

## Outlook for 10Y JGBi Auction

### Bidding at 20-23bp BEI level

- ✓ Support confirmed below the break-even inflation rate (or BEI) of 20bp
- ✓ Although impact of weak observed inflation on JGBi investor sentiment is a concern, positive return is expected
- ✓ It appears to be very difficult for Japan to delay the consumption tax hike
- ✓ Although expected inflation will likely remain low, it can be good for investors especially with long horizon to think about buying JGBis
- ✓ We think about placing our bids at the 20-23bp BEI level

Strategic Memorandum DSTE306  
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### Auction Details

<b>Auction Date:</b>	May 10, 2019
<b>Issue Date:</b>	May 13, 2019
<b>Maturity Date:</b>	March 10, 2029
<b>Offering Amount:</b>	About 400 billion yen
<b>Auction Method:</b>	Dutch auction on an inflation-not-adjusted price with the increment of 0.05 yen
<b>Base CPI:</b>	101.40 (Nat'l core-CPI in Dec. 2018)
<b>Ref. CPI:</b>	101.319 (as on May 13)
<b>Index ratio:</b>	0.99920 (as on May 13)

\* New 10Y JGBis to be redeemed in March 2029, JBI24, will likely carry a 0.1% coupon.

\*\* On May 9, WI barely traded, and closed at -0.265% (+2.5bp v. previous day's close). Based on it, JBI24 BEI is assumed to be 21.5bp, down 2bp v. previous day's close.

### Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

### Support confirmed below the break-even inflation rate (or BEI) of 20bp

Since the previous auction on February 15 for a reopening of JBI23, JGBis had largely performed well toward early April (Chart 1). The break-even inflation rate (or BEI) had also risen moderately from around 22bp as of the February auction to 27bp at one point (closing on April 5) amid the softness of nominal JGBs (Chart 2). Subsequently, however, JGBis also faced selling pressure, as witnessed by weak results of a BOJ purchase of JGBis, pushing the benchmark BEI down below 20bp, the lowest level since July 2016. Before the Golden Week holiday, the BEI recovered to 24.5bp at one point, given the stronger-than-expected April CPI in the ward-area of Tokyo. For the recent few days, it has been moving mostly at the 23-24bp level.

**Although impact of weak observed inflation on JGBi investor sentiment is a concern, positive return is expected**

In predicting the future developments, we concern about negative impact on JGBis investor sentiment by expected weak observed inflation. The nationwide core CPI growth rate has been consistently in positive territory for more than two years, and recently announced March reading came in at 0.8% y/y. Going forward, however, the y/y growth rate is expected to gradually slow to around 0.5% toward this summer due to (1) the absence of the positive contribution from rising energy prices thus far and (2) the emergence of the impact from the plunge in crude oil prices since November 2018 via mainly electricity charges with a time lag (Chart 4). The impact of reductions in mobile phone charges also warrants attention.

Meanwhile, the index ratio is expected to rise toward summer and then to decline toward autumn in line with forecasts for the nationwide core CPI growth rate. After that, the ratio is likely to sharply rise toward February 2020 partly due to the impact from the consumption tax hike (Chart 5). For example, if we buy JGBis at tomorrow's auction, they are expected to generate quite positive return, which could be higher than the return expected from 20Y JGBs, even under the assumption that the JGBi price will be unchanged until August (Chart 6). The longer the holding period is, the higher the expected return from JGBis can be.

**It appears to be very difficult for Japan to delay the consumption tax hike**

On April 18, Koichi Hagiuda, executive acting secretary-general of the Liberal Democratic Party of Japan (LDP), who is regarded as a close aide of Prime Minister Shinzo Abe, made a remark on the postponement of the consumption tax hike, which came to an issue among some market participants. On the next day, Chief Cabinet Secretary Yoshihide Kan made firefighting-type remarks. However, as the LDP was unable to win a sweeping victory in the first half of the nationwide local elections in the month, the possibility is strong that the party tried to check responses of public opinion ahead of by-elections for the lower house and the latter half of the nationwide local elections. In addition, the party may have tried to find the possibility of a lower house snap election alongside the upper house election scheduled for this summer. In by-elections for the lower house, the LDP ended in dismal failure and lost seats. This appears to have proved that the postponement of the consumption tax hike can not be a trump card for elections. After the elections, Toshihiro Nikai, LDP Secretary-General, expressed a sense of discomfort about the remark by Mr. Hagiuda.

