

Outlook for 5Y JGB Auction

Placing bids to be able to cover short positions for sure

- ✓ In the environment that JGB yields are not expected to face strong upward pressure for a while, tomorrow's sale of new 5Y JGBs would go smoothly, supported by some positive factors, such as an expected improvement in the market sentiment on the short- to intermediate-term zone of the JGB yield curve and 5Y's cheapness v. 7Y etc.
- ✓ We would like to think about our bidding stance to cover short positions for sure, assuming that the 5Y JGB yield will move in the -0.185 to -0.145% range over the next one month.

Strategic Memorandum DSTE297
FICC Research Dept.

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Auction Details

Auction Date: March 12, 2019
Issue Date: March 13, 2019
Maturity Date: December 20, 2023
Offering Amount: About 2.0 trillion yen

* New 5Y JGBs will likely be the final reopening of JS138 carrying a 0.1% coupon.

** On March 11, JS138 barely traded and closed at -0.160% (-0.5bp v. previous day's close) . WI barely traded and closed at -0.160% (-0.5bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Placing bids to be able to cover short positions for sure

After the previous 5Y JGB auction went smoothly at the -0.155 to -0.150% level on February 13, the 5Y JGB yield temporarily declined to -0.185% on an intraday basis with a bullish tone in the JGB market. From late February to early March, the JGB market softened amid a clearer trend of higher stock prices/lower bond prices in the US market as well as further depreciation of the yen. The BOJ adjusted the purchase amount in the 5-10Y zone, dampening the JGB market sentiment as well. In such a situation, the GC repo rate continued to rise on the back of deterioration in the supply/demand balance of funding. That put the 0-2Y zone of the JGB yield curve under downward pressure, pushing 5Y JGBs down to -0.145% at one point. Since then, the 5Y JGB yield has been moving in the -0.160 to -0.150% level amid the solid performance in the JGB market.

Let's check the environment surrounding JGBs. Since the beginning of March, the trend of lower stock prices/higher bond prices has been strengthening. Amid persisting concerns about the global economy on the back of mixed US economic indicators in addition to sluggish European and Chinese data, the ECB Governing Council announced dovish measures on March 7, following the Fed that has already shifted to a dovish stance. Also in Japan, a part of economic indicators pointed that Japan economy could be already in recession. Market participants are apt to get further cautious about the economic outlook.

JGB yields are thus unlikely to face strong upward pressure. In such an environment, key points to think about the bidding level at tomorrow's auction are as follows:

- ✓ Ahead of the March reserve maintenance period, the repo market is expected to improve, helped by the BOJ, which conducted extraordinary funds-supplying operations last week;
 - Market sentiment is expected to improve substantially in the short/intermediate zone.
- ✓ Amid the flattening of the zone up to the 7Y, JS138 appears cheap especially in the 3-7Y zone of the curve (Appendix 9);
- ✓ The 5Y sector is undervalued vs. the 7-10Y sectors at the current level (Appendix 3).
 - In particular, the 5Y/7Y spread has tightened to negative territory (Appendix 10). The comparison with the case in 2016 shows that the spread may not stay in negative territory so long. It would thus be worth considering short-term switching out from the 7Y sector or buying 5Y JGBs by selling the JGB futures.
- ✓ Lingering caution about the BOJ's trimming in JGB purchases
 - With its "flexible" stance to its JGB purchase operations, the BOJ has been adjusting to reduce the monthly purchase amounts in the 5-10Y zone and the over 10Y zone since mid-February. In such a trend, caution about trimming buying JGBs in the 3-5Y zone will linger, although such a trimming depends on FX and stock markets.

If auction participants can take new 5Y JGBs at the -0.140% level, we would be able to take an aggressive stance—e.g., building small long positions

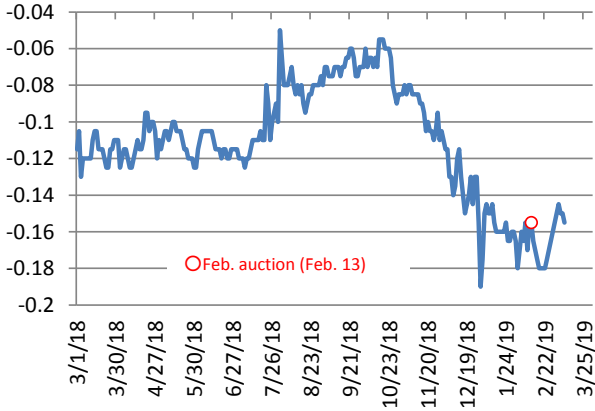
All in all, we would like to think about our bidding stance to cover short positions for sure, assuming that the 5Y JGB yield will move in the -0.185 to -0.145% range over the next one month. If we gain confidence to be able to take new 5Y JGBs at the -0.140% level in the pre-auction market, we would be able to take an aggressive stance—e.g., building of small-lot long positions.

