

Outlook for 20Y JGB Auction

Bidding solidly

- ✓ May be the first auction to be conducted at the yield level below 0.4% since October 2016
- ✓ Although the low level of absolute yields is a concern, this should be a favorable auction for auction participants, given that conditions are not conducive for any significant expectations of future rate increases, the BOJ's trimming purchasing in the over-10-year to 25-year zone are unlikely, and the 20Y sector is not rich on the curve at the moment.
- ✓ Placing solid bids to build small-lot long positions

Strategic Memorandum DSTE298
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Auction Details

Auction Date: March 19, 2019
Issue Date: March 20, 2019
Maturity Date: December 20, 2038
Offering Amount: About 1.0 trillion yen

* New 20Y JGBs will be the final reopening of JL167 carrying a 0.5% coupon.

** On March 18, JL167 traded at 0.395% (unch v. previous day's close) and closed at 0.395% (unch).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

May be the first auction to be conducted at the yield level below 0.4% since October 2016

After the previous 20Y JGB auction, which was held at yield levels of 0.420-0.425%, went well on February 19, the market sentiment for superlong JGBs remained good and the 20-year JGB yield dropped as low as 0.390% during intraday trading at one point. Toward the end of February, as the strong stocks/weak bonds theme gained momentum in the US, the JGB market also softened. In addition, it negatively surprised the JGB market when the BOJ announced its JGB purchase operations plan for March at end-February and reduced the number of its operations in the over-5-year to 10-year zone from 5 to 4. While the JGB market sentiment weakened, the 20-year yield rose as high as 0.450%. With the start of March, stocks weakened and bonds strengthened in US markets. In Japan, the 30-year JGB auction held on March 7 went smoothly, improving the market sentiment around the long end of the curve. In such a situation, the 20-year JGB yield fell as low as 0.385% during intraday trading late last week. As JL167 traded at 0.395% today, it looks likely that this will be the first auction to be conducted at the yield level below 0.4% since the one held in October 2016.

Next we check some key points to consider the bidding stance at tomorrow's auction. We start by looking at the environment affecting superlong JGBs. 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 point that Japan economy could be already in recession. Market participants are apt to get further cautious about the economic outlook. (Whether realistic or not,) the external environment is likely to continue fanning expectations of additional easing. Current conditions make strong expectations of higher yields unlikely to materialize.

We think the BOJ is unlikely to reduce its purchases in the over-10-year to 25-year sector anytime soon

One domestic factor of concern is that the BOJ may adjust the amount of its purchases, but we think it is unlikely to reduce its purchases in the over-10-year to 25-year sector anytime soon. At its operations on February 12, the BOJ substantially reduced the amount it offered in the over-10-year to 25-year zone, and in March it reduced the number of its operations in the over-5-year to 10-year zone, which is expected to make the monthly purchase amount in the zone smaller than that in February. Looking ahead, we think that it will likely be the 1-5Y zone if the BOJ trims purchasing next time, while the 10Y JGB yield has been moving rather stably. This is because the Bank has not reduced the purchase amounts in the zone since the government decided to reduce JGB issuance in FY2019.

The 20-year sector is notably cheap relative to the 21-25yr and 40yr sectors

Next, we confirm positioning relative to the curve and relative to swaps. The 20-year sector has not looked that rich relative to the curve, particularly since the most recent auction. Relative to the 21-25-year and 40-year sectors, on the other hand, it looks cheap (Reference 3). With a 40-year JGB auction coming up on March 26 (Tuesday), we think that this cheapness may be corrected (Reference 6) by switching-out activities from those sectors into the 20Y sector. Since the previous auction in February, the 20-year asset swaps have traded flat and in a narrow range. As the current level is near the median of the range, we do not expect much demand for 20Y JGBs related to asset swaps.

Although the upcoming FOMC meeting is a source of concern, we think a collapse of the market for 20-year JGBs is unlikely

One factor of concern in terms of the auction's timing is the FOMC meeting scheduled for March 19-20, when the committee's members will announce their forecasts for the economy and for the policy rate. The market consensus is that both will be revised downward. Given also that the 10-year Treasury yield is near the bottom of its range since January, concerns linger over US markets' reactions if the Fed is not as dovish as the consensus expects. Even in that case, however, Japan's national holiday on March 21 (Thursday) provides a chance to digest the U.S. market trend on March 20-21, and given also that the BOJ has two operations in the over-10-year to 25-year sector scheduled after the auction until end-March (for a total of Y360 billion), a collapse of the 20-year JGB market is unlikely.

Placing solid bids to go long in small lot

Overall, expecting the 20-year JGB yield to trade in a range of 0.35-0.40% over the next month, we would like to place solid bids to go long in small lot.

