

## Outlook for 10Y JGB Auction

### Unlikely to tail even in negative yield territory

- ✓ New 10Y JGBs will likely be auctioned in negative yield territory for the first time since November 2016. However, expectations for demand from investors for short-term parking of fund appear strong, while superlong JGBs become overvalued on the flattening yield curve. The auction is unlikely to tail even in negative yield territory. Expecting an average result, we would like to place our bids to take the amount we need to cover.

Strategic Memorandum DSTE290  
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### Auction Details

**Auction Date:** February 5, 2019  
**Issue Date:** February 6, 2019  
**Maturity Date:** December 20, 2028  
**Offering Amount:** About 2.2 trillion yen

\* New 10Y JGBs will likely be the first reopening of JB353 carrying a 0.1% coupon.

\*\* On February 4, JB353 traded at -0.020 - -0.015% 0.745% (+0.5 - +1.0bp v. previous day's close) and closed at -0.015% (+1.0bp).

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

### New 10Y JGBs expected to be auctioned in negative-yield territory for the first time since November 2016

After the previous 10Y JGB auction went well at the 0.010-0.015% level on January 8, the 10Y JGB yield (on-the-run issue's conventional yield) temporarily rose to 0.030% on an intraday basis amid higher equity prices/lower bond prices around the globe due to more optimistic view about US-China trade talks. Since then, global bond markets have mostly firmed up partly because the January FOMC statement and Fed chairman's press conference showed a patient stance for rate hike and balance sheet run-off policies, while market participants have become more worried about the outlook for the global economy. Those worries were heightened by caution about weak economic indicators in China and the US as well as the impact of the prolonged US government partial shutdown. In such an environment, we have been seeing the 10Y JGB yield increasing moving in the negative-yield territory since late January. With the start of February, it temporarily declined to -0.025%, the lowest level since January 4 on an intraday basis. As of 14:00 today, on-the-run JB353 traded at -0.020 - -0.015%, which indicates that new 10Y JGBs will likely be auctioned in the negative-yield territory for the first time since November 2016 with a high probability.

### Key points to think about placing bids

On Feb. 1, the US market staged higher stock prices/lower bond prices as excessive concerns about a US economic slowdown have diminished due to a series of the announcements of strong economic indicators (such as jobs data) and favorable corporate earnings results. That being said, concerns about the global economy are lingering.

Inflation expectations are unlikely to rise sharply partly because of crude oil prices hovering at a low level. In such an environment where JGB yields are unlikely to face strong upward pressure, key points to think about placing bids at tomorrow's auction are as follows:

- ✓ Short-covering by primary dealers does not appear strong;
- ✓ Expectations for demand from investors;
  - 10Y JGBs look attractive as short-term parking of fund in terms of carry or expected return (Appendix 6), although their yields are negative.
- ✓ At the current level, the 10Y sector is noticeably overvalued vs. the 2-4Y sectors, while it is undervalued vs. the 15Y, 20Y, and 30Y sectors (Appendix 3). 10Y cash is also undervalued against swaps compared to the level at the previous auction (Appendix 4);
  - The 10Y sector is neither noticeably overvalued nor undervalued vs. the 7Y sector, indicating its relative-value advantages vs. the JGB futures. Meanwhile, the 10Y sector is strongly undervalued vs. the superlong sector, but it is difficult to expect demand related to activities to unwind existing positions as flattening bias appears to persist in the long-term to superlong zone of the curve.
- ✓ Decreased possibility of BOJ's cut in offer amounts in JGB purchase operations
  - In its JGB purchase guidelines for February (Outline of Outright Purchases of Japanese Government Securities) announced on January 31, the BOJ has kept the number of offers and offer ranges in the 5-10Y zone from those in January. Similar to the guidelines, the offer amount at the first operation of the month in the zone (scheduled for Feb 6) appears to be easily adjustable for the BOJ, irrespective of the external environment. If the offer amount at the first operation is kept unchanged, the possibility of adjustments to the offer amounts in February is likely to diminish substantially. In addition, downward pressure on yields may heighten due to the emergence of speculation on a pause in the BOJ's trimming buying JGBs.

