

Outlook for 20Y JGB Auction

Keep in mind the possibility of a further yield decline

- ✓ Under conditions that make yields unlikely to rise, we think about our bidding stance at the auction on the expectation that the yield could momentarily drop below 0.6% or the 10Y/20Y spread could narrow to below 50bp.
- ✓ Relative-value wise, it will be worth considering buying asset swaps.

Strategic Memorandum DSTE278
FICC Research Dept.

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Auction Details

Auction Date: November 20, 2018

Issue Date: November 21, 2018

Maturity Date: September 20, 2038

Offering Amount: About 1.0 trillion yen

* New 20Y JGBs will likely be the first reopening of JL166 carrying a 0.7% coupon.

** On November 19, JL166 traded at 0.610-0.625% (-2.0 - -0.5bp v. previous day's close) and closed at 0.610% (-2.0bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

20Y JGB yield heading near to 0.6%

After the previous auction held on October 18, which went smoothly at the 0.680-0.685% level, the JGB market remained firm amid a global weakening of share prices and the 20-year JGB yield fell to as low as 0.625% on an intraday trading basis. Beginning in November, a fading of worries about US-China trade friction and the release of strong US jobs data sent share prices higher and bonds lower. That pushed the 20-year yield to as high as 0.670%. Since then, the domestic and overseas bond markets have been firm on a fading of concerns over excessive worsening of the US budget deficit in response to the midterm election results, as well as on a heightening of concerns that the global economy will become less stable on the sharp decline in crude oil prices. In such an environment, the 20-year JGB yield has also been trending lower. The 20Y JGB yield declines to 0.610% as of 14:00 JST today.

Conditions are making it difficult for expectations of rising yields to emerge

We look first at the environment surrounding 20-year JGBs. 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 last week, thereby weakening expectations of accelerated pace of rate hikes and pushing US long-term rates lower. Both oil prices and global share prices have failed to recover significantly after falling sharply in October and remain lackluster. Because of those external factors, conditions are making it difficult for expectations of rising domestic yields to

grow. In terms of domestic factors, there has been lingering concerns that the BOJ will reduce the amount of its JGB purchases in the over-10-year sector. While the 10-year JGB yield drops below 0.1%, however, the 20-year yield remains above 0.6%. That may imply the possibility of those purchases being reduced in the future have been priced in to some extent. This is a conclusion that could also be drawn from the widening difference between the actual and theoretical value of the 20-year JGB yield since August (Appendix 8a). Additionally, the Ministry of Finance is expected to reduce the issuance of 20Y JGBs in FY2019 with a high probability.

20Y JGB yield may temporarily drop below 0.6%

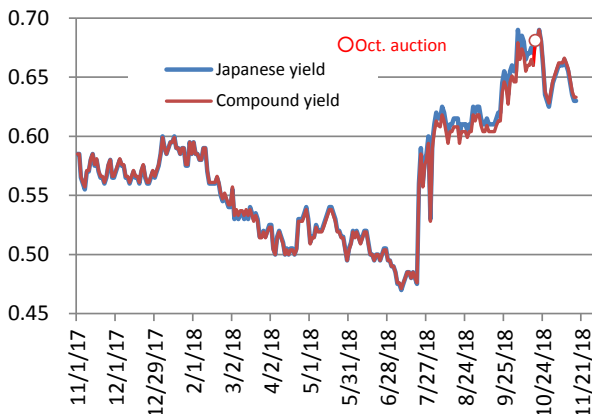
Overall, given these conditions that make JGB yields unlikely to rise especially in the near term, we would like to think about our bidding stance at the auction on the expectation that the 20Y JGB yield could momentarily drop below 0.6% or the 10Y/20Y spread could narrow to below 50bp. Relative-value wise, it will be worth considering buying asset swaps. Although recent receiving pressures on 20Y swaps bear watching, 20Y JGB asset swaps has tightened into positive territory vs. 3M-LIBOR. At the level, expectations on demand from investors may grow (Appendix 4a).

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
11/20/18	166R	0.7	9/20/38	1,000*									
10/18/18	166	0.7	9/20/38	1,075	4.23	100.29	100.25	0.04	0.683	0.685	0.002	41.8922	Avg
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

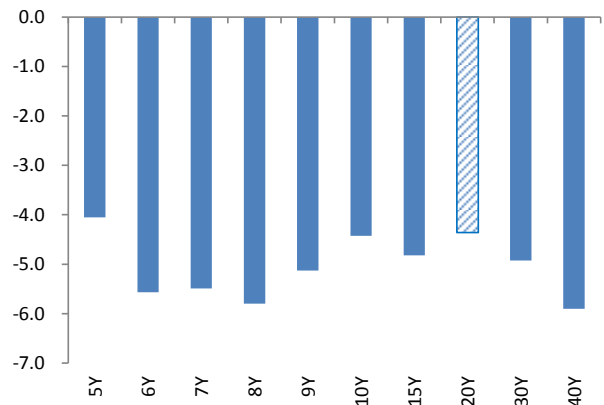
* Amount the Ministry of Finance plans to issue
 Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 20Y JGB Yield (%)