Regarding the upcoming consumption tax hike, careful preparations have been in progress, such as the introduction of lower tax rates for certain items and the formulation of economic measures to prevent a recession. Given the fact that the FY19 budget was compiled under the assumption of the consumption tax hike, making a judgment on the tax hike again after the announcement of June BOJ Tankan (in accordance with Mr. Hagiuda's remark) could cause major confusion in terms of time and cost. The possibility of postponement of the consumption tax hike appears quite limited, unless a Lehman crisis-level shock happens.

**Impact of determination of delay on JGBis may be limited**

For reference, we look at the impact of the past cases of the delayed consumption tax hike on JGBi prices (Chart 8). When the delay was announced in November 2014, prices fell substantially with the decline of the BEI. In the case of June 2016, however, both prices and BEI rose immediately after the announcement probably because market participants grew understanding that the tax hike would be just delayed, unlike cancellation.

**Although expected inflation will likely remain low, it can be good for investors especially with long horizon to think about buying JGBis**

Let's confirm the environment surrounding JGBis. Amid persisting worries about the global economic outlook, it is difficult to anticipate a rise in inflation expectations. In such an environment, the BEI may lose upward momentum at the 25-30bp level in the near term, partly because of recent moves of the slow rise in crude oil prices and the decline in US TIPS BEI. Under the yield curve control policy, however, 10-year inflation expectations have been mostly stable at around 0.8-1.0% level (Chart 7). Given this, we think that the BEI of the 20bp level still points to cheapness of JGBis. In particular for investors with longer investment horizon, it can be good think about buying JGBis at the auction.

**Bidding at the 20-23bp BEI level**

All in all, we would like to think about placing our bids at the 20-23bp BEI level (Table 2).

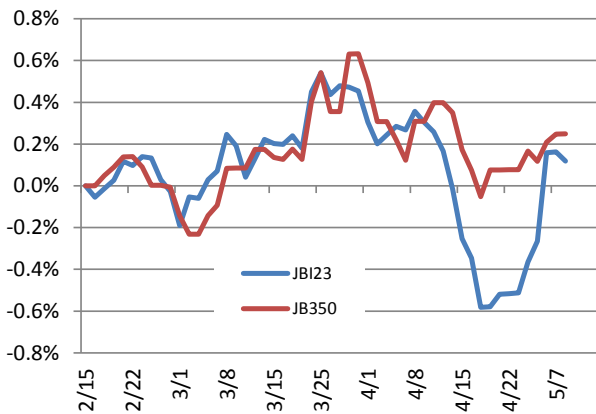
**10Y JGBi Auction Results**

Auction Date	Issue #	Coupon (%)	Maturity Date	Issue Size (billion yen)	B/C	Lowest Accepted Price/Issue Price (Yen) (Note 1)	Highest Accepted Yield (%)	Issue Price Before Multiplied by Index Ratio (Note 2)	Allotment (%)	BEI Before Auction (Note 3)	BEI on Auction Day (bp) (Note 3)	Change from p.d. (bp) (Note 3)	Market Expectation of Lowest Accepted Price (Yen) (Notes 4)	Expected range	
5/10/19	24	0.1*	3/10/29	400**						23.5					
2/15/19	23R	0.1	3/10/28	421.8	3.34	103.60	-0.287	-	16.3120	21.6	21.7	0.1	103.50	103.40-103.50	Good
11/6/18	23R	0.1	3/10/28	435.4	3.70	103.90	-0.305	-	43.0272	41.1	41.1	0.0	103.85	103.75-103.90	Avg
8/7/18	23R	0.1	3/10/28	418.4	3.12	104.05	-0.309	-	6.3636	48.0	41.0	-7.0	104.00	103.75-104.30	Avg
5/10/18	23	0.1	3/10/28	447.1	4.02	106.35	-0.513	-	32.0441	56.5	58.7	2.2	106.20	106.10-106.30	Good
2/6/18	22R	0.1	3/10/27	440.8	3.38	105.35	-0.464	-	5.0000	62.4	55.7	-6.7	106.25	106.00-106.30	Poor
10/5/17	22R	0.1	3/10/27	446.4	3.10	104.50	-0.361	-	55.6088	38.8	39.9	1.1	104.40	104.30-104.50	Good
8/3/17	22R	0.1	3/10/27	419.3	3.19	104.55	-0.358	104.048	69.4877	36.0	38.5	2.5	104.45	103.70-104.50	Good
4/11/17	22	0.1	3/10/27	453.9	3.64	105.00	-0.385	105.210	50.5643	44.0	46.7	2.7	104.80	104.65-105.00	Good
2/7/17	21R	0.1	3/10/26	412.2	2.61	105.10	0.439	105.406	25.7142	62.9	58.2	-4.7	105.30	105.00-105.50	Poor
10/6/16	21R	0.1	3/10/26	425.1	3.21	104.80	-0.391	105.316	40.0537	30.9	37.1	6.2	104.75	104.50-104.90	Good
8/4/16	21R	0.1	3/10/26	454.3	2.85	104.20	-0.324	104.509	72.0520	30.0	31.0	1.0	103.80	103.40-104.05	Good
4/12/16	21	0.1	3/10/26	435.6	2.84	104.90	-0.376	105.629	80.0000	35.0	36.7	1.7	104.70	104.30-105.40	Good

