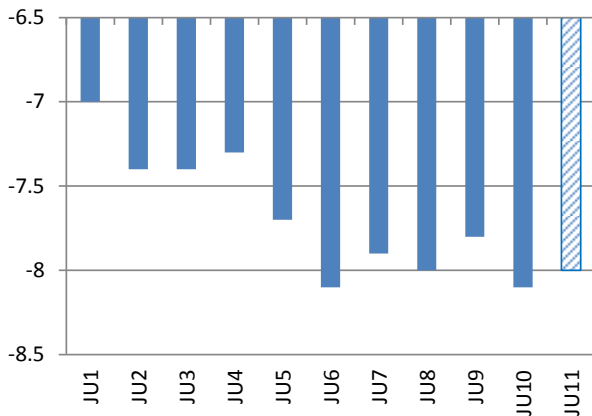
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Sept. 26 v. Nov. 22



Source: Daiwa Securities.

Appendix 3: JU Yield Change (bp): Sept. 26 v. Nov. 22



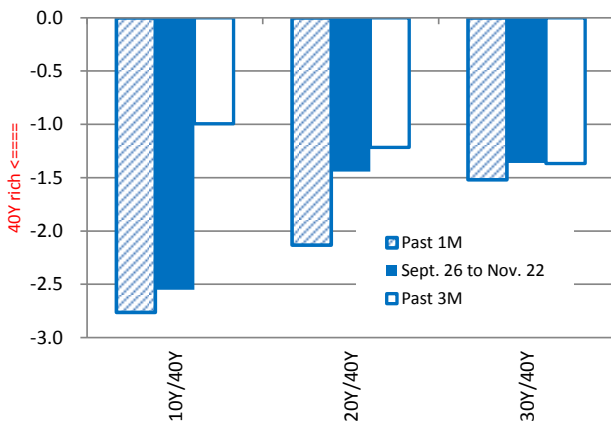
Source: Daiwa Securities.

Appendix 4: 40Y JGBs held by BOJ (Yen trillions)

	MOF Issue Size	BOJ Holding	% of BOJ Holding	Market Outstanding
JU1	975.4	178.7	18.3%	796.7
JU2	1,335	62	4.7%	1,273
JU3	1,356	193	14.3%	1,162
JU4	1,957	217	11.1%	1,740
JU5	1,918	131	6.8%	1,787
JU6	1,985	922	46.4%	1,063
JU7	2,144	1,055	49.2%	1,089
JU8	2,313	1,223	52.9%	1,090
JU9	3,352	1,454	43.4%	1,898
JU10	3,323	979	29.5%	2,343
JU11	1,255	321	25.6%	934

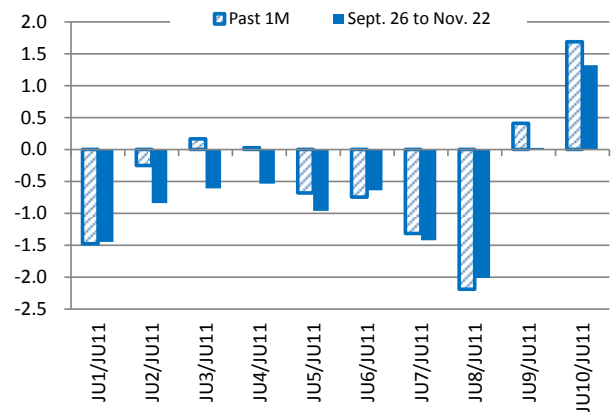
Note: as of Nov. 20
Source: Daiwa Securities.