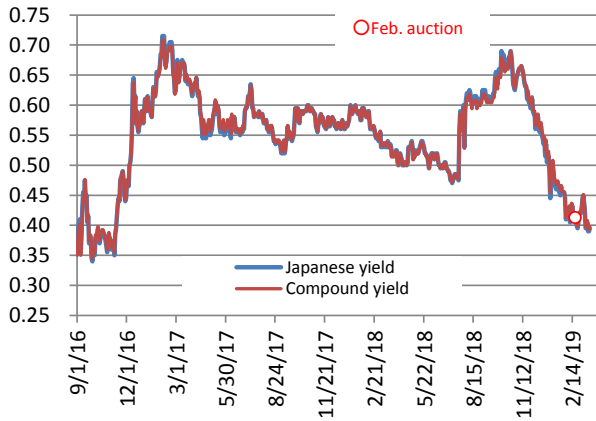
20Y JGB Auction Results

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
3/19/19	167R	0.5	12/20/38	1,000*									
2/19/19	167R	0.5	12/20/38	1,118	4.67	101.47	101.40	0.07	0.419	0.423	0.004	29.3637	Good
1/24/19	167	0.5	12/20/38	1,133	4.57	100.59	100.55	0.04	0.467	0.469	0.002	24.2842	Good
12/18/18	166R	0.7	9/20/38	1,121	3.44	102.80	102.75	0.05	0.543	0.545	0.002	65.7187	Good
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

* Amount the Ministry of Finance plans to issue

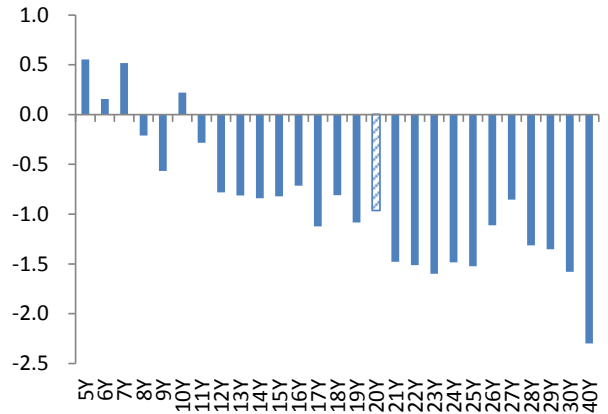
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 20Y JGB Yield (%)



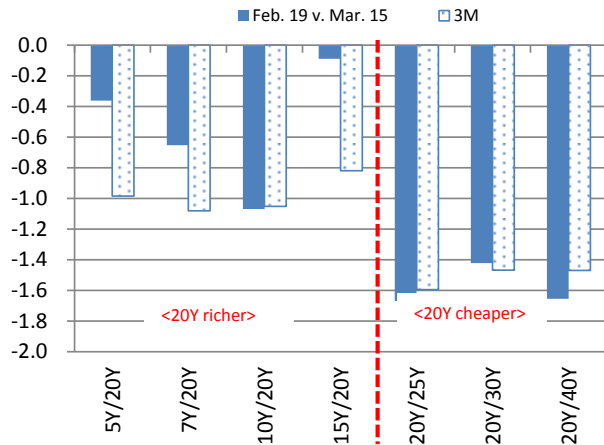
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Feb. 18 v. Mar. 15



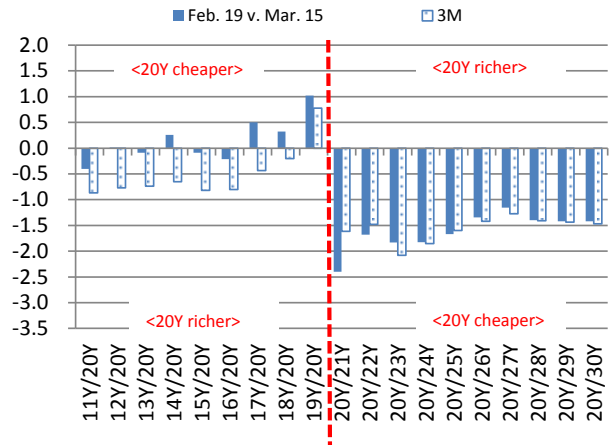
Source: Daiwa Securities.

Appendix 3a: Z-score I



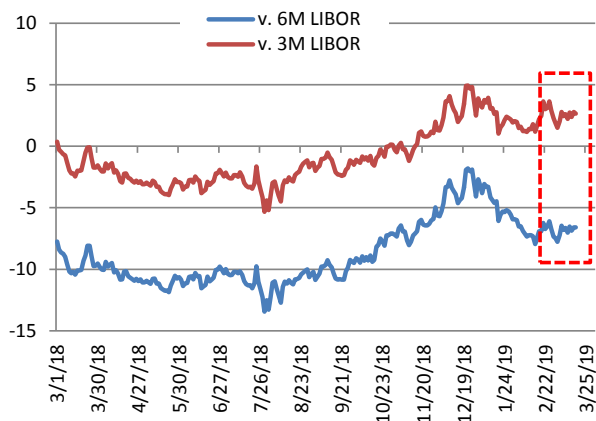
Source: Daiwa Securities.

