

Outlook for 20Y JGB Auction

Demand from investors should be carefully measured

- ✓ While 20Y JGBs show an optimistic market sentiment, we would like to place our bids to take necessary amount under careful measurement on demand from investors at the current yield level (around 0.55%).
- ✓ In terms of relative value, we think of switching out from 10Y sector into 20Y sector, expecting the 10Y/20Y spread to narrow below 50bp in the near term.

Strategic Memorandum DSTE281
FICC Research Dept.

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Auction Details

Auction Date: December 18, 2018

Issue Date: December 19, 2018

Maturity Date: September 20, 2038

Offering Amount: About 1.0 trillion yen

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

** On December 17, JL166 traded at 0.540 - 0.545% (-1.0 - -0.5bp v. previous day's close) and closed at 0.545% (-0.5bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Placing bids to take necessary amount under careful measurement on demand from investors at the current level (around 0.55%)

Since the previous 20Y JGB auction had an average result at the 0.610-0.615% level on November 20, the 20Y JGB yield (on-the-run issue's conventional yield basis) has been on downtrend amid the firmness of the bond markets around the globe partly on the back of rising speculations on a slower pace of US rate hikes. Today (Dec. 17), the 20Y JGB yield declined temporarily to 0.540% on an intraday basis, the lowest since August 2018 (as of 2:00pm JST).

Amid the lackluster trends of crude oil and global equity prices, concerns about the global economic outlook are intensifying partly on the back of a wave of weak economic indicators recently released in China and Europe. Although we need to pay attention to post-FOMC directions in the financial markets after this week's FOMC meeting, JGBs may remain high in the near term. In such an environment, key points to think about the bidding level at tomorrow's auction are as follows:

- ✓ Decent short-covering by primary dealers is expected;
- ✓ We need to carefully watch how demand from investors will be realized at the current level (around 0.55%), while investors start picturing their portfolios' should-be at the end of the fiscal year. In December, they will likely have a lot of JGB redemptions as well;

- ✓ The BOJ will not offer a purchase operation for JGBs in the 10-25Y zone the day after tomorrow's auction;
- ✓ Rather than the 10-25Y zone, the 1-3Y zone and/or the 5-10Y zone may become a near-term reduction target in the BOJ's purchase operations;
- ✓ The 20Y sector is not cheap on the curve at the current level (Appendix 3). 20Y cash is neither noticeably overvalued nor undervalued against swaps (Appendix 4).

All in all, we would like to think about placing our bids to take the necessary amount at tomorrow's auction under careful measurement on demand from investors at the current level (around 0.55%). In terms of the relative value, we think of switching out from the 10Y sector into the 20Y sector. Despite the trimming in the BOJ's purchase amount on December 14, the 10Y JGB yield declined to 0.025% today on an intraday basis. However, we think that the upside of 10Y JGBs from the current level is limited, given the fact that the 10Y JGB yield has been mostly in positive territory under the yield curve control policy except a period of time immediately after the introduction. Although the 10Y sector is not noticeably cheap to the 20Y sector at the moment, we think that the 10Y/20Y spread may narrow below 50bp in the near term (Appendix 3, 6).

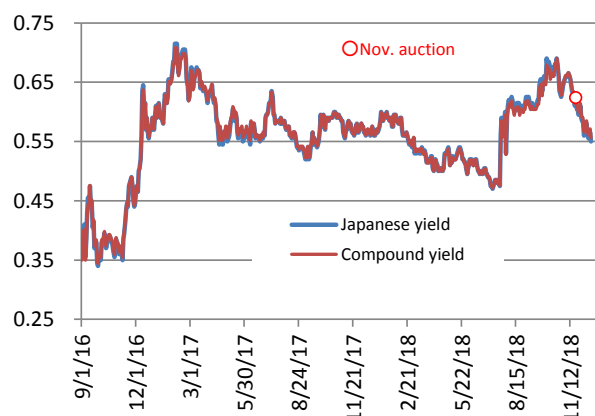
20Y JGB Auction Results

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
12/18/18	166R	0.7	9/20/38	1,000*									
11/20/18	166R	0.7	9/20/38	999	3.91	101.55	101.50	0.05	0.612	0.615	0.003	45.3947	Avg
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