5Y JGB Auction Results

Auction Date	Issue #	Maturity Date	Coupon %	Issue Size (trillion yen)	B/C	Average Price	Lowest Price	Price Tail (yen)	Average Yield	Highest Yield	Yield Tail (%)	Allotment (%)	
3/12/19	138R*	12/20/23	0.1*	2.0**									
2/13/19	138R	12/20/23	0.1	2.3	4.84	101.23	101.22	0.01	-0.151	-0.149	0.002	15.4016	Avg
1/16/19	138	12/20/23	0.1	2.3	5.15	101.21	101.21	0.00	-0.144	-0.144	0.000	85.4629	Good
12/13/18	137R	9/20/23	0.1	2.2	3.84	101.02	101.00	0.02	-0.112	-0.108	0.004	13.0155	Poor
11/15/18	137R	9/20/23	0.1	2.3	3.89	100.91	100.91	0.00	-0.087	-0.087	0.000	68.1985	Good
10/16/18	137	9/20/23	0.1	2.0	4.88	100.77	100.76	0.01	-0.055	-0.053	0.002	40.2505	Avg
9/13/18	136R	6/20/23	0.1	2.0	5.53	100.82	100.81	0.01	-0.071	-0.069	0.002	10.5496	Good
8/16/18	136R	6/20/23	0.1	2.1	3.95	100.86	100.85	0.01	-0.076	-0.074	0.002	37.0117	Avg
7/10/18	136	6/20/23	0.1	2.0	4.87	101.03	101.02	0.01	-0.107	-0.105	0.002	39.4402	Avg
6/21/18	135R	3/20/23	0.1	2.0	3.88	101.02	101.00	0.02	-0.113	-0.109	0.004	61.1594	Poor
5/17/18	135R	3/20/23	0.1	2.0	4.22	100.99	100.98	0.01	-0.103	-0.101	0.002	33.7643	Avg
4/17/18	135R	3/20/23	0.1	2.0	4.40	101.09	101.08	0.01	-0.120	-0.118	0.002	95.5045	Good
3/13/18	135	3/20/23	0.1	2.2	4.18	101.05	101.04	0.01	-0.108	-0.106	0.002	67.4216	Avg
2/14/18	134R	12/20/22	0.1	2.5	4.67	100.94	100.94	0.00	-0.093	-0.093	0.000	91.9530	Good

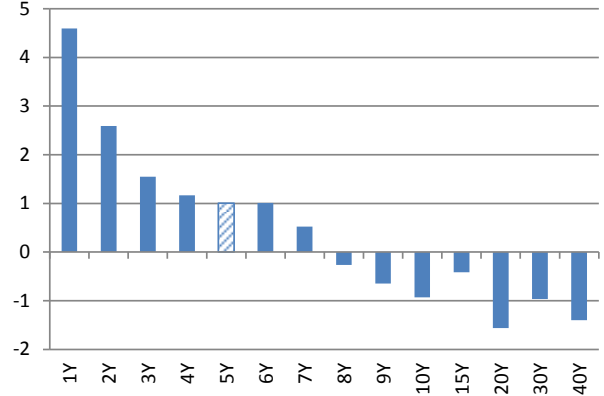
* Daiwa forecast (as of Mar. 11) ** Amount the MOF plans to issue
Source: Ministry of Finance, Daiwa Securities.

