

Outlook for 20Y JGB Auction

Smooth auction expected

- ✓ New 20Y JGBs to be redeemed in Sept. 2038, JL166, will likely carry 0.7% coupon
- ✓ 0.650-0.700% is the highest yield level since Feb-Mar 2017
- ✓ Especially in the near term, recent yield uptrend may lose momentum
- ✓ BOJ may not be in a rush to reduce its purchases in the 10-25Y zone
- ✓ Bidding at JL165 Japanese yield + 0.5bp or winder level
- ✓ Thinking about buying asset swaps at the level near 3M LIBOR flat

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Auction Details

Auction Date: October 18, 2018
Issue Date: October 19, 2018
Maturity Date: September 20, 2038
Offering Amount: About 1.0 trillion yen

* New 20Y JGBs, JL166, will likely carry a 0.7% coupon.

** On October 17, JL165 was traded at 0.670-0.675% (-0.5bp - unch v. previous day's close) and closed at 0.670% (-0.5bp). WI was barely traded and closed at 0.675% (-0.5bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

0.650-0.700% is the highest yield level since Feb-Mar 2017

Since the previous 20Y JGB auction went well at the 0.615-0.620% level on September 20, the 20Y JGB yield has been mostly in an uptrend, as witnessed by a temporal rise to 0.69% on an intraday basis. The US market has softened on the back of higher stock prices and good economic data, pushing up the 10Y Treasury yield to the 3.0% level. That has put JGB yields under upward pressure. For the past few days, the 20Y JGB yield is moving at the 0.660-0.675% level. The 0.650-0.700% level is the highest yield since Feb-Mar 2017.

Especially in the near term, recent yield uptrend may lose momentum

Let's check the environment surrounding 20Y JGBs. At its monetary policy meeting in July, the BOJ strengthened the framework for the YCC policy alongside a downward revision to its inflation outlook through FY2020. In the environment where the observed inflation rate is expected to stay at around 1%, the 10Y JGB yield has been edging up to 0.15-0.20% level, triggered by the uptrend of US Treasury yields under the tightening cycle, and the 20Y JGB yield has been also edging up. On the other hand, rate hike projections among FOMC participants as of September are unchanged from those as of June (four hikes in 2018 and three hikes in 2019). Partly because of this, the uptrend of US long-term interest rates (from the current levels) may lose momentum. In addition to concerns about cyclical slowdown in the global economy, caution about an economic setback due to US-China trade friction appears deep-rooted. Especially over the next one month, the recent yield uptrend may lose momentum partly due to the unwinding of existing positions etc. amid strong uncertainty over the outlook of the US mid-term election to be held on November 6. The

latest global weakening of stocks and strengthening of bonds appears to have made it impossible to ignore the possibility of a lull in the rise in bond yields. We thus can say that the environment surrounding 20Y JGBs is currently not so bad.

BOJ may not be in a rush to reduce its purchases in the 10-25Y zone

In the BOJ's JGB purchase schedule and guideline for October (Outright Purchases of Japanese Government Securities) announced on September 28, the offer range in the 10-25Y zone was unchanged at 150-250bn yen. Although the BOJ currently manages purchase operations in a flexible way, market participants will likely remain cautious about the BOJ's trimming of buying JGBs in the 10-25Y zone to 150 billion yen, the bottom of the current range, given the way how the BOJ trimmed buying JGBs in the zone over 25Y. That being said, superlong JGB yields are now around their highest level since the YCC policy began, and the current yield curve shape suggests that it has largely corrected from the excessive flattening that it underwent at one point (Appendix 8). Unless the central bank needs to respond to tighter supply-demand etc., we think it is unlikely to be in a hurry to cut its purchases in the 10-25Y zone. In addition, the BOJ is expected to conduct at least five purchase operations in the 10-25Y zone (three scheduled for this month and we now expect two operations in Nov) by the next 20Y JGB auction (Nov. 20) after tomorrow's auction. For example, even if the offer amount is trimmed by 10bn yen during the period, the total purchases would amount to the 850-900bn yen level vs. tomorrow's 1 trillion yen of issuance. Accordingly, strong caution would be not needed with respect to reduction in the BOJ's offer amounts.

