

Outlook for 20Y JGB Auction

Smooth primary sale expected, but upside may be limited

- ✓ Primary sale will likely go smoothly amid growing expectations on solid short-covering and good demand from investors
- ✓ The current yield level, however, would not motivate auction participants to bid in an aggressive stance; unless we see further adjustment in pre-auction trading, we would like to place our bids to take only necessary amount
- ✓ In terms of relative value, it would be worth considering switching out from 22-24Y sectors or building 20Y/24Y/30Y butterfly position (by selling the body); moreover, buying asset swaps would also be attractive if the spread to Yen LIBOR goes into positive territory

Strategic Memorandum DSTE343
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Auction Details

Auction Date: November 20, 2019

Issue Date: November 21, 2019

Maturity Date: September 20, 2039

Offering Amount: About 900 billion yen

* New 20Y JGBs will be the first reopening of JL170 carrying a 0.3% coupon.

** On November 19, JL171 traded at 0.275 - 0.280% (-1.0 - -0.5bp v. previous day's close) and closed at 0.280% (-0.5bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

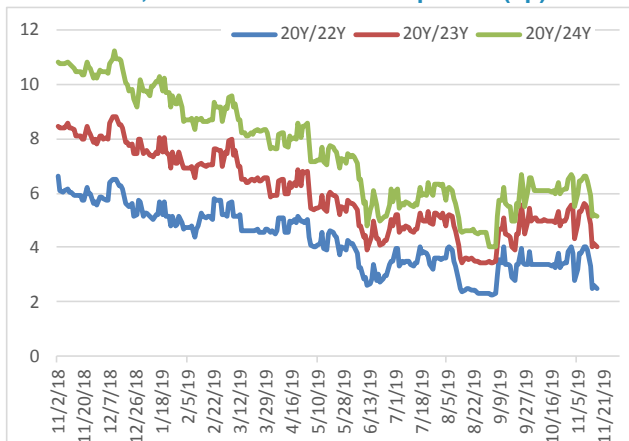
After the previous 20Y JGB auction went smoothly at the 0.245-0.250% level on October 24, the yield of on-the-run 20Y JGBs (on conventional yield basis) temporarily rose to 0.320% on an intraday basis amid JGB downtrend. While the downtrend has started to recede since last week, the yield momentarily declined to 0.280% on an intraday basis on November 15. Since the beginning of this week, the yield has been moving in the 0.275-0.290% level. If tomorrow's auction is held at the today's level (0.275-0.280%), new 20Y JGBs would be sold at the highest bidding yield since the May 2019 auction.

Let's look at the environment surrounding the JGB market. Recent risk-on mode appears to be now letting up. However, unless speculations on additional easing strengthen, for example, JGBs would lack strong factors to gain upward momentum in the near term, which may limit the upside of JGBs. As there are many uncertain factors, it would be difficult to fully eliminate worries about the global economy in the longer term. In Europe and the US, a next step of monetary policies appears to be to keep the current easing stance unchanged or move for additional easing (such as rate cuts). As such, fundamental factors prevent us from expecting a major uptrend in JGB yields. Overall, the current market level suggests that a dip-buying stance is effective. In such an environment, we summarize the key points to think about the bidding stance at tomorrow's auction as follows:

- ✓ **The BOJ will likely keep JL170 out of purchase list:** However, as the ratio of recently-issued superlong JGBs held by the BOJ is quite low, investors appears to have strong demand for superlong JGBs in the primary stage. Depending on demand from investors, negative impact by the BOJ's operation risk on tomorrow's primary sale of new 20Y JGBs may be limited;
- ✓ **Demand from investors is expected to be stronger:** In terms of carry and risk exposure, JL170 is slightly less attractive than JB356 (10Y) at the current level. However, it is more attractive than JX64 (30Y) and JU12 (40Y) as shown in Appendix 6. Compared to 30Y and 40Y JGBs, 20Y JGBs have the broad base of investors and the market size is large. In addition, the direct impact from the BOJ's monetary policy is limited unlike 10Y JGBs. From a comprehensive viewpoint, investors appear to have strong preference to 20Y JGBs. Thus, demand from investors is likely to be stronger;
- ✓ **Decent short-covering is expected:** Based on data as of closing on November 18, short-covering by primary dealers is expected to be greater than that at the previous auction;
- ✓ **In terms of relative value, the 20Y sector appears to be noticeably undervalued vs. the 22-24 sectors on the curve:** Both the data since the previous auction and that over the past three months show that the 20Y sector is neither noticeably overvalued nor undervalued vs. major sectors in the 5-40Y zone of the curve (Appendix 3a). However, the 20Y sector is noticeably undervalued vs. the 22-24Y sectors, which are off-the-run sectors of 30Y JGBs (Appendix 3b)

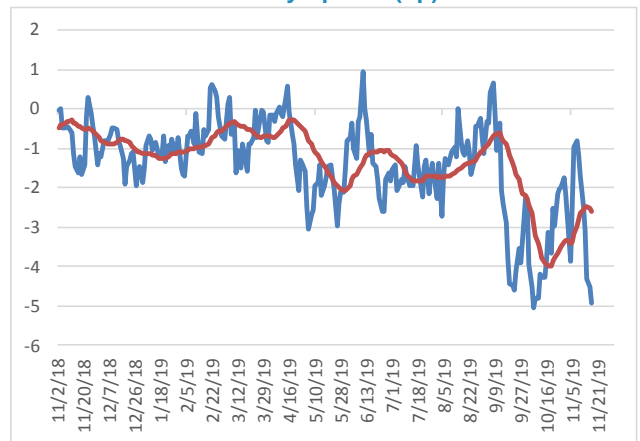
All in all, we would like to think of our bidding stance at tomorrow's auction, assuming that the JL170 yield will move in the 0.25-0.30% level until the next auction. In terms of the relative value, switching out from sectors over 20Y seems attractive. For example, it would be worth considering switching out from the 22-24Y sectors in anticipation of the correction in the 20Y cheapness v. those sectors. 20Y/24Y/30Y butterfly (selling the body) trade looks profitable as well. The butterfly spread is currently at a reversal level and positive carry is expected from the trade. In addition, buying asset swaps would become more attractive if the spread v. Yen LIBOR moves into positive territory.

JGB 20Y/22Y, 20Y/23Y and 20Y/24Y Spreads (bp)



Source: Daiwa Securities.

JGB 20Y/24Y/30Y Butterfly Spread (bp)



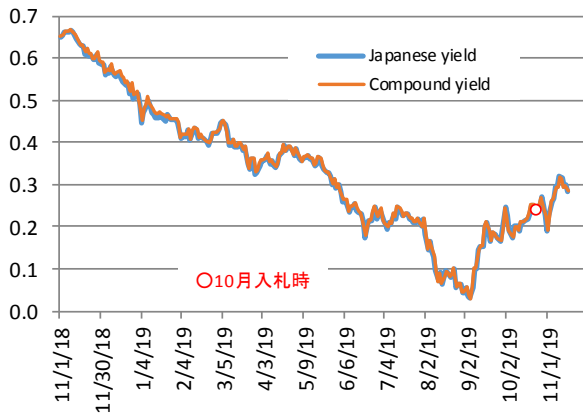
Source: Daiwa Securities.