Appendix 3b: Z-score II



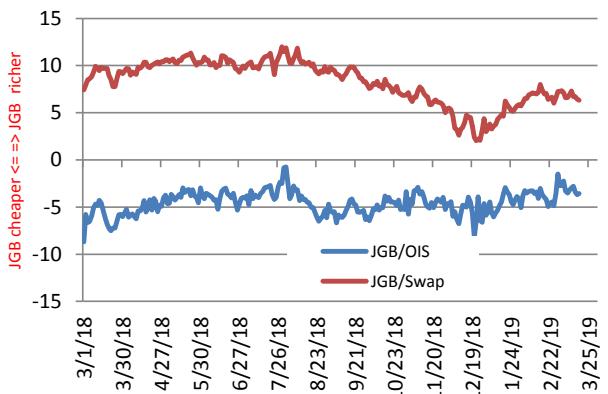
Source: Daiwa Securities.

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



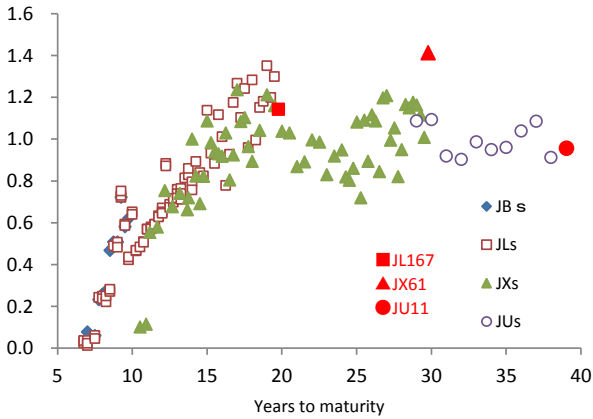
Note: since Feb. auction
Source: Daiwa Securities.

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



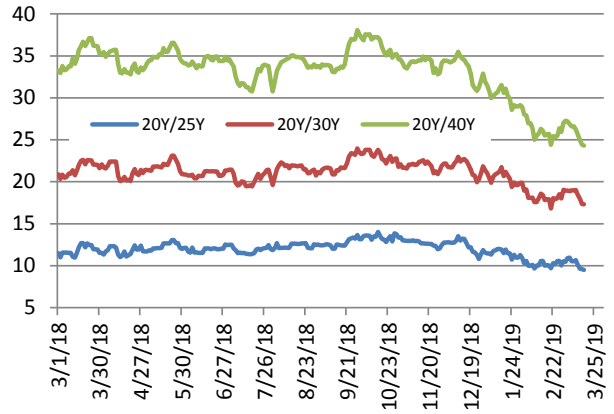
Source: Daiwa Securities.

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



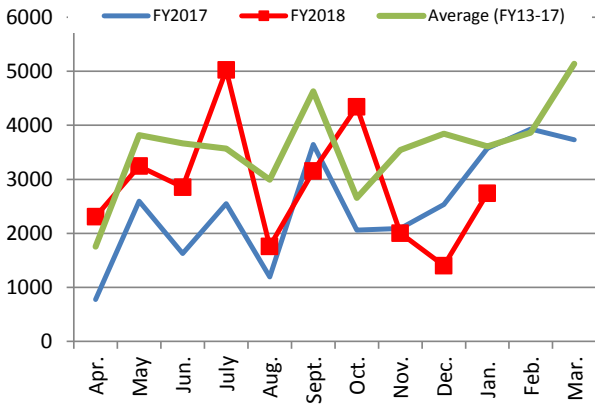
Note: Based on the Mar. 15 JGB yield curve; factoring in roll-down effect etc.
Source: Daiwa Securities.

Appendix 6: JGB Yield Spreads (bp)



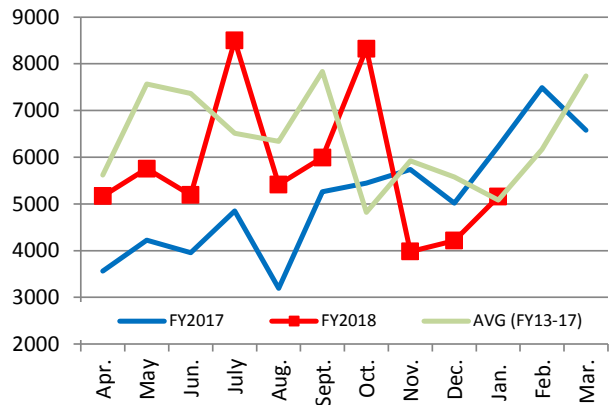
Note: Generic yield basis
Source: Daiwa Securities

Appendix 6a: Trend of Life and Non-life Insurers' Net Purchase of Superlong JGBs (Yen 100M)



Source: JSDA

Appendix 6b: Trend of Life and Non-life Insurers' Goss Purchase of Superlong JGBs (Yen 100M)



Source: JSDA

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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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- 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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