\* Daiwa forecast as of May 9 \*\* Planned by MoF (Note 1) Inflation adjusted price until August 2017 and inflation unadjusted price from October 2017 (Note 2) Daiwa calculation (Note 3) Closing price; WI basis for new issues; as of May 8 for the May 2019 auction (Note 4) Bloomberg

Source: Ministry of Finance, Daiwa Securities

**Chart 1: Realized Return (%)**



Note: Cumulative return from Feb. 15 to each month  
Source: Daiwa Securities

**Table 1: BOJ Purchase and MOF Buyback Results**

	Previous Day's Close (Yen)	Pro-rata Price Spread (Yen)	Average Successful Price Spread (Yen)	Allotment on Pro-rata (%)	B/C	Close Price (Yen)
1/9/19	103.60	-0.100	-0.106	93.6	5.48	103.45
1/25/19	103.30	-0.110	-0.134	67.0	4.93	103.30
2/6/19	103.60	0.050	-0.050	100.0	4.72	103.65
2/20/19	103.60	-0.020	-0.035	71.2500	6.46	103.65
2/22/19	103.75	-0.020	-0.076	100.0	5.13	103.75
3/6/19	103.65	0.030	-0.024	50.0000	5.51	103.75
3/18/19	104.00	0.080	0.006	44.4	4.38	104.00
4/10/19	104.25	0.000	-0.051	20.0	3.39	104.20
4/17/19	103.55	-0.160	-0.214	49.0	4.64	103.30
4/19/19	103.30	0.000	-0.045	53.3333	3.81	103.35

Note: Previous Day's Close and Close Price are based on JBI23. Buybacks by the Ministry of Finance on Feb. 20, Mar. 6 and Apr. 19  
Source: Bank of Japan, Ministry of Finance, Daiwa Securities

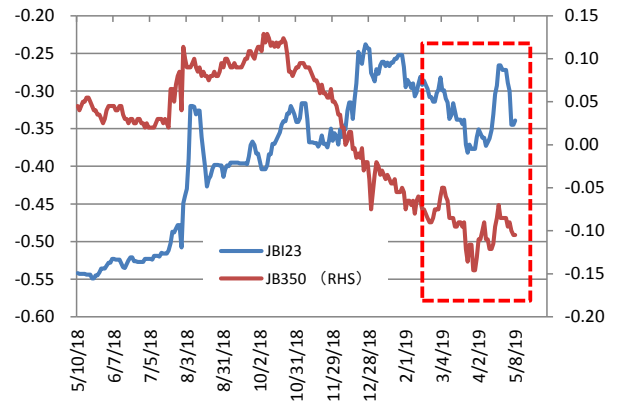
Source: Daiwa Securities

**Chart 2: BEI (bp)**



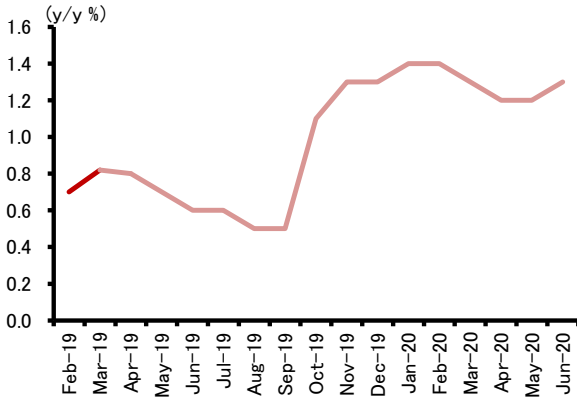
Note: On-the-run issues basis  
Source: Daiwa Securities

