

Outlook for 10Y JGBi Auction

Bidding at 0-5bp BEI level

- ✓ Partly due to decline in crude oil prices and BEI in US etc., JBI24 BEI fell below 10bp
- ✓ The auction will likely be held at the lowest BEI level since MOF restarted issuing JGBis in October 2013
- ✓ From viewpoint of index ratio path, it is not a good timing now to buy JGBis in an aggressive stance
- ✓ Meanwhile, JGBis appear to remain cheap for investors with longer investment horizon
- ✓ Support at 0-5bp level in BEI is expected

Strategic Memorandum DSTE359
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Auction Details

Auction Date:	February 12, 2020
Issue Date:	February 13, 2020
Maturity Date:	March 10, 2029
Offering Amount:	About 400 billion yen
Auction Method:	Dutch auction on an inflation-not-adjusted price with the increment of 0.05 yen
Base CPI:	101.40 (Nat'l core-CPI in Dec. 2018)
Ref. CPI:	102.2 (as on Feb. 13)
Index ratio:	1.00789 (as on Feb. 13)

* New 10Y JGBis will be the final reopening of JBI24 carrying a 0.1% coupon.

** On Feb. 10, JBI24 traded at 102.30-102.40 yen (unch - +0.10 yen v. previous day's close) and closed at 102.40 yen (+0.10 yen). JBI24 BEI is estimated to be about 7.2bp, down from 7.6bp on Feb. 7.

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

BEI fell below 10bp after rising close to 20bp

After the previous JGBi auction went well at the 12bp level in the break-even inflation rate (or BEI), JBI24 BEI temporarily rose close to 20bp amid an uptrend in crude oil prices and the US BEI (Chart 1). With falling crude oil prices and the US BEI since the beginning of January, the BEI fell below 10bp around the end of the month. Since the beginning of February, the BEI has been moving at the lowest level since August/October 2019 (BEI closing at 7.6bp on Feb 7) amid mounting attention to this JGBi auction. The possibility is increasing that the auction will be held at the lowest BEI level since the Ministry of Finance restarted issuing JGBis in October 2013. In such an environment, key points to think about the bidding stance at the auction are as follows.

Nationwide core-CPI growth is expected to hover around 0.5% again after moving in the 0.5-1.0% level over the next several months

First, we check domestic inflation. As Japan's inflation expectation is greatly influenced by "adaptive expectation formation" in comparison with other nations, the current weakness in observed inflation tends to have an impact on JGBi investor sentiment. Recently-announced December 2019 nationwide core-CPI grew by 0.7% y/y, up 0.2%pt vs. the previous month. Reflecting a big decline in oil prices in late 2018, the y/y decline in energy price softens substantially. The nationwide core-CPI growth is expected to move in the 0.5-1.0% range over the next several months. Then, it is likely to hover around 0.5% again. It is highly possible that (1) negative contributions from energy prices will continue (although the degree of decline may narrow) and (2) the growth rate of non-energy prices will be weak at around +0%, although such prices are assumed to remain on an uptrend. Provision of free higher education is slated for April, which is estimated to push down the core CPI by around 0.1% point y/y.

From viewpoint of index ratio path, it is not a good timing to buy JGBis in an aggressive stance

Next, we check the index ratio path based on our CPI forecasts. The ratio is likely to remain largely flat from February to March. After that, it is expected to decline toward April and then to remain lower than the level at the February 12 auction by around October (Chart 6). If we assume that the JGBi price will be unchanged after buying at the auction, we are likely to continuously earn negative return from JGBis (Chart 8). Unless a surge in JGBi prices is expected, it is not a good timing now to buy JGBis in an aggressive stance.

