

Outlook for 10Y JGBi Auction

Hoping to see good support around 35bp

- ✓ Since August auction, BEI has been mostly in 40-50bp range; recently moving at around 40bp
- ✓ As the environment surrounding JGBis looks unfavorable, primary dealers would hesitate to aggressively bid at the auction.
- ✓ JGBis appear undervalued at BEI level below 40bp.
- ✓ We think about placing primary bids around 35bp, expecting good support at the level.

Strategic Memorandum DSTE275
FICC Research Dept.

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Auction Details

Auction Date:	November 6, 2018
Issue Date:	November 7, 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:	100.70 (December 2017)
Ref. CPI:	101.171 (on Nov. 7)
Index ratio:	1.00468 (on Nov. 7)

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

** On November 2, JBI23 closed at 104.15 yen (-0.05 yen v. previous day's close). JBI23 BEI was 43.2bp (43.1bp at previous day's close).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Since August auction, BEI has been mostly in 40-50bp range; recently moving at around 40bp

After the BEI of JBI23 substantially declined close to 40bp when the previous JGBi auction was conducted (August 7), it rose to around 50bp driven by a gain in JBI23 partly reflecting rises in crude oil prices, US TIPS BEI, and the growth rate of nationwide core CPI. Since then, the BEI had been range-bound around 50bp for a while. In early October, the BEI temporarily rose to 53bp, the highest level since July 2017 amid an uptrend of nominal yields of JGBs and US Treasuries. Subsequently, however, the BEI has been sharply down, and it is moving at around 40bp in recent days (Chart 1).

In unfavorable environment around JGBis, aggressive bidding would be unlikely

We attribute the recent BEI decline to deterioration in market participants' sentiment for JGBis due to declining crude oil prices, falling US TIPS BEI, and a major broker's change in the method used to calculate JGB closing prices. Although the nationwide core CPI in September grew 1.0% y/y for the first time since February 2018, JGBis lack positive catalysts because (1) the government has been promoting a substantial cut in mobile phone

charges, (2) the consumption tax rate hike in October 2019 is expected to employ the reduced tax rate system and free early education¹, and (3) many observers are still skeptical about the tax hike itself. As the environment surrounding JGBs looks unfavorable, primary dealers would hesitate to aggressively bid at the upcoming auction.

However, as JGBs at BEI level below 40bp appear undervalued, we hope to see good support around 35bp

However, the nationwide core CPI is expected to rise through the end of this year (though the growth rate would likely be limited to around 1%). As a result, the index ratio is expected to maintain an uptrend until around February 2019 (charts 4-5). Over the long term as well, the index ratio is expected to largely show an uptrend (Chart 6). This means that a positive return is expected from JBI23 even if the price remains unchanged during the same period (Chart 7). A BEI level below 40bp points to undervaluation in the range under the YCC policy (Chart 10). In addition, as the level is the most undervalued since the initial issuance of JBI23, it could be good to dip-buy JGBs, especially for investors with a longer investment horizon. We think about placing our primary bids around 35bp, expecting good support at the level.

10Y JGB 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
11/6/18	23R	0.1	3/10/28	400*						43.1				
8/7/18	23R	0.1	3/10/28	418.4	3.12	104.05	-0.309	-	6.3636	48.0	41.0	-7.0	104.00	103.75-104.30
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
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
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
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
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
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
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
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
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
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

* 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 Nov. 1 for the Nov. 2018 auction (Note 4) Bloomberg