**Chart 3: JBI23 and JB350 Yields (%)**



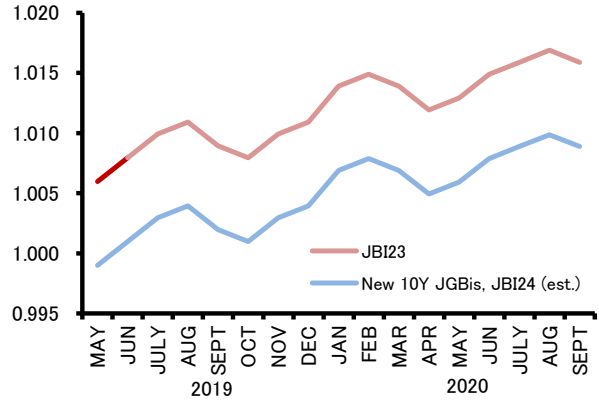
Note: Since the Feb. auction in red box  
Source: Daiwa Securities

**Chart 4: Nationwide Core-CPI Growth Outlook (y/y %)**



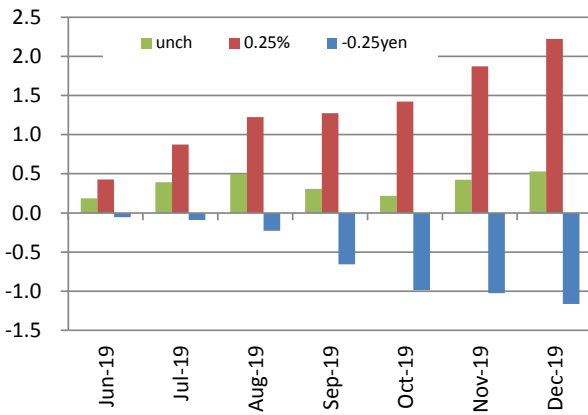
Note: Actual for Feb-Mar. 2019  
Source: Daiwa Securities

**Chart 5: Index Ratio Forecast**



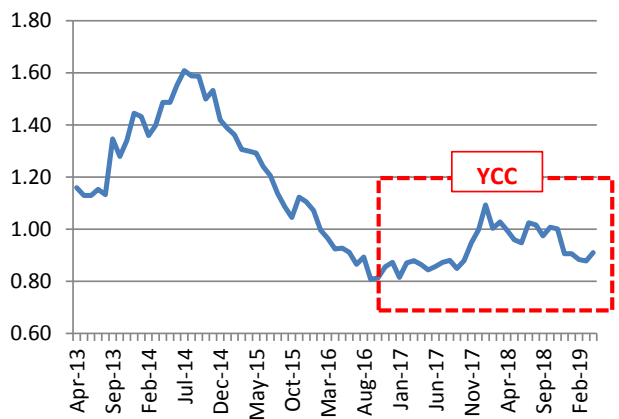
Note: Based on Chart 4  
Source: Daiwa Securities

**Chart 6: JBI24 HPR Analysis (%)**



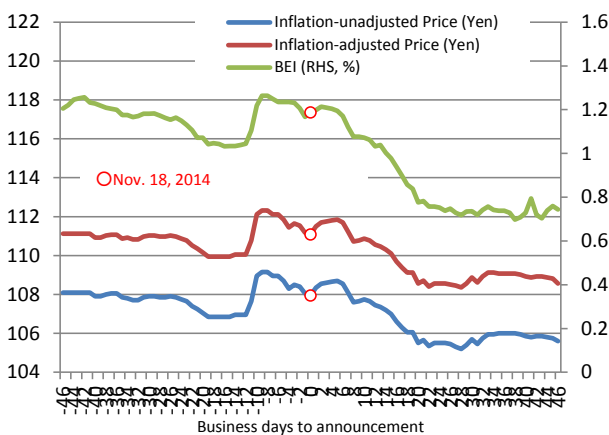
Note: From the issuance day (May 13) to the 10<sup>th</sup> or the following business day, if the 10<sup>th</sup> is a holiday, of each month; factoring in index ratio in Chart 5; price at the end of period is assumed to be (1) unchanged, (2) increased by 0.25 yen each month and (3) decreased by 0.25 yen each month from the issuance day; coupon is assumed to be 0.1%.  
Source: Daiwa Securities