* Amount the Ministry of Finance plans to issue

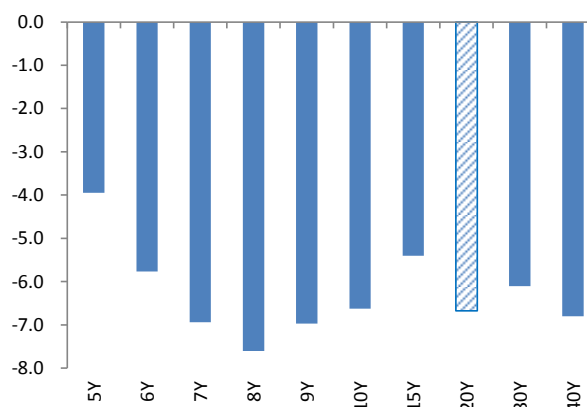
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 20Y JGB Yield (%)

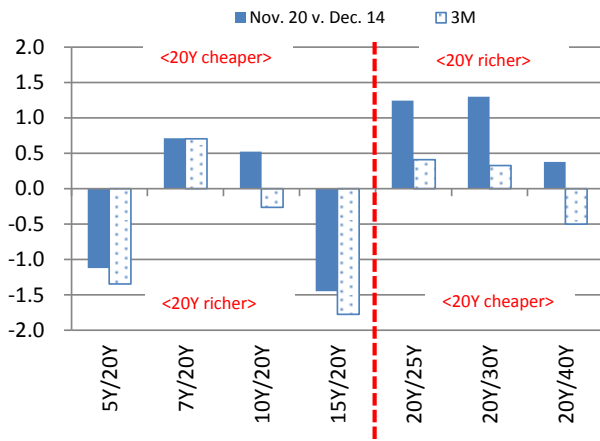


Source: Daiwa Securities.

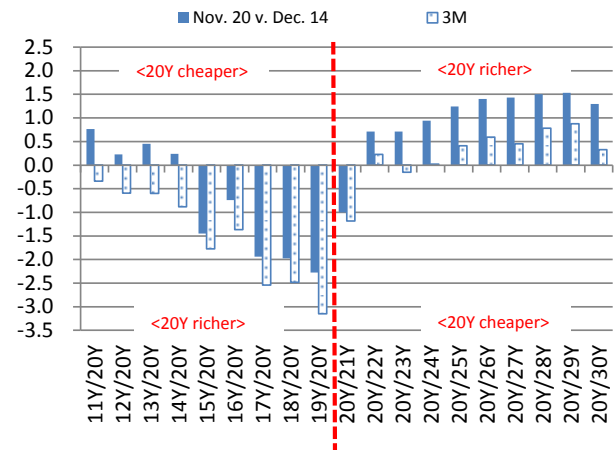
Appendix 2: JGB Yield Change (bp): Nov. 20 v. Dec. 14



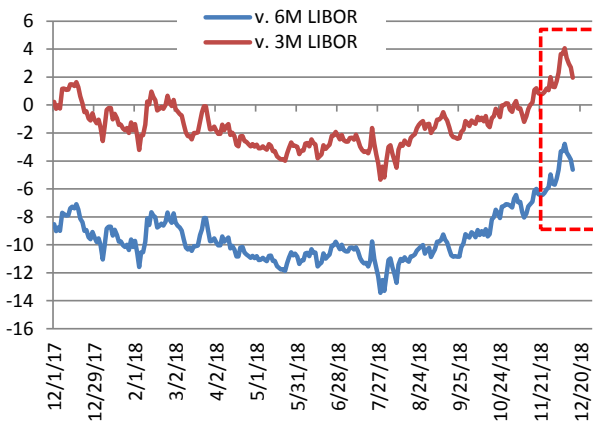
Source: Daiwa Securities.

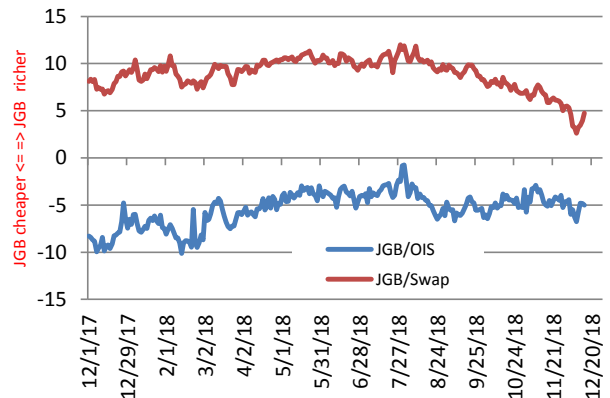
Appendix 3a: Z-score I


Source: Daiwa Securities.