Appendix 5a: Z-score I



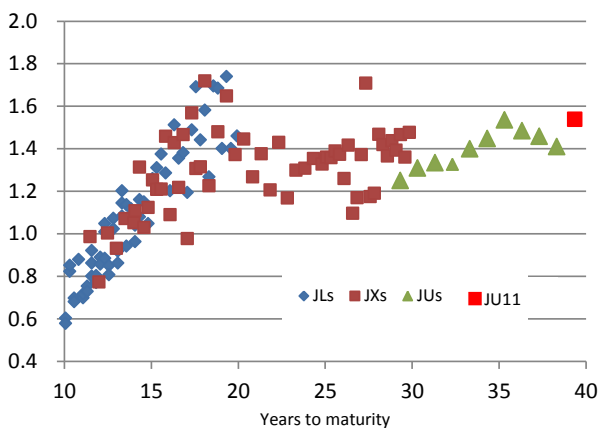
Source: Daiwa Securities. Note: Based on on-the-run issues

Appendix 5b: Z-score II



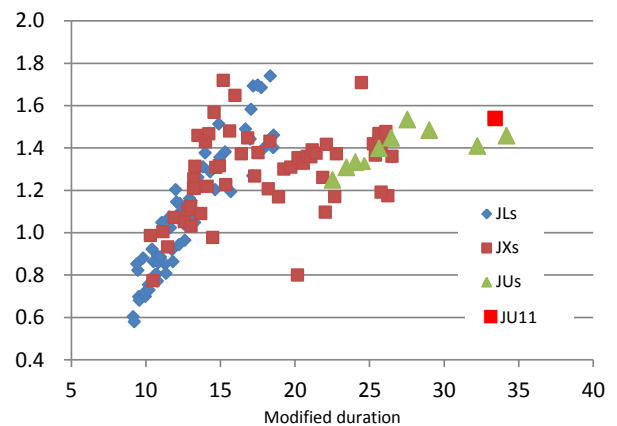
Source: Daiwa Securities.

Appendix 6a: 3M Total Return Curve on Years to Maturity (%)



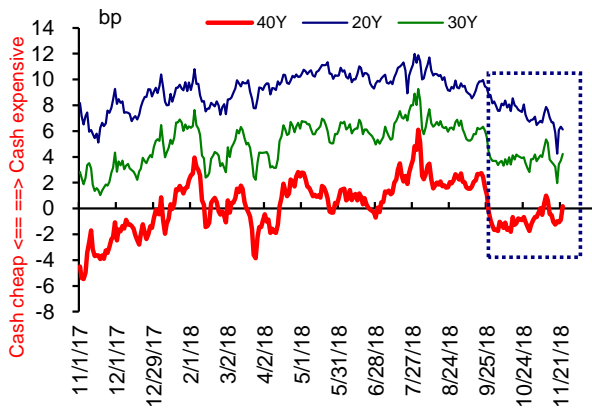
Note: Assuming that the yield curve shape as on Nov. 22 is unchanged and factoring in roll-down effect etc.
Source: Daiwa Securities.

Appendix 6b: 3M Total Return Curve on Modified Duration (%)



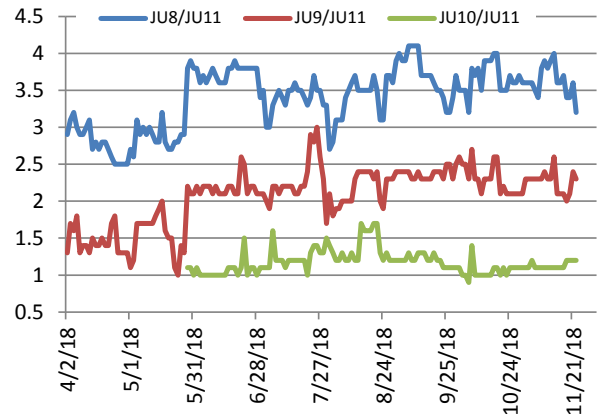
Note: Assuming that the yield curve shape as on Nov. 22 is unchanged and factoring in roll-down effect etc.
Source: Daiwa Securities.

Appendix 7: Swap Spreads



Source: Daiwa Securities.

Appendix 8: 40Y JGB Yield Spread (bp)



Source: Daiwa Securities.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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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.
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