Appendix 1: 5Y JGB Yield (%)



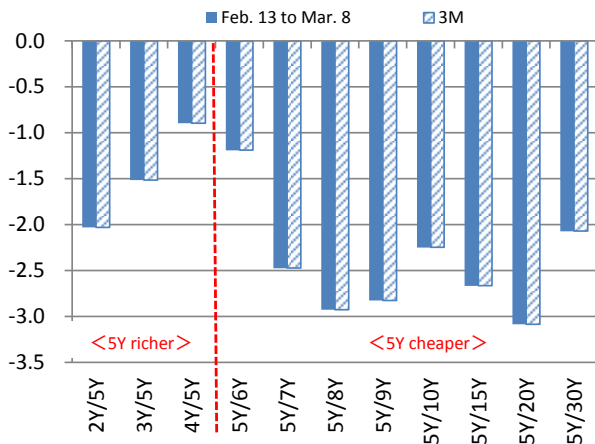
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Feb. 13 v. Mar. 8



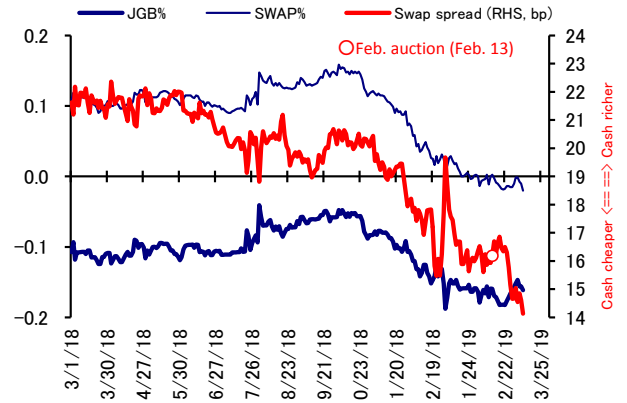
Source: Daiwa Securities.

Appendix 3: Z-scores of JGB Yield Spreads



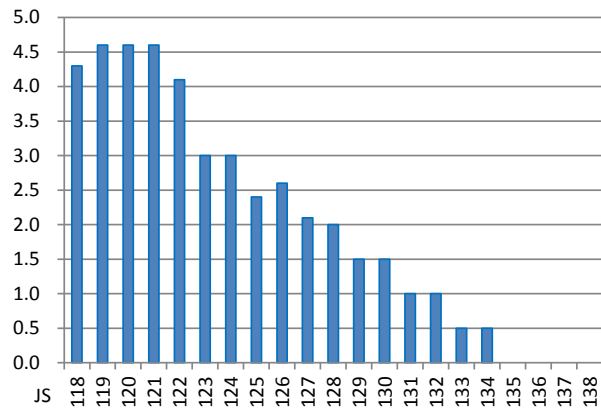
Source: Daiwa Securities.

Appendix 4: 5Y Swap Spread



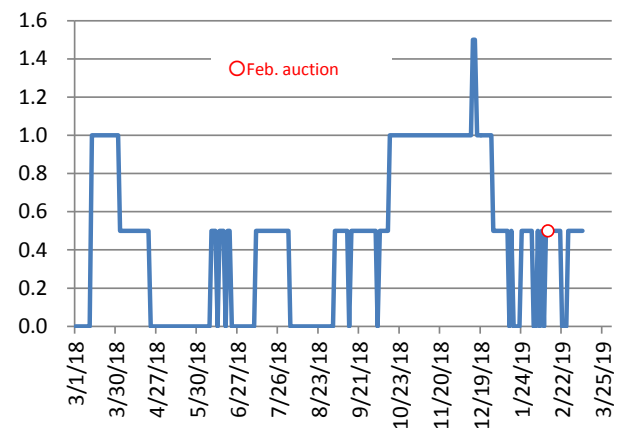
Source: Daiwa Securities.

Appendix 5: JS Yield Change (bp): Feb. 13 v. Mar. 8



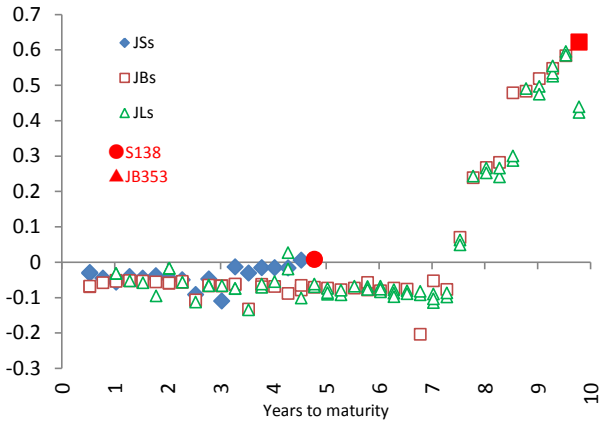
Source: Daiwa Securities.