Bidding at JL165 + 0.5bp or wider level on Japanese (simple) yield basis

All in all, we expect tomorrow's auction to go smoothly. Decent short-covering is likely to help the primary sales as well. In addition, we would not need strong concerns about demand from investors because 20Y JGBs are still attractive in terms of expected carry (Appendix 5) and new 20Y JGBs belong to a new maturity basket. We would like to place our bids at the JL165 Japanese yield + 0.5bp or wider level.

Thinking about buying asset swaps

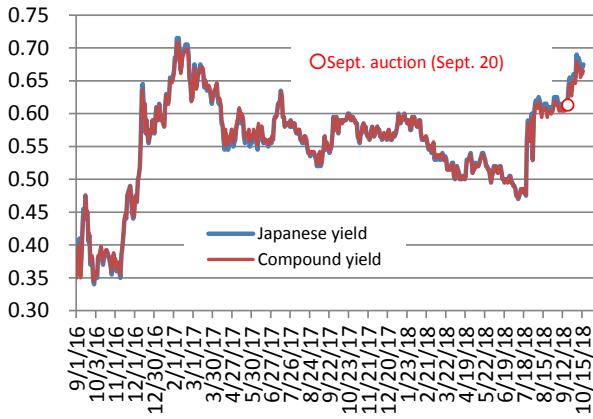
The 20Y sector is not noticeably cheap on the curve at the current level. It is rather overvalued vs. some off-the-run sectors (Appendix 3a-b). We thus do not anticipate strong support for sales of new 20Y JGBs from activities to build new curve positions. Since the previous auction, the asset swap spread has been mostly tightening. If the spread approaches the 3M Yen LIBOR +/-0bp level, it would be worth considering buying JL166 in asset swaps.

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
10/18/18	166	0.7*	9/20/38	1,000**									
9/20/18	165R	0.5	6/20/38	999	4.03	97.91	97.85	0.06	0.618	0.622	0.004	13.0174	Good
8/21/18	165R	0.5	6/20/38	1,121	4.66	98.10	98.05	0.05	0.607	0.610	0.003	15.0048	Good
7/12/18	165	0.5	6/20/38	1,118	4.54	100.13	100.10	0.03	0.492	0.494	0.002	63.8373	Good
6/26/18	164R	0.5	3/20/38	999	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	999	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	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	1,127	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	1,146	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	1,069	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	1,139	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	1,043	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	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	1,076	4.15	100.71	100.65	0.06	0.560	0.563	0.003	67.8513	Avg

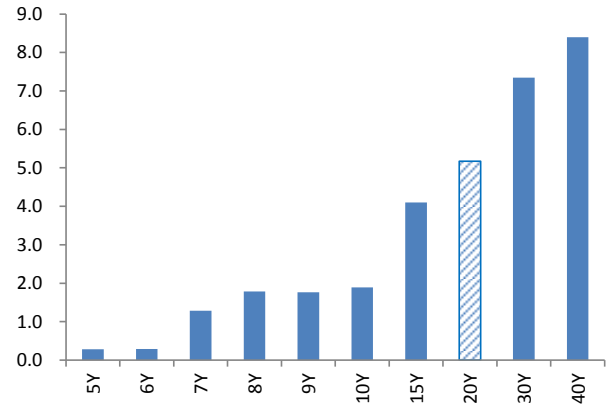
* Daiwa forecast as of Oct. 17 ** Amount the Ministry of Finance plans to issue
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 20Y JGB Yield (%)



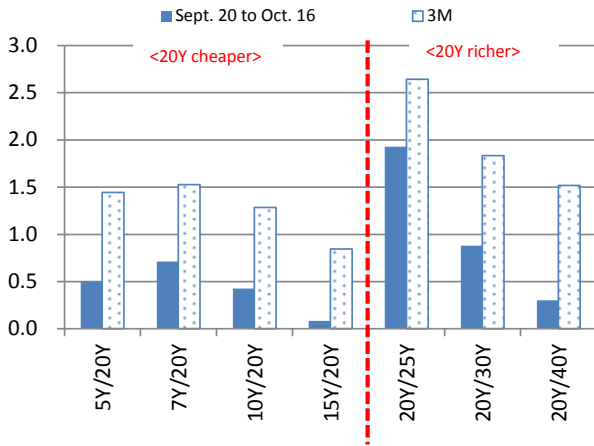
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (Sept. 20 v. Oct. 16, bp)



