

JGB Insight

Checkup on the environment surrounding JGBis

- ✓ BEI is very close to 40bp
- ✓ Prime Minister Abe shows serious attitude toward consumption tax hike in Oct. 2019, +0.4 to 1.0%pt impact on core-CPI
- ✓ Meanwhile, Chief Cabinet Secretary Suga repeatedly emphasizes great potential for a cut in mobile charges, -0.96%pt impact on core CPI
- ✓ Currently, we see yen appreciation, declining crude oil prices and sluggish US TIPS BEI
- ✓ Although environment appears unfavorable, BEI level below 40bp can be good level for dip-buying JGBis

Strategic Memorandum DSTE272
FICC Research Dept.

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

Daiwa Securities Co. Ltd.

In early October, the BEI of on-the-run JGBis rose to the highest level since July. Since then, it has sharply declined and now is moving at around 40bp (Chart 1). We attribute this to deterioration in market participants' mind for JGBis due to declining crude oil prices, falling US TIPS BEI, and a major broker's change in the method to calculate JGB closing prices. In addition, we can say that the latest substantial decline in nominal JGB yields amid growing risk-off sentiment is also serving as a factor to lead the BEI down. In such an environment, JGBis are scheduled to be auctioned on November 6. In this report, we would like check the environment surrounding JGBis.

Prime Minister Abe shows serious attitude toward consumption tax hike in Oct 2019 --- +0.4 to 1.0%pt impact on core CPI

On October 15, Prime Minister Shinzo Abe stated, "The government will raise the consumption tax rate from 8% to 10% on October 1, 2019 as stipulated by the law." At the same time, he instructed relevant cabinet members to formulate economic measures to curb expected impact by surging last-minute demand and ensuing pullbacks. When the consumption tax was raised in April 2014 (from 5% to 8%), the government announced it six months before. This time, meanwhile, the tax hike was announced twelve months before. It is said that this is because the government wants to urge companies/markets to prepare for the hike in a complicated system with the introduction of lower tax rates for certain items. In addition, some presume that the government wants to clarify its intention to raise the consumption tax at an early stage prior to national and local elections scheduled for FY2019. No matter what reasons are behind, the consumption tax rate will be raised in October 2019 (unless Japan faces a big economic shock, such as the Lehman crisis). We thus can say that one of the most worrisome factors for JGBi market participants has been eliminated. According to estimates by Daiwa Institute of Research, the consumption tax rate hike from 8% to 10% with the introduction of lower tax rates for certain items is expected to boost the nationwide core CPI by 0.4-1.0 percentage points (Table 1).

Meanwhile, Chief Cabinet Secretary Suga repeatedly emphasizes great potential for a cut in mobile charges --- -0.96%pt impact on core CPI

Meanwhile, market participants have been becoming more cautious about a substantial decline in mobile phone charges especially since this summer. On August 21, Chief Cabinet Secretary Yoshihide Suga said, "Japan's top mobile phone carriers can lower service fees by about 40%." Since then, he has been repeatedly making similar remarks. Those carriers have already activated price-slashing war in line with a rise in the market share of emerging carriers with low price setting for smartphones, which has been recognized as a factor to push prices down. If mobile phone charges are cut by 40% at once, the nationwide core CPI is estimated to be pushed down by around 0.96 percentage points. Even if such a one-shot big cut is done with or after the consumption tax rate hike in October 2019, when Rakuten is planned to enter the mobile phone business, it may drive down the core CPI growth rate to near 0% again. In reality, 40% markdown at a time is very unlikely. In addition, if the government induces markdowns in an incorrect manner, Prime Minister Abe aiming to declare an "end to deflation" during his term of office may be put in an inconvenient situation. Market participants need to carefully monitor the developments of the cut in mobile charges.

Although environment appears unfavorable, BEI level below 40bp can be good level for dip-buying JGBs

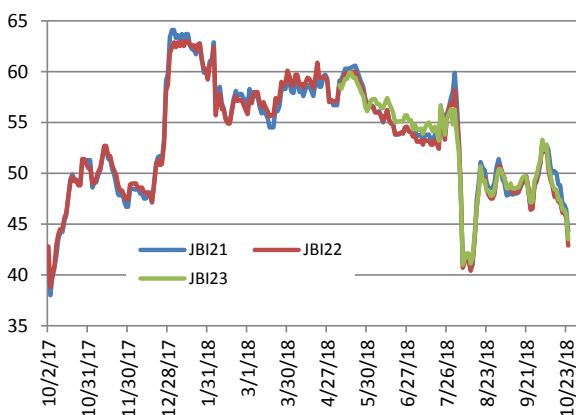
Currently, both crude oil prices and US TIPS BEI remain on a downtrend. Moreover, we are still concerned about the development of the latest risk-off trend. All in all, we are unable to say that the environment surrounding JGBs is favorable. As the JGBi auction is to be held in such an environment, it could tail. However, the nationwide core CPI itself is expected to rise through the end of this year (although growth rate would be limited to around 1%). As a result, the index ratio is expected to maintain an uptrend until around February 2019 (charts 3-5). Over the long term as well, the index ratio is likely to post an uptrend largely (Chart 5). If the BEI falls below 40bp, JGBs would become quite cheap. Partly because of this, although the environment surrounding JGBs appears unfavorable, BEI level below 40bp can be good level for dip-buying JGBs especially with a longer investment horizon. With all factors in mind, we would like to place our bids at the upcoming auction. (13:00 JST on October 26)