Appendix 6: JS On- and Off-the-run Spread (bp)



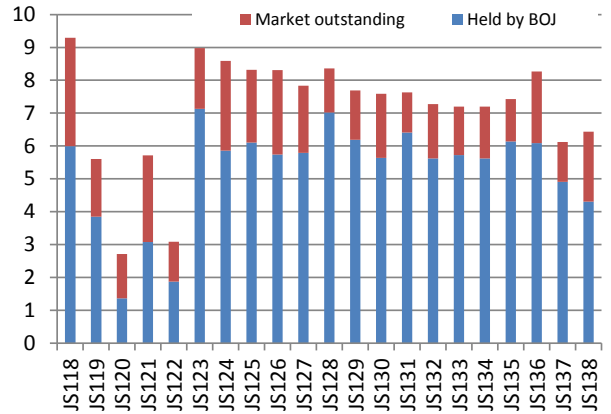
Source: Daiwa Securities.

Appendix 7: 3M Total Returns of JSs, JBs and JJs (%)



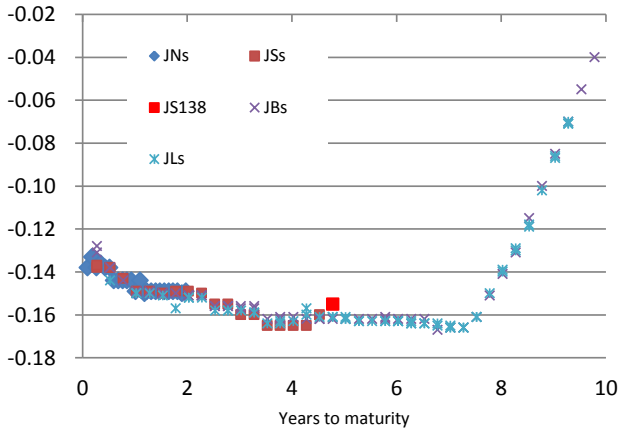
Note: Based on JB, JS and JJ yield curves on Mar. 8, respectively; Assuming that those yield curve shapes do not change and factoring roll-down effect etc.
Source: Daiwa Securities.

Appendix 8: BOJ and Market Outstanding of JSs (Yen trillions)



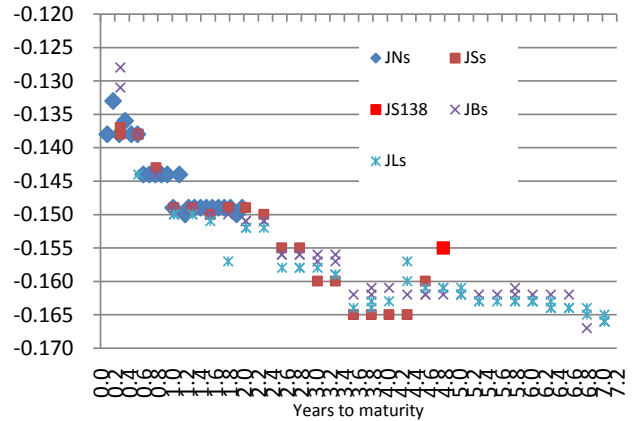
Note: as of Feb. 28
Source: Bank of Japan, Ministry of Finance, Daiwa Securities.

Appendix 9a: JGB Yield Curve (%): March 8



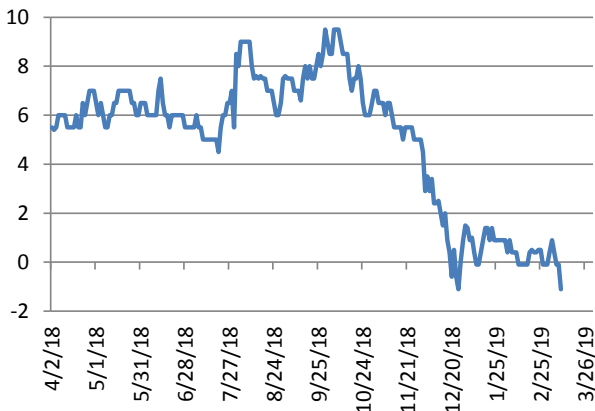
Note: 0-10Y zone excluding 10Y and 20Y JGBs maturing in March 2019
Source: Daiwa Securities.

Appendix 9b: JGB Yield Curve (%): March 8



Note: 0-7.2Y zone excluding 10Y and 20Y JGBs maturing in March 2019
Source: Daiwa Securities.

Appendix 9a: JGB 5Y/7Y Spread (bp)



Note: On-the-run 5Y and CTD basis
Source: Daiwa Securities.

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[Standard & Poor's]

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[Moody's]

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May 2018

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