**Chart 7: CPI Core Change Forecast: 10Y average (%)**



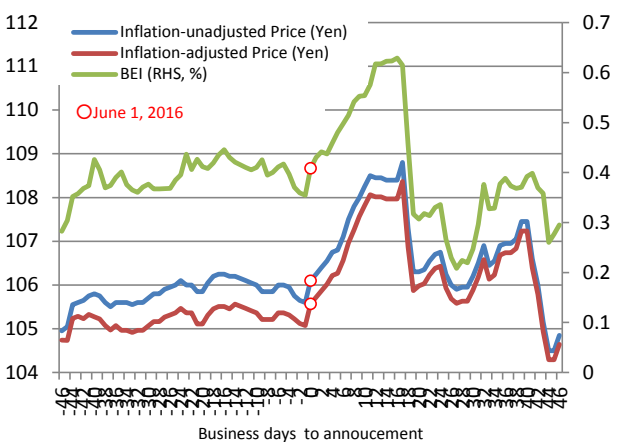
Source: QUICK

**Chart 8a: JGB Linker Price and BEI Movement\*: Nov. 2014**



Note: JBI18 basis  
Source: Daiwa Securities

**Chart 8b: JGB Linker Price and BEI Movement\*: Jun. 2016**



Note: JBI20 basis  
Source: Daiwa Securities

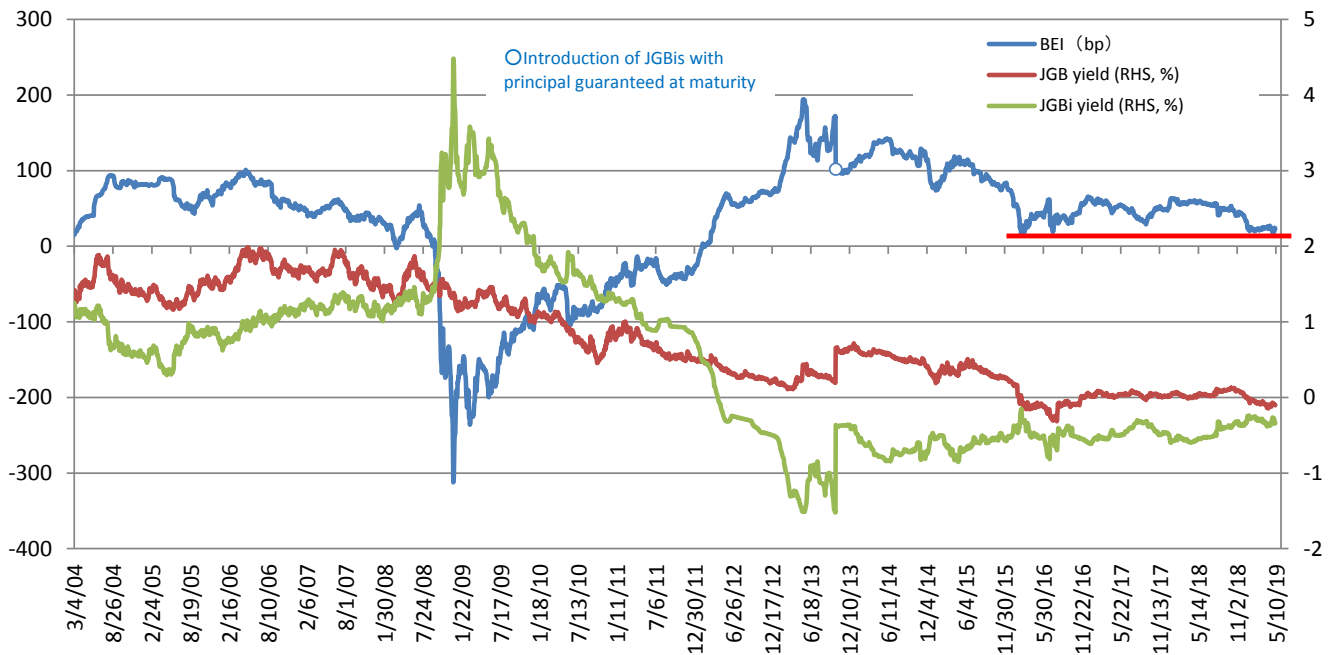
Table 2: Image of Bidding Price at Auction and BEI