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
11/20/19	170R	0.3	9/20/39	900*									
10/24/19	170	0.3	9/20/39	899	3.91	101.04	100.95	0.09	0.245	0.249	0.004	57.2532	Avg
9/18/19	169R	0.3	6/20/39	949	3.48	101.79	101.70	0.09	0.205	0.210	0.005	20.3703	Good
8/20/19	169R	0.3	6/20/39	1,019	3.81	103.67	103.60	0.07	0.110	0.114	0.004	32.8061	Avg
7/17/19	169	0.3	6/20/39	1,018	4.89	100.96	100.95	0.01	0.249	0.249	0.000	84.8219	Good
6/25/19	168R	0.4	3/20/39	1,017	4.08	103.63	103.55	0.08	0.208	0.212	0.004	25.6662	Avg
5/22/19	168R	0.4	3/20/39	1,007	5.47	100.75	100.70	0.05	0.359	0.362	0.003	23.4032	Good
4/16/19	168	0.4	3/20/39	989	5.10	100.63	100.60	0.03	0.366	0.367	0.001	47.1709	Good
3/19/19	167R	0.5	12/20/38	1,143	4.84	101.99	101.95	0.04	0.391	0.393	0.002	14.9462	Good
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

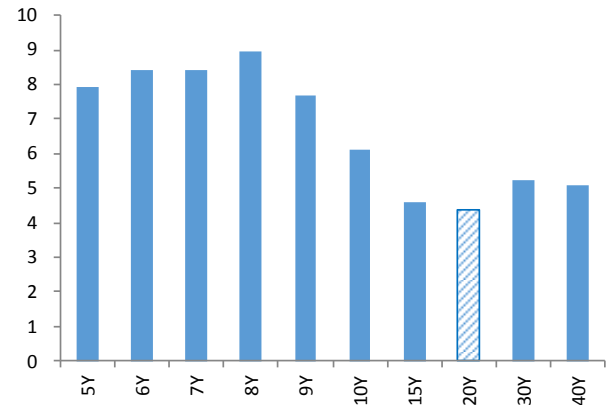
* Amount the Ministry of Finance plans to issue
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 20Y JGB Yield (%)



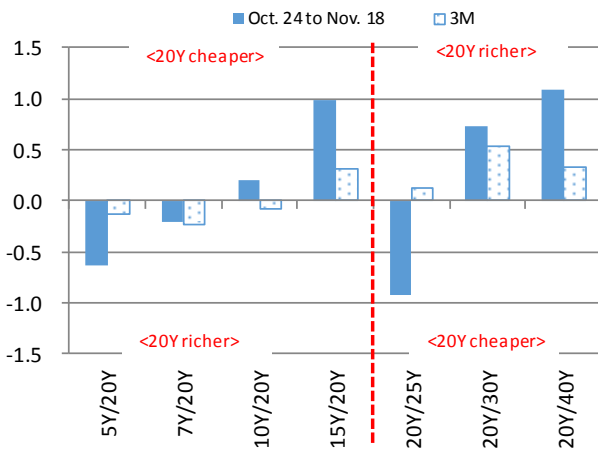
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Oct. 24 v. Nov. 18



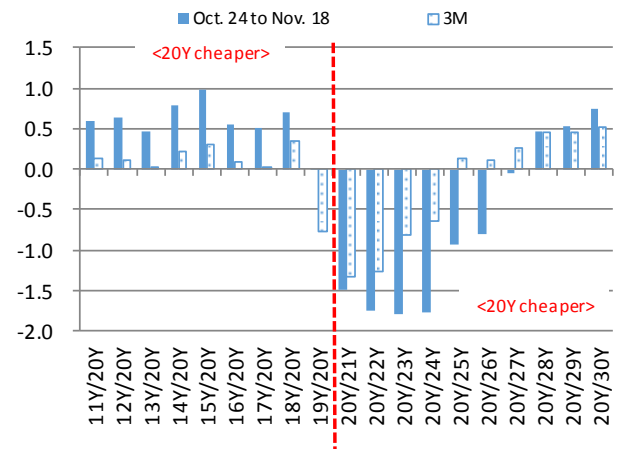
Source: Daiwa Securities.