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

Image of Bidding Price at Auction

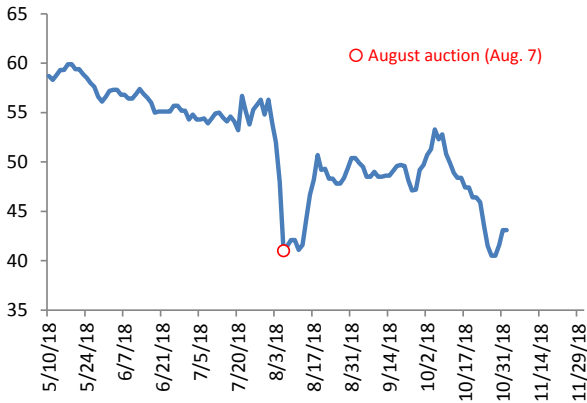
		Nominal bond yield (%、JB350)									
		0.070	0.075	0.080	0.085	0.090	0.095	0.100	0.105	0.110	0.115
BEI (bp)	41	104.18	104.13	104.08	104.03	103.98	103.94	103.89	103.84	103.79	103.74
	40	104.08	104.03	103.98	103.94	103.89	103.84	103.79	103.74	103.69	103.65
	39	103.98	103.94	103.89	103.84	103.79	103.74	103.69	103.65	103.60	103.55
	38	103.89	103.84	103.79	103.74	103.69	103.65	103.60	103.55	103.50	103.45
	37	103.79	103.74	103.69	103.65	103.60	103.55	103.50	103.45	103.40	103.36
	36	103.69	103.65	103.60	103.55	103.50	103.45	103.40	103.36	103.31	103.26
	35	103.60	103.55	103.50	103.45	103.40	103.36	103.31	103.26	103.21	103.16
	34	103.50	103.45	103.40	103.36	103.31	103.26	103.21	103.16	103.12	103.07
	33	103.40	103.36	103.31	103.26	103.21	103.16	103.12	103.07	103.02	102.97
	32	103.31	103.26	103.21	103.16	103.12	103.07	103.02	102.97	102.92	102.88
	31	103.21	103.16	103.12	103.07	103.02	102.97	102.92	102.88	102.83	102.78
30	103.12	103.07	103.02	102.97	102.92	102.88	102.83	102.78	102.73	102.69	
29	103.02	102.97	102.92	102.88	102.83	102.78	102.73	102.69	102.64	102.59	

Note: actual bidding with the increment of 0.05 yen; as on Nov. 6 with the Nov. 7 settlement

Source: Daiwa Securities

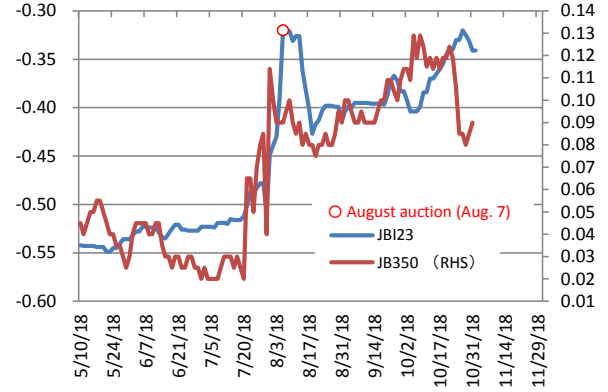
¹ See our report "JGB Insight--Checkup on the environment surrounding JGBs (DSTE272)" dated October 26 for more details

Chart 1: BEI of JBI23 (bp)



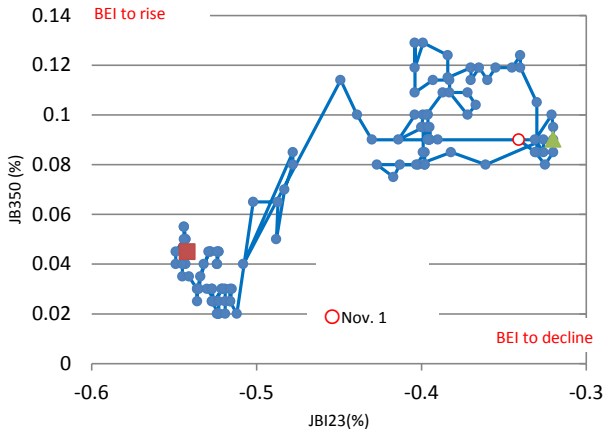
Source: Daiwa Securities

Chart 2: JBI23 and JB350 Yields (%)



Source: Daiwa Securities.