#### **Looking back at the first 10Y JGB auction conducted in the negative-yield territory**

We look back at the first 10Y JGB auction that was conducted in the negative-yield territory (highlighted by red square in the table on the next page). After the BOJ introduced the "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate," in January 2016, the 10Y JGB auction (for initial issuance of JB34<sup>1</sup> in March 2016) was held for the first time at the negative yield level. Despite pre-auction adjustments, the result of the auction was poor as witnessed by the fact that the lowest accepted price was slightly lower than the market consensus. In the secondary market, however, the price recovered to the previous day's level reflecting foreign investors buying. Since then, the 10Y JGB yield had remained mostly flat at around -0.100%. In summer 2016, the yield declined to -0.300% at one point on an intraday basis as speculations on the Fed's rate hike diminished due to greater concerns about the global economy. Currently, as the BOJ is setting the policy target for the long-term interest rate (10Y JGB yield) at "around 0%" with the operational target of -0.20% to 0.20%, the downside of yields in negative territory appears limited to some extent. As shown in Appendix 7, the yield curve has now substantially flattened compared to that in March 2016.

#### **Average result expected; we would like to place our bids to take the amount we need to cover**

All in all, we expect tomorrow's auction to have an average result, without tail, backed by expectations for demand from investors. We may see a strong result if the JGB market softens in morning trading and JB353 trades at the level very close to 0% (e.g., -0.005 to 0.000%). We would like to place our bids to take the amount we need to cover.

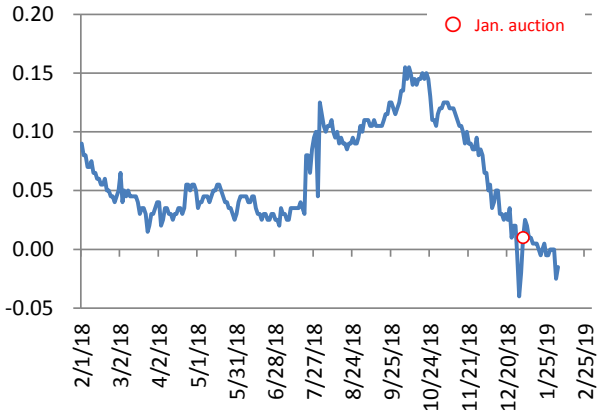
<sup>1</sup> First 10Y JGBs given 0.1% coupon, following 2Y and 5Y JGBs.

10Y JGB Auction Results

Auction Date	Issue#	Coupon %	Maturity Date	Issue Size (billion yen)	Bid/Cover	Average Accepted Price	Lowest Accepted Price	Tail (yen)	Average Accepted Yield	Highest Accepted Yield	Tail (%)	Allotment %	
2/5/19	353R*	0.1*	12/20/28	2,200**									
1/8/19	353	0.1	12/20/28	2,235	4.04	100.84	100.83	0.01	0.015	0.016	0.001	39.9871	Good
12/4/18	352R	0.1	9/20/28	2,526	3.82	100.25	100.22	0.03	0.074	0.077	0.003	8.7628	Poor
11/1/18	352R	0.1	9/20/28	2,513	4.33	99.95	99.93	0.02	0.135	0.137	0.002	12.9543	Avg
10/2/18	352	0.1	9/20/28	2,436	4.21	99.59	99.58	0.01	0.141	0.142	0.001	47.4678	Good
9/5/18	351R	0.1	6/20/28	2,506	4.55	99.87	99.86	0.01	0.113	0.115	0.002	57.5664	Avg
8/2/18	351R	0.1	6/20/28	2,485	4.17	99.74	99.62	0.12	0.126	0.138	0.012	48.9994	Poor
7/3/18	351	0.1	6/20/28	2,478	4.37	100.62	100.60	0.02	0.037	0.039	0.002	38.2288	Good
6/5/18	350R	0.1	3/20/28	2,255	4.38	100.50	100.49	0.01	0.048	0.049	0.001	94.4896	Good
5/8/18	350R	0.1	3/20/28	2,432	4.20	100.53	100.52	0.01	0.046	0.047	0.001	91.9407	Good
4/3/18	350R	0.1	3/20/28	2,528	4.16	100.67	100.66	0.01	0.032	0.033	0.001	4.0302	Good
3/1/18	350	0.1	3/20/28	2,639	4.53	100.38	100.37	0.01	0.061	0.062	0.001	41.7549	Good
2/1/18	349R	0.1	12/20/27	2,456	4.58	100.11	100.09	0.02	0.088	0.090	0.002	72.9297	Avg
1/10/18	349R	0.1	12/20/27	2,467	3.74	100.21	100.20	0.01	0.078	0.079	0.001	65.5523	Avg
3/1/16	342	0.1	3/20/26	2,758	3.20	101.25	101.16	0.09	-0.024	-0.015	0.009	9.1976	Poor