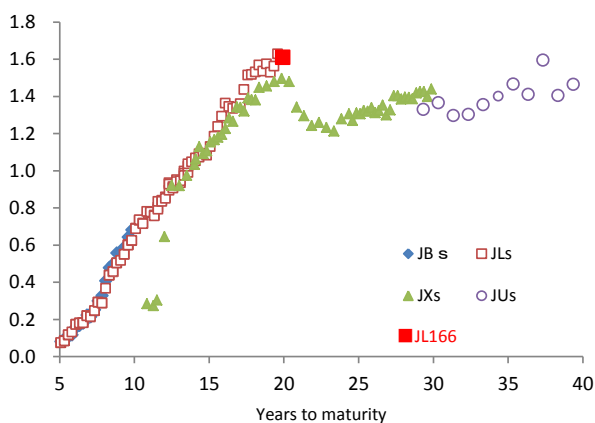
Appendix 3b: Z-score II


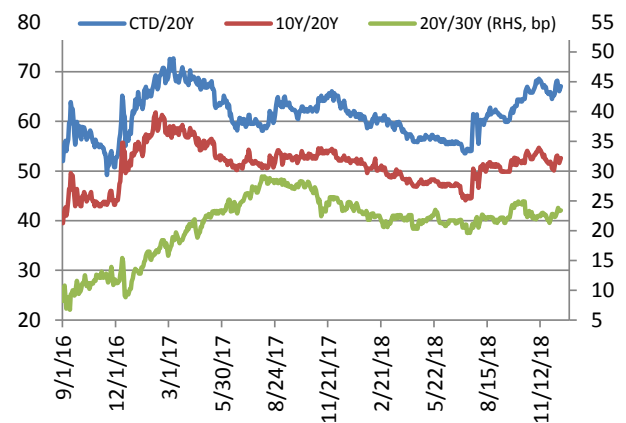
Source: Daiwa Securities.

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

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

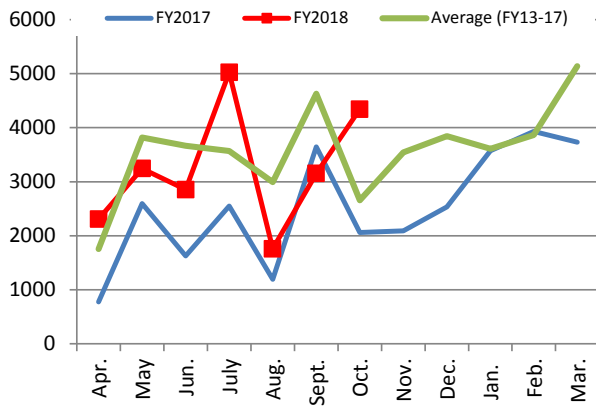
Appendix 4b: 20Y JGB/Swap and JGB/OIS Spreads (bp)


Source: Daiwa Securities.

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

 Note: Based on the Dec. 14 JGB yield curve; factoring in roll-down effect etc.
 Source: Daiwa Securities.

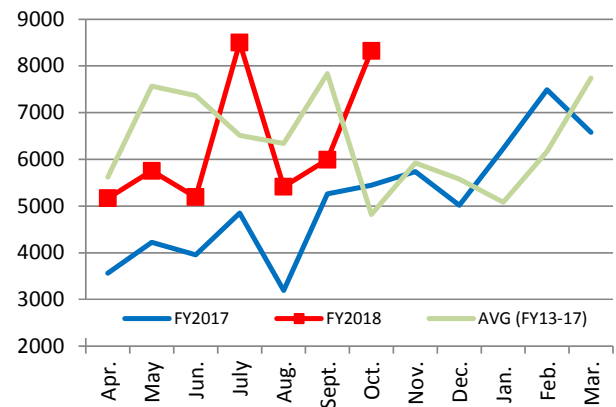
Appendix 6: JGB Yield Spreads (bp)

 Note: CTD and on-the-run issues
 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' Gross Purchase of Superlong JGBs (Yen 100M)



Source: JSDA

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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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May 2018

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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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