Chart 3: Correlation between JBI23 and JB350 (%)



Source: Daiwa Securities

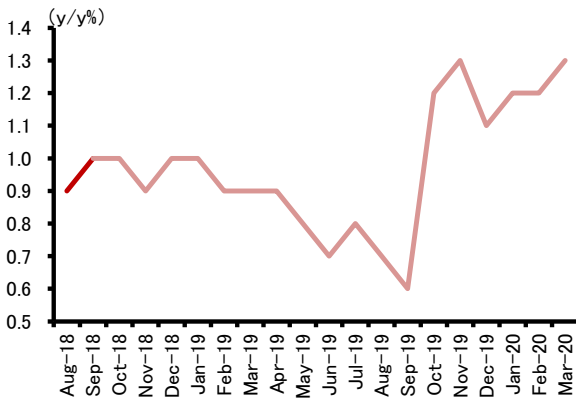
Table 1: BOJ Purchase and MOF Buyback Results

	Previous Day's Close (Yen)	Pro-rata Price Spread (Yen)	Average Successful Price Spread (Yen)	Allotment on Pro-rata (%)	B/C	Close Price (Yen)
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
8/8/18	104.10	-0.060	-0.092	54.9	5.41	104.10
8/17/18	104.70	0.040	-0.036	93.3	4.74	104.90
8/22/18	105.05	-0.160	-0.208	52.2	5.15	105.00
9/4/18	104.90	-0.120	-0.131	88.8	5.02	104.85
9/25/18	104.70	-0.220	-0.225	74.9	5.89	104.55
10/5/18	104.85	-0.060	-0.062	96.4	5.79	104.85
10/12/18	104.65	-0.110	-0.133	76.0	5.10	104.50
10/19/18	104.35	-0.050	-0.089	20.0	4.95	104.25

Note: Previous Day's Close and Close Price are based on JBI22 until April 23 and JBI23 from May 11 and beyond; buybacks by the Ministry of Finance on February 13, April 11, June 20, August 17 and October 12, 2018

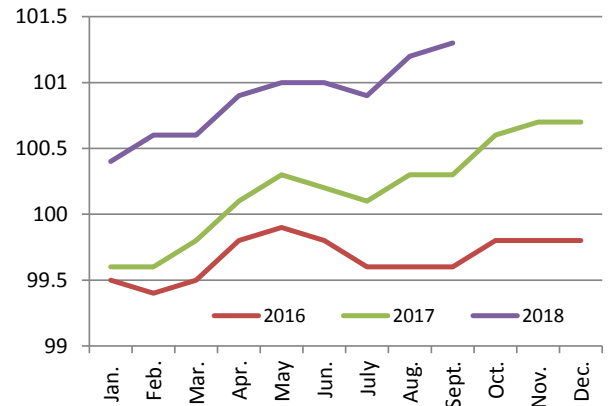
Source: Bank of Japan, Ministry of Finance, Daiwa Securities
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Chart 4: Nationwide Core-CPI Growth Outlook



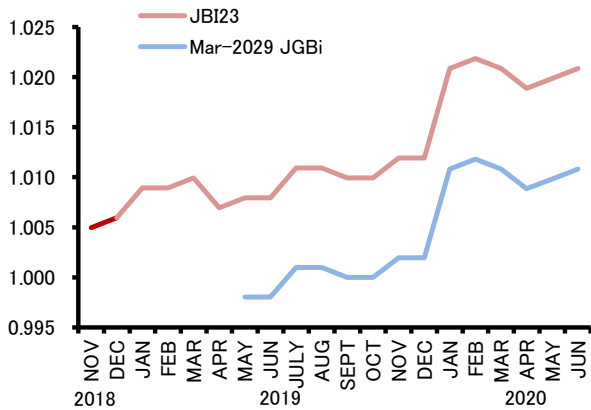
Note: actual for April to Sept. 2018
Source: Daiwa Securities.