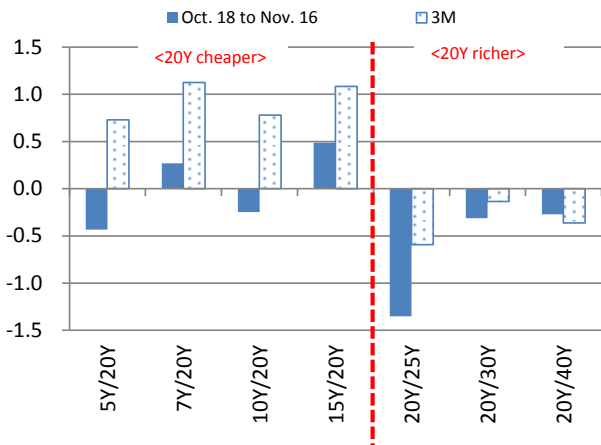
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (Oct. 18 v. Nov. 16, bp)



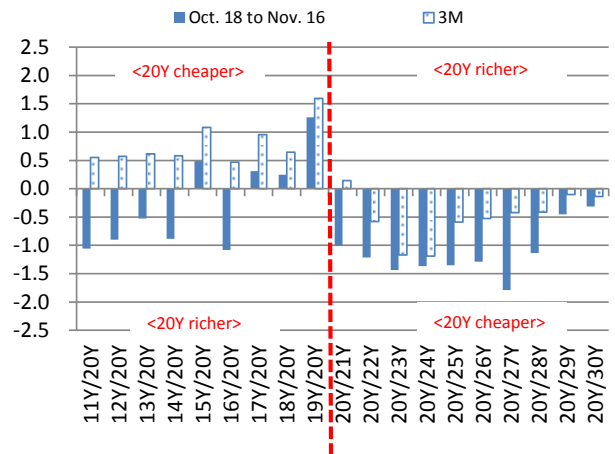
Source: Daiwa Securities.

Appendix 3a: Z-score I



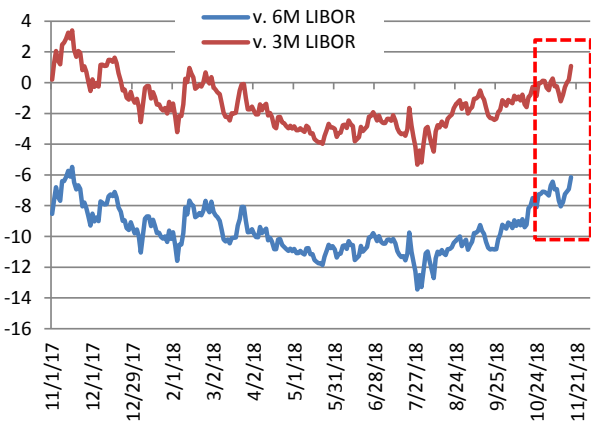
Source: Daiwa Securities.

Appendix 3b: Z-score II



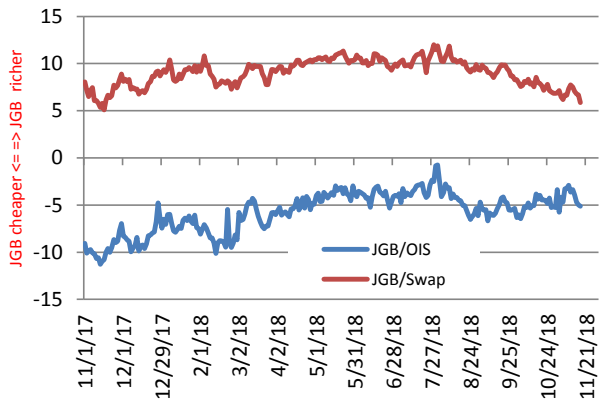
Source: Daiwa Securities.

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



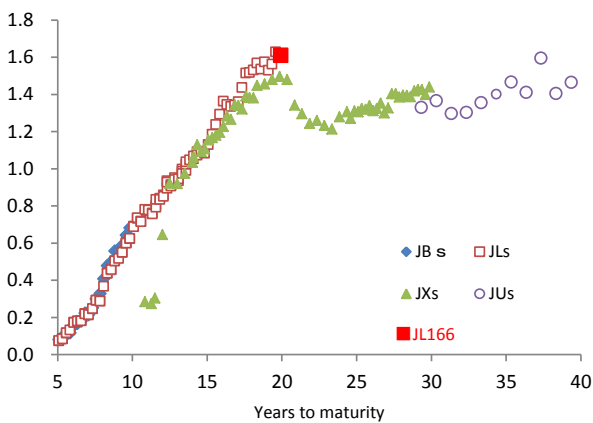
Note: since the Oct. auction
Source: Daiwa Securities.