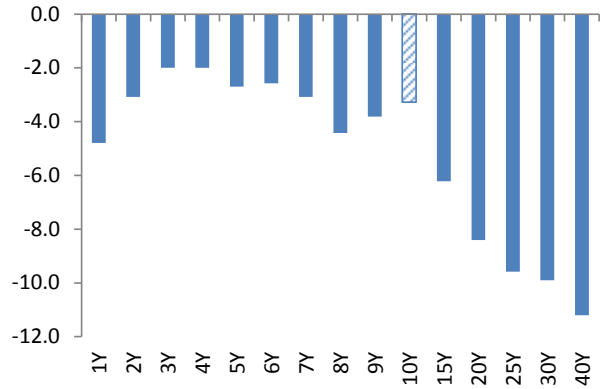
\* Daiwa forecast as of Feb. 4 \*\* Amount the MOF plans to issue  
 Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 10Y JGB Yield (%)



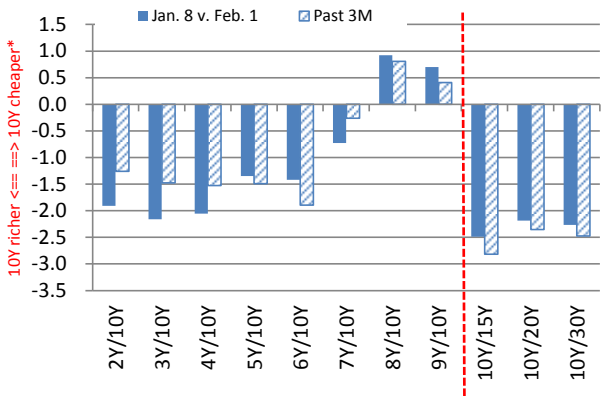
Note: as of 14:00 JST on Feb. 4  
 Source: Daiwa Securities.

Appendix 2: JGB Yield Change (Jan. 8 v. Feb. 1, bp)



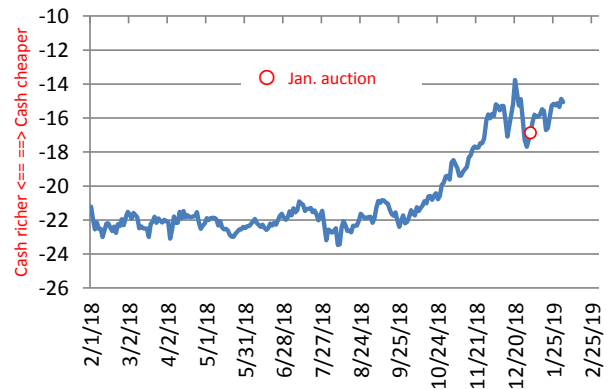
Source: Daiwa Securities.