Previous Consumption Tax Hikes and Impact on CPI (y/y)¹

	Estimated by		CPI (%pt)	Core-CPI (%pt)	
3% in April 1989	Economic Planning Agency		1.2	-	
3% to 5Y in April 1997	Ministry of Internal Affairs and Communications		1.4	1.4	
	Economic Planning Agency		1.5	-	
5% to 8% in April 2014	Ministry of Internal Affairs and Communications		2.0	2.0	
	BOJ		2.1	2.0	
	Cabinet Office		2.0	2.0	
8% to 10% in October 2019	DIR	w/o lower tax rates	w/o free pre-school	1.3	1.3
			w/ free pre-school	0.7	0.6
	w/ lower tax rates	w/o free pre-school	1.0	1.0	
		w/ free pre-school	0.3	0.4	

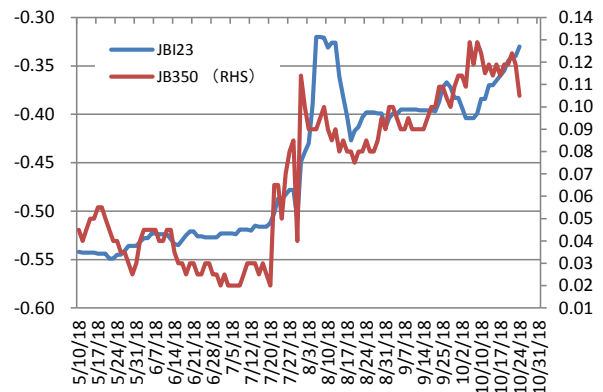
Note: Estimated value by DRI (Daiwa Research Institute) for 2019 is calculated by using the data of CPI in April 2018 with the effect of assuming full pass-through. Based on CPI statistics, it is assumed that the influence on 'nursery school child care fee' will affect only 3 to 5 years old, and its weight is estimated based on the number of children in nurseries by age. The results are needed to be taken with certain ranges.
 Source: Economic Planning Agency, Cabinet Office, Bank of Japan and Memos from Cabinet Secretariat, compiled by Daiwa Securities

Chart 1: JGBi BEIs (bp)



Source: Daiwa Securities

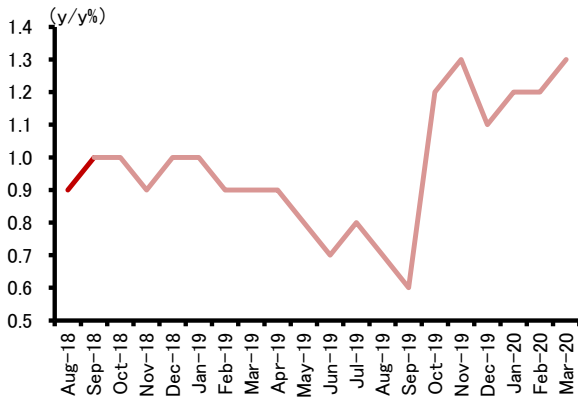
Chart 2: JBI23 and JB360 Yields (%)



Source: Daiwa Securities

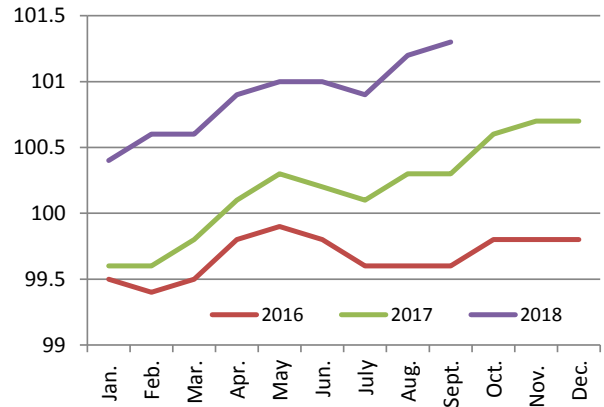
¹ Daiwa Institute of Research (DIR) "Impact on Goal of Deflation and Inflation Target by Consumption Tax Hike and Higher Oil Price – Watch deterioration of GDP gap after consumption tax hike" dated October 18 (only available in Japanese)