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



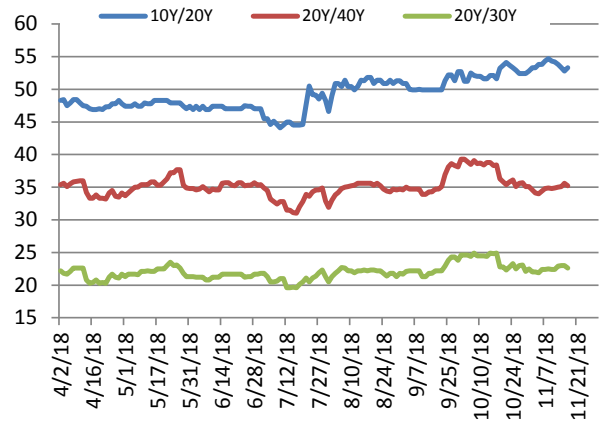
Source: Daiwa Securities.

Appendix 5: JGB Total Return Curve (1M, %)



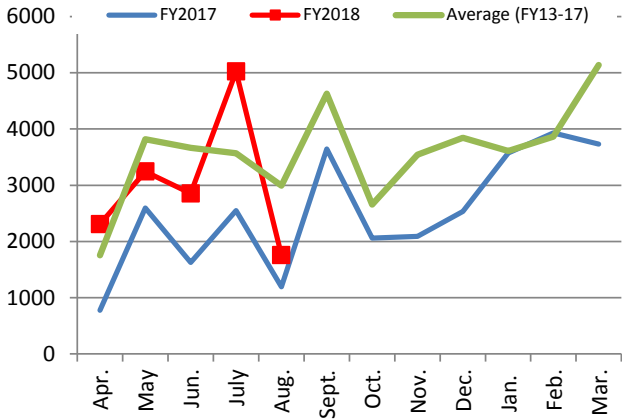
Note: Based on the Nov. 16 curve; factoring in roll-down effect etc.
Source: Daiwa Securities.

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



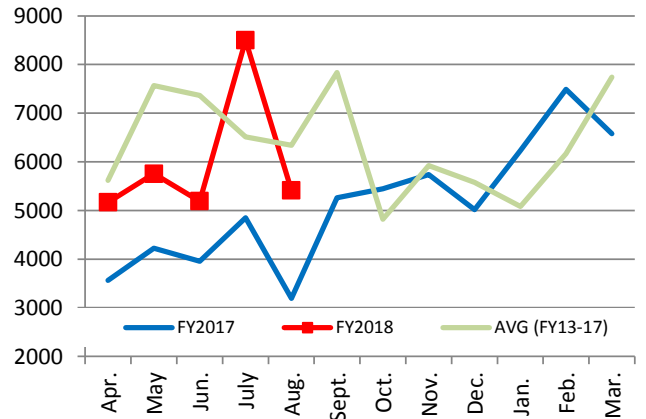
Source: Daiwa Securities.

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



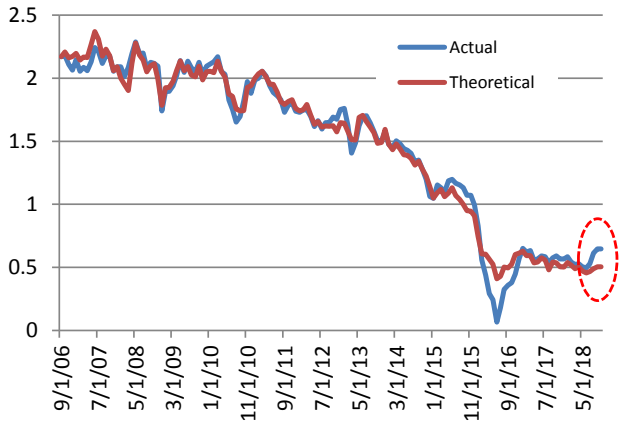
Source: JSDA

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



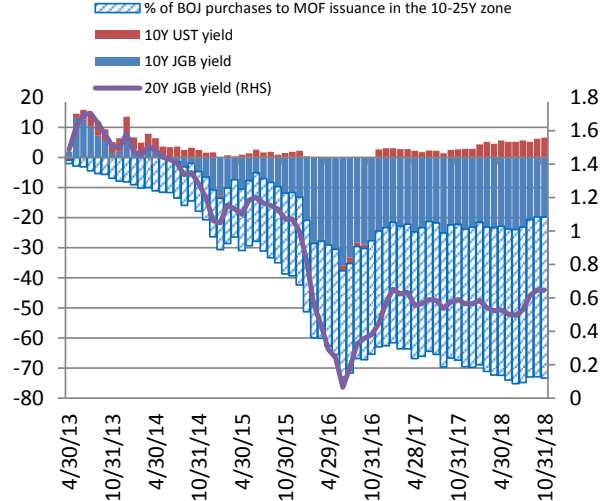
Source: JSDA

Appendix 8a: 20Y JGB Yield (%)



Note: Monthly basis
Source: Daiwa Securities

Appendix 8b: Factor Breakdown of 20Y JGB Yield (%)



Source: Daiwa Securities

Explanatory Document of Unregistered Credit Ratings

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[Standard & Poor's]

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[Moody's]

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[Fitch]

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May 2018

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- 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.
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* 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.

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