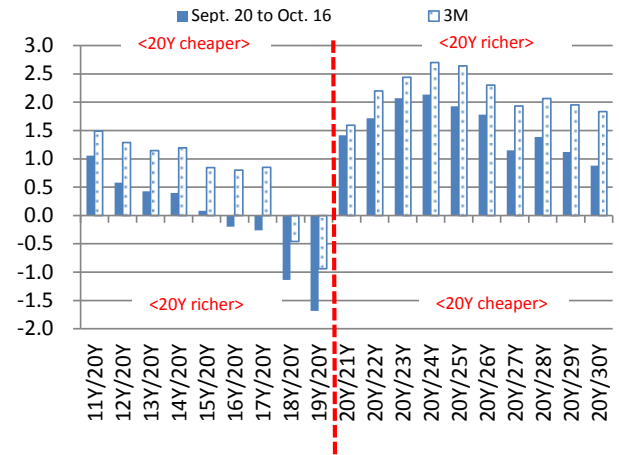
Source: Daiwa Securities.

Appendix 3a: Z-score I



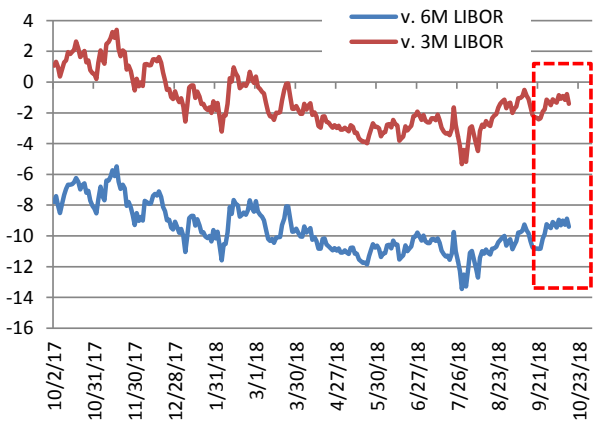
Source: Daiwa Securities.

Appendix 3b: Z-score II



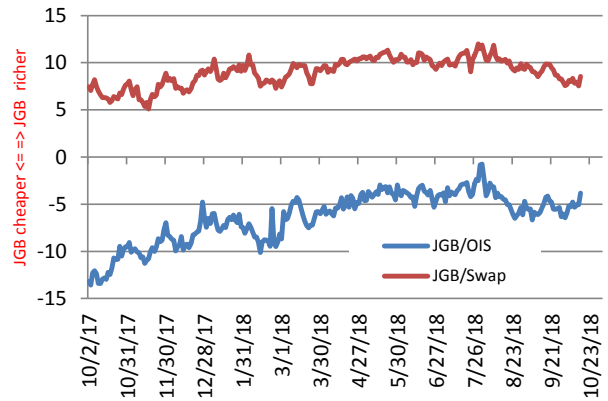
Source: Daiwa Securities.

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



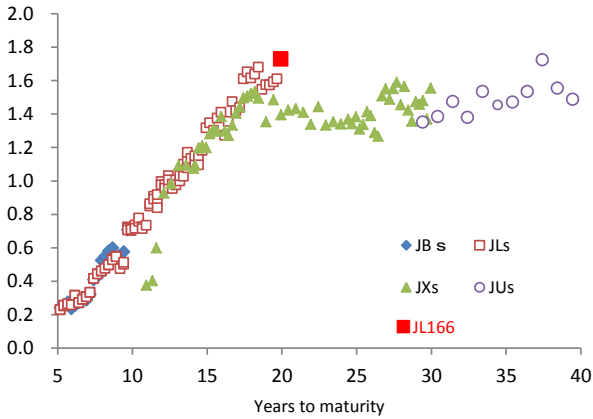
Note: since the Sept. auction
Source: Daiwa Securities.