Chart 3: Nationwide Core-CPI Growth Outlook (y/y %)



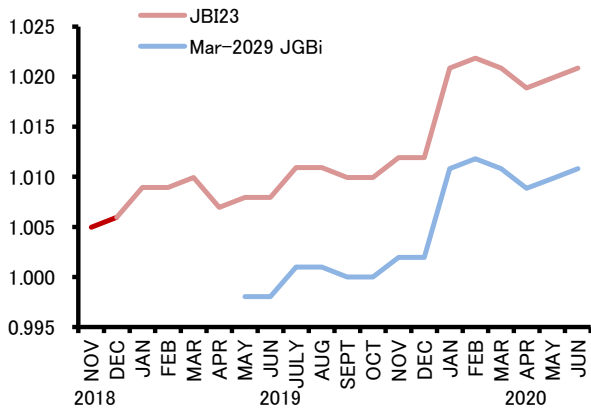
Source: Daiwa Securities

Chart 4: Nationwide Core-CPI Seasonality



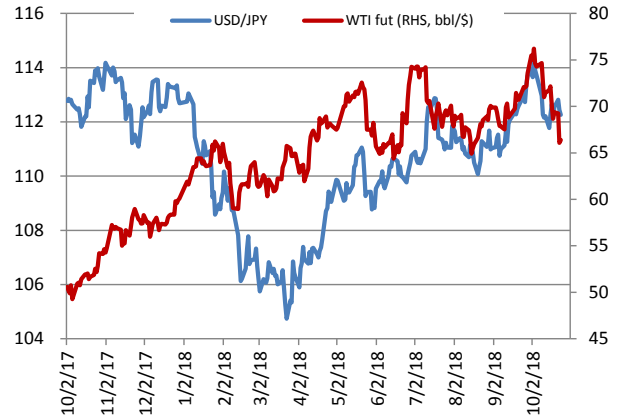
Source: Ministry of Internal Affairs and Communications, compiled by Daiwa Securities

Chart 5: Index Ratio Forecast



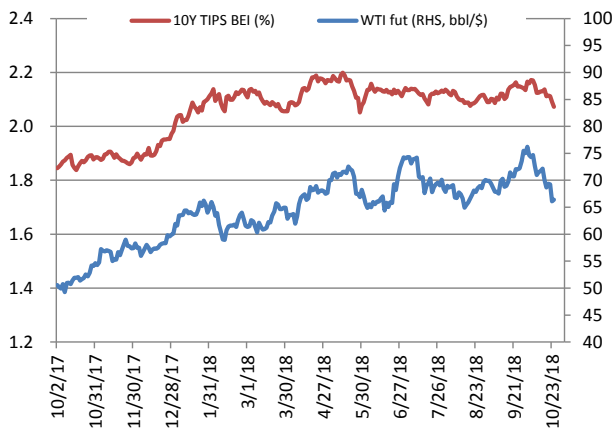
Note: Actual for Nov.-Dec. 2014; based on inflation outlook in Chart 3; for Mar-2019 JGBIs, assuming that it will be issued in May 2019 and its base CPI will be Dec. 2018 on our forecast.
Source: Daiwa Securities

Chart 6: USD/JPY and Oil Price



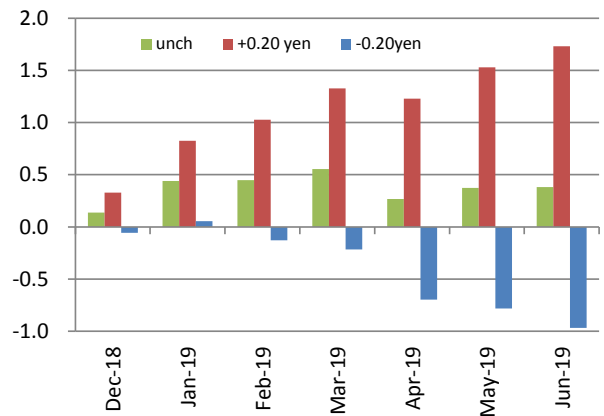
Source: Bloomberg

Chart 7: UST TIPS BEI (10Y) and Oil Price



Source: Bloomberg

Chart 8: JBI23 HPR by Scenario (%)



Note: From Nov. 6 (settlement Nov. 7) to the 10th of each month; factoring in index ratio in Chart 5; price at the end of period is assumed to be (1) unchanged, (2) increased by 0.20 yen each month and (3) decreased by 0.20 yen each month.
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 ("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'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 April 16th, 2018, 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/>) May 2018

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