Appendix 3: Z-scores of JGB Yield Spreads



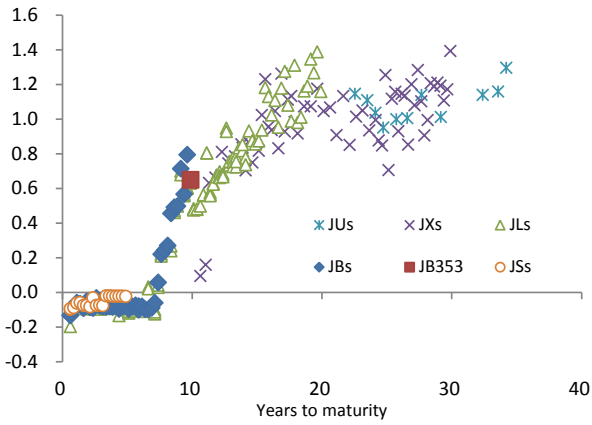
Note: + (-) 10Y richer (cheaper) for 10Y/15Y, 10Y/20Y and 10Y/30Y  
 Source: Daiwa Securities.

Appendix 4: 10Y JGB Asset Swap Spread (bp)



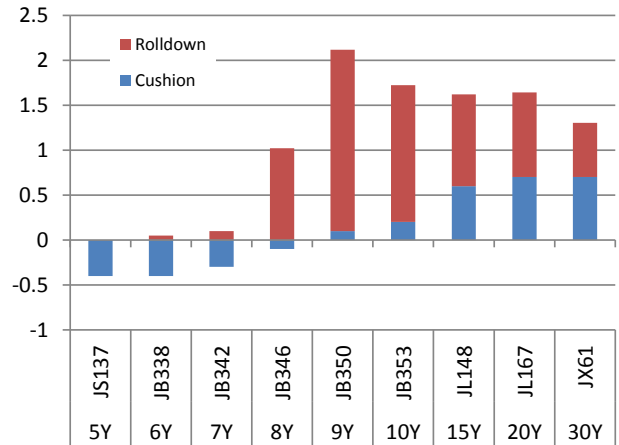
\* Yen LIBOR basis  
 Source: Daiwa Securities.

**Appendix 5: JGB Total Return Curve (3M, %)**



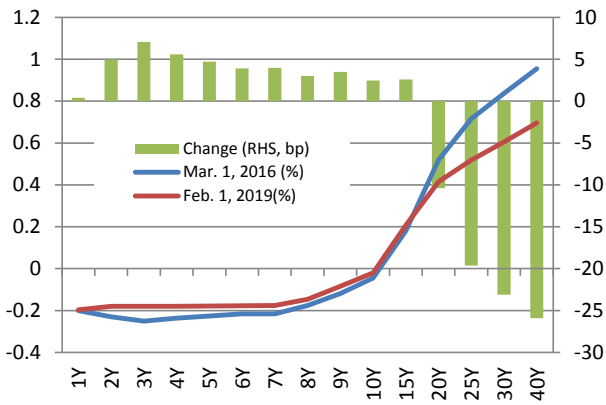
Note: Based on JGB yield curve on Feb. 1; assuming that those yield curve shapes do not change and factoring roll-down effect etc.  
Source: Daiwa Securities.

**Appendix 6: JGB Cushion and Roll-down (3M, bp)**



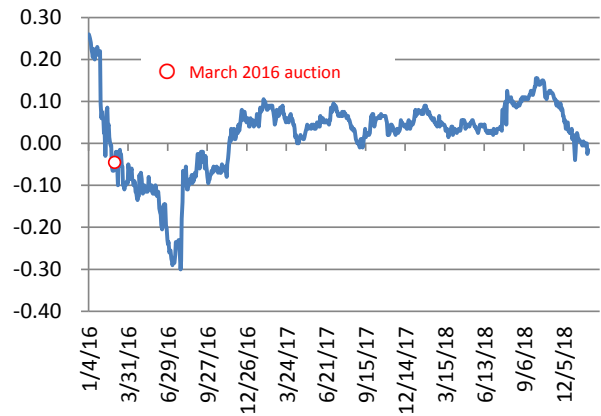
Source: Daiwa Securities

**Appendix 7: JGB Yield Change (bp): Mar. 1, 2016 v. Feb. 1, 2019**



Source: Daiwa Securities.

**Appendix 8: 10Y JGB Yield (%): Jan. 2016 to present**



Source: Daiwa Securities

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- 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).

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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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\* 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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