Appendix 3a: Z-score I



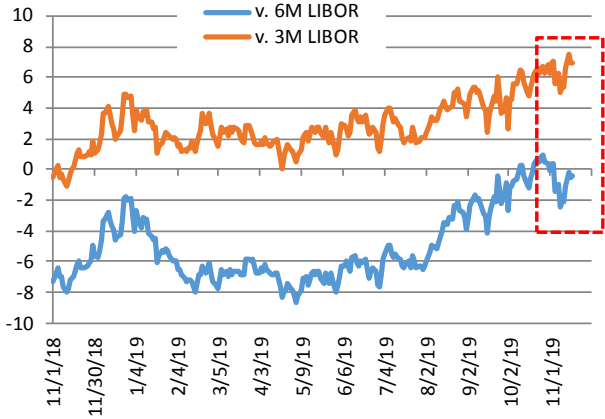
Source: Daiwa Securities.

Appendix 3b: Z-score II



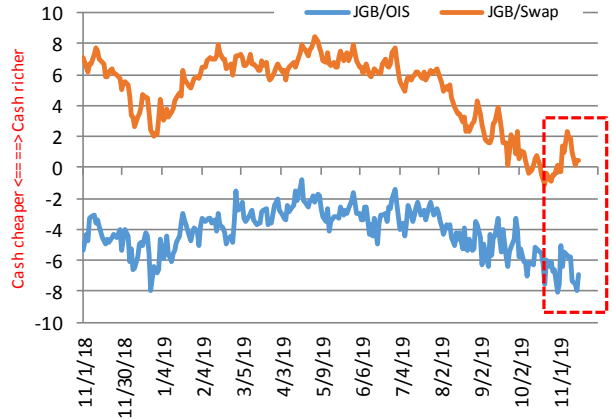
Source: Daiwa Securities.

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



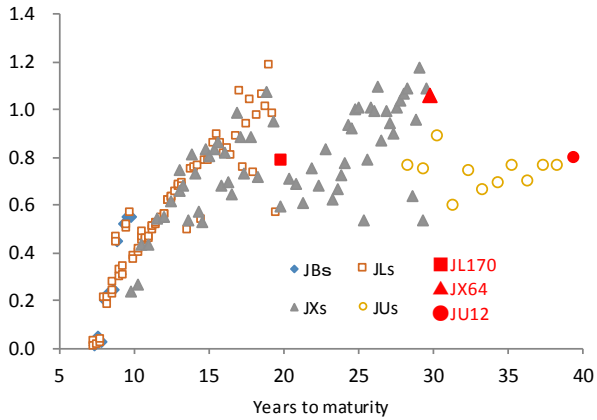
Note: since the Oct. auction
Source: Daiwa Securities.

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



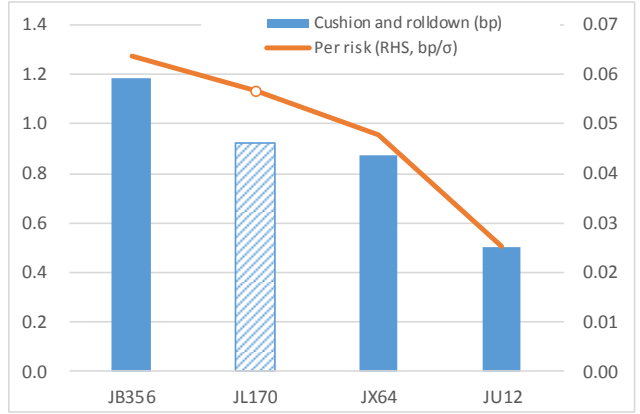
Note: since the Oct. auction
Source: Daiwa Securities.