Chart 5: Nationwide Core-CPI Seasonality



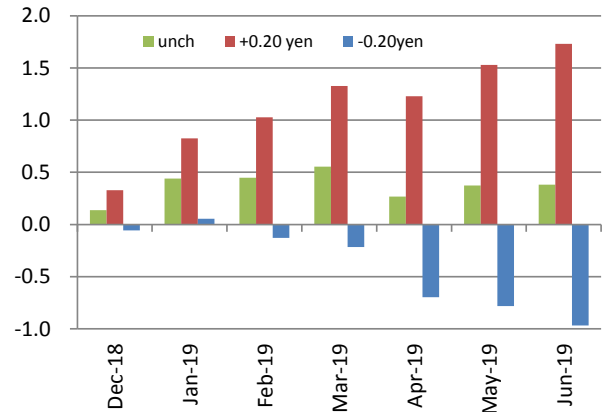
Source: Ministry of Internal Affairs and Communications

Chart 6: Index Ratio Forecast



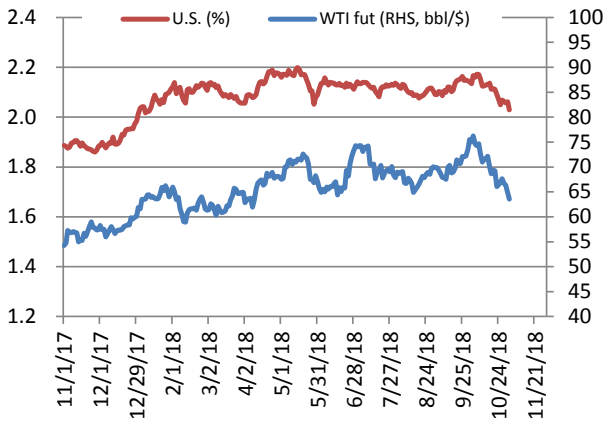
Note: based on Chart 4; actual for Nov. to Dec. 2018
Source: Daiwa Securities

Chart 7: Index Ratio Forecast on JBI22 and New (JBI23)



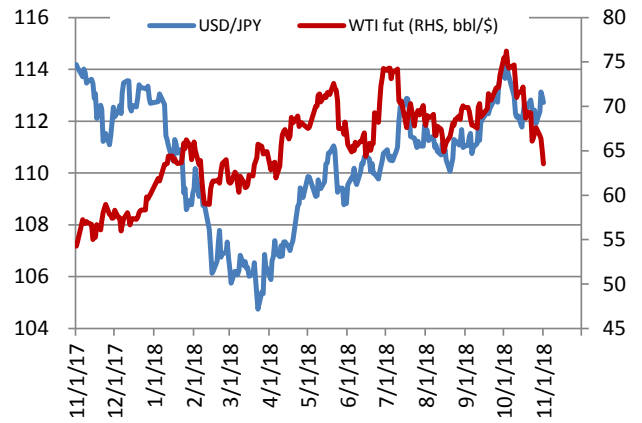
Note: From the issuance day (Nov. 7) to the 10th of each month; factoring in index ratio in Chart 6; price at the end of period is assumed to be (1) unchanged, (2) increased by 0.20 yen each month and (3) decreased by 0.20 yen each month.
Source: Daiwa Securities

Chart 8: US BEI and Oil Price



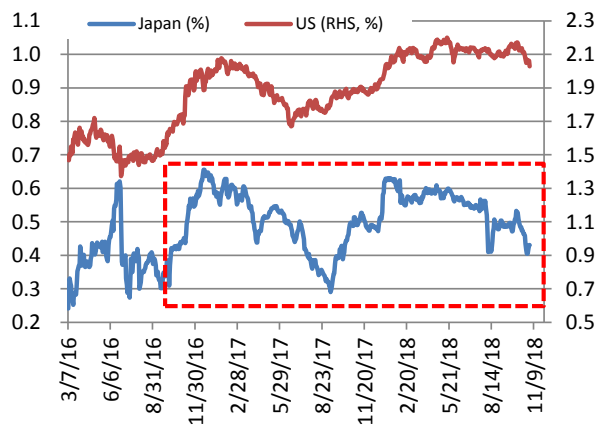
Source: Bloomberg

Chart 9: USD/JPY and Oil Price



Source: Bloomberg, Daiwa Securities.

Chart 10: US and Japan BEI (10Y)



Source: Bloomberg

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[Standard & Poor's]

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May 2018

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- 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.

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