(Unit: bp)

		Nominal Yield (% JB354)									
		-0.075	-0.070	-0.065	-0.060	-0.055	-0.050	-0.045	-0.040	-0.035	-0.030
Bidding Price (Yen)	104.50	27.5	28.0	28.5	29.0	29.5	30.0	30.5	31.0	31.5	32.0
	104.45	27.0	27.5	28.0	28.5	29.0	29.5	30.0	30.5	31.0	31.5
	104.40	26.5	27.0	27.5	28.0	28.5	29.0	29.5	30.0	30.5	31.0
	104.35	26.0	26.5	27.0	27.5	28.0	28.5	29.0	29.5	30.0	30.5
	104.30	25.5	26.0	26.5	27.0	27.5	28.0	28.5	29.0	29.5	30.0
	104.25	25.0	25.5	26.0	26.5	27.0	27.5	28.0	28.5	29.0	29.5
	104.20	24.5	25.0	25.5	26.0	26.5	27.0	27.5	28.0	28.5	29.0
	104.15	24.1	24.6	25.1	25.6	26.1	26.6	27.1	27.6	28.1	28.6
	104.10	23.6	24.1	24.6	25.1	25.6	26.1	26.6	27.1	27.6	28.1
	104.05	23.1	23.6	24.1	24.6	25.1	25.6	26.1	26.6	27.1	27.6
	104.00	22.6	23.1	23.6	24.1	24.6	25.1	25.6	26.1	26.6	27.1
	103.95	22.1	22.6	23.1	23.6	24.1	24.6	25.1	25.6	26.1	26.6
	103.90	21.6	22.1	22.6	23.1	23.6	24.1	24.6	25.1	25.6	26.1
	103.85	21.1	21.6	22.1	22.6	23.1	23.6	24.1	24.6	25.1	25.6
	103.80	20.6	21.1	21.6	22.1	22.6	23.1	23.6	24.1	24.6	25.1
	103.75	20.1	20.6	21.1	21.6	22.1	22.6	23.1	23.6	24.1	24.6
	103.70	19.6	20.1	20.6	21.1	21.6	22.1	22.6	23.1	23.6	24.1
	103.65	19.1	19.6	20.1	20.6	21.1	21.6	22.1	22.6	23.1	23.6
	103.60	18.6	19.1	19.6	20.1	20.6	21.1	21.6	22.1	22.6	23.1
	103.55	18.2	18.7	19.2	19.7	20.2	20.7	21.2	21.7	22.2	22.7
103.50	17.7	18.2	18.7	19.2	19.7	20.2	20.7	21.2	21.7	22.2	
103.45	17.2	17.7	18.2	18.7	19.2	19.7	20.2	20.7	21.2	21.7	
103.40	16.7	17.2	17.7	18.2	18.7	19.2	19.7	20.2	20.7	21.2	
103.35	16.2	16.7	17.2	17.7	18.2	18.7	19.2	19.7	20.2	20.7	
103.30	15.7	16.2	16.7	17.2	17.7	18.2	18.7	19.2	19.7	20.2	

Note: Based on the settlement day of May 13  
Source: Daiwa Securities

Appendix: BEI (March 2004 to present)



Note: on-the-run issue basis  
Source: Daiwa Securities.

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#### [Standard & Poor's]

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The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

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#### [Moody's]

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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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#### [Fitch]

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- In addition to the purchase price of a financial instrument, our company will collect a trading commission\* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- 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.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

\* 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.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name:	Daiwa Securities Co. Ltd.
Registered:	Financial Instruments Business Operator Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships:	Japan Securities Dealers Association The Financial Futures Association of Japan Japan Investment Advisers Association Type II Financial Instruments Firms Association