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



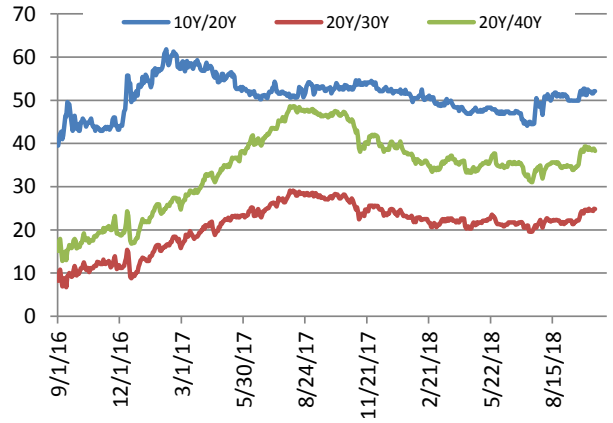
Source: Daiwa Securities.

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



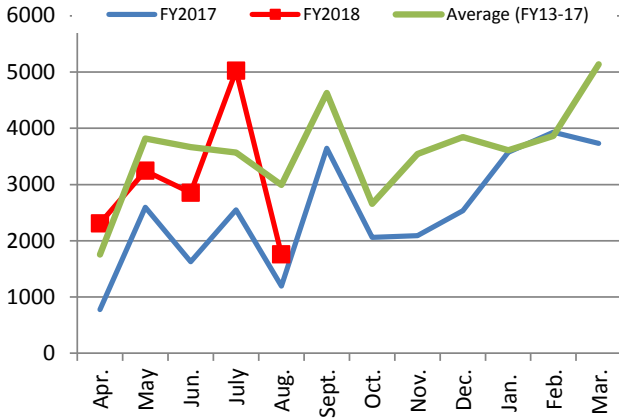
Note: Based on the Oct. 16 curve; factoring in roll-down effect etc.; For new 20Y (JL166), assuming that the coupon is 0.7% and the spread to JL165 Japanese yield is 0.5bp (about 1.6bp to its compound yield)
Source: Daiwa Securities.

Appendix 6: JGB 10Y/20Y, 20Y/30Y, 20Y/40Y Spreads (bp)



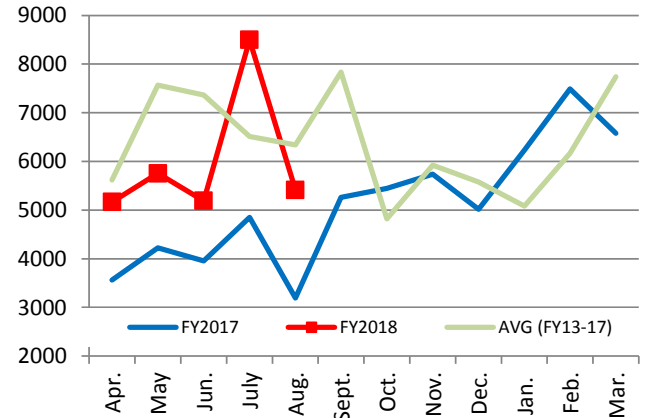
Source: Daiwa Securities.

Appendix 7a: Trend of Life and Non-life Insurers' Net Purchase of Superlong JGBs (Yen 100M)



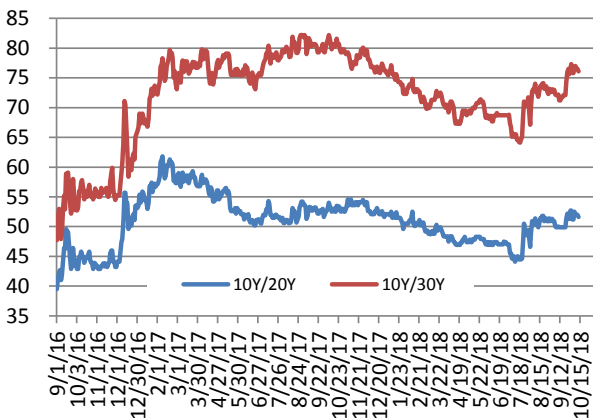
Source: JSDA

Appendix 7b: Trend of Life and Non-life Insurers' Goss Purchase of Superlong JGBs (Yen 100M)



Source: JSDA

Appendix 8: JGB 10Y/20Y and 10Y/30Y Spreads (bp)



Note: On-the-run issue basis
Source: Daiwa Securities

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[Standard & Poor's]

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May 2018

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