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



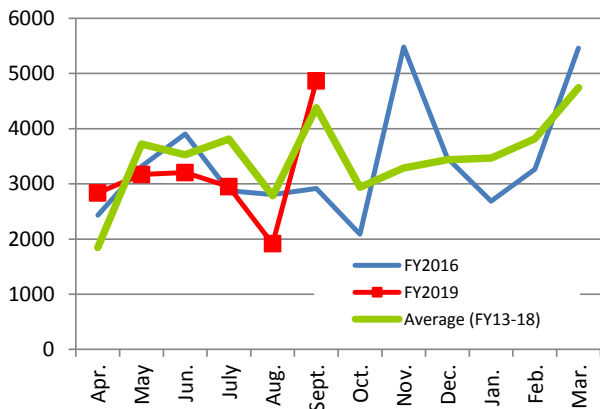
Note: Based on the Nov-18 JGB yield curve; factoring in roll-down effect etc.
Source: Daiwa Securities.

Appendix 6: Cushion and Roll-down (3M)



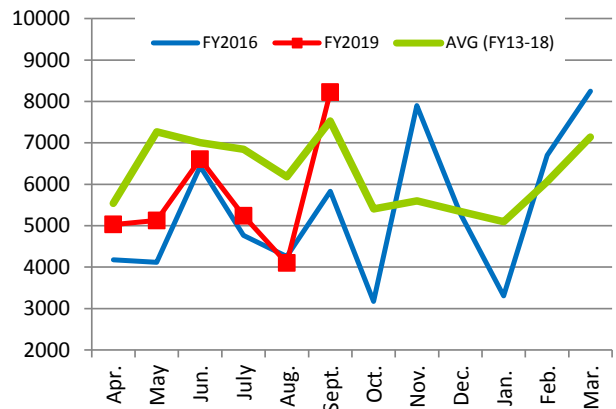
Note: Based on the Nov-18 JGB yield curve; factoring in roll-down effect etc.
Source: Daiwa Securities.

Appendix 7a: Trend of Life and Non-life Insurers' Net Purchase of Superlong JGBs (Yen 100M)



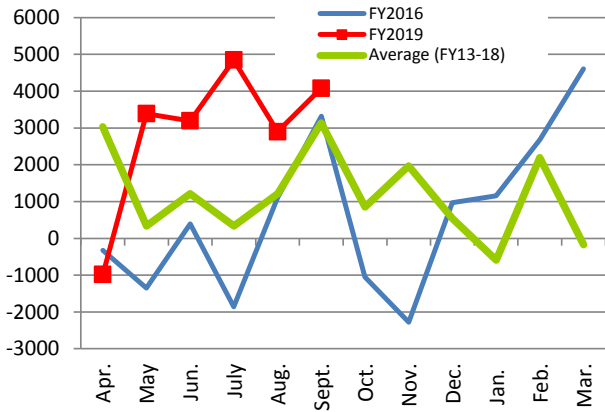
Source: JSDA

Appendix 7b: Trend of Life and Non-life Insurers' Gross Purchase of Superlong JGBs (Yen 100M)



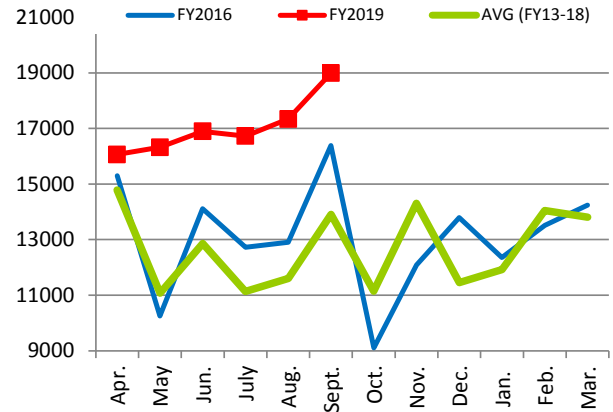
Source: JSDA

Appendix 8a: Trend of Overseas Accounts' Net Purchase of Superlong JGBs (Yen 100M)



Source: JSDA

Appendix 8b: Trend of Overseas Accounts' Gross Purchase of Superlong JGBs (Yen 100M)



Source: JSDA

Explanatory Document of Unregistered Credit Ratings

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[Standard & Poor's]

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[Moody's]

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May 2018

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4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of ¥10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.

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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.
- 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.

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