Thinking about placing bids at the 0-5bp BEI level

Amid lingering concerns about the global economy due to the ongoing spread of the new coronavirus, a recent drop in crude oil prices as well as the BEI in Europe and the US are preventing us from expecting a big rise in inflation expectations. In addition, the market appears to be facing technical adjustments, as witnessed by the plunge in 10Y inflation swap since the BEI of the on-the-run JBI24 started to fall below 10bp (Appendix 2). According to some surveys, however, 10-year inflation expectations have been mostly stable at around 0.8-1.0% level under the BOJ's yield curve control policy (Chart 10). Given this, we think that the BEI of below 10bp still points to quite cheapness of JGBis and no hesitation to buy would be needed for investors with longer investment horizon. If the BEI declines close to 0bp, the MOF or/and the BOJ could take any actions, such as increasing buyback amount, revising the buyback scheme, or increasing offer amount in purchase operations). All in all, we would like to think about placing our bids at the 0-5bp 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 (%)	Allotment (%)	BEI Before Auction (Note 2)	BEI on Auction Day (bp) (Note 2)	Change from p.d. (bp) (Note 2)	Market Expectation of Lowest Accepted Price (Yen) (Note3)	Expected range	
2/12/20	24R	0.1	3/10/29	400*					7.6					
11/8/19	24R	0.1	3/10/29	410.3	3.43	102.90	-0.204	83.6431	12.8	13.8	1.0	102.90	102.50-102.95	Good
8/8/19	24R	0.1	3/10/29	414.3	3.84	104.25	-0.329	86.6906	12.3	11.8	-0.5	104.20	103.90-104.65	Avg
5/10/19	24	0.1	3/10/29	430.2	3.72	103.70	-0.266	94.4029	21.5	22.6	1.1	103.50	103.30-103.60	Good
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	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	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	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	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	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	80.0000	35.0	36.7	1.7	104.70	104.30-105.40	Good

* Planned by MoF (Note 1) Inflation adjusted price until August 2017 and inflation unadjusted price from October 2017 (Note2) Closing price; WI basis for new issues; as of Feb. 7 for the Feb. 2020 auction (Note 3) Bloomberg

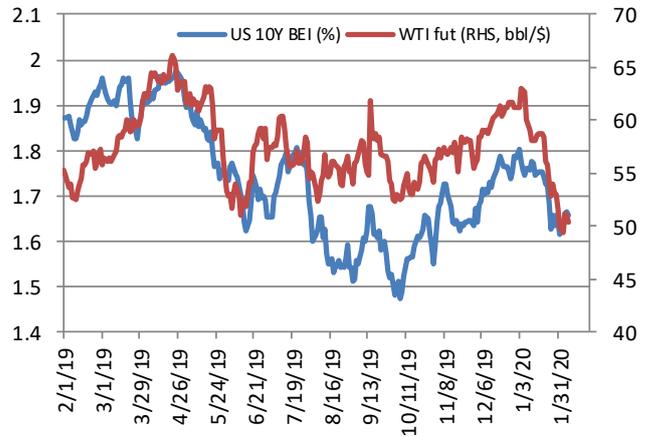
Source: Ministry of Finance, Daiwa Securities

Chart 1: BEI (bp)



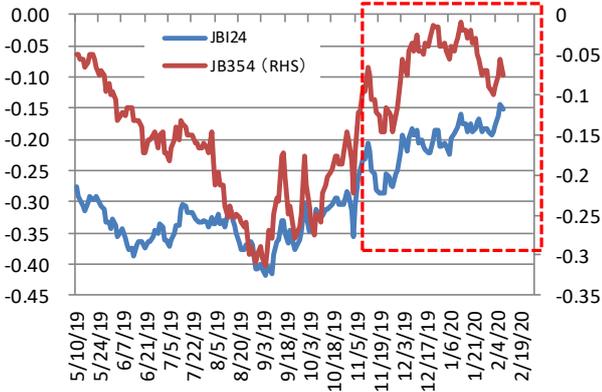
Note: On-the-run issues basis
Source: Daiwa Securities

Chart 2: 10Y US BEI and Oil Price



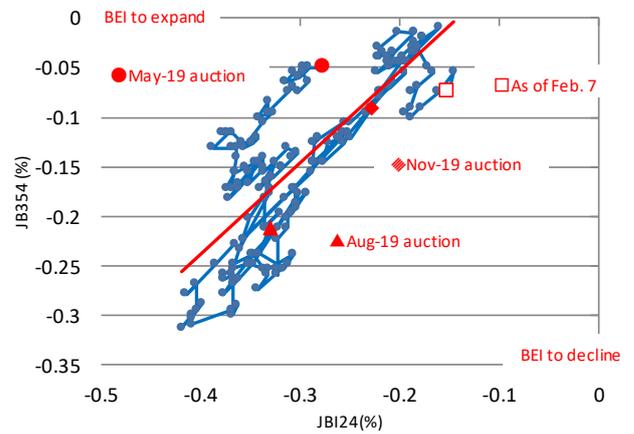
Source: Bloomberg

Chart 3: JBI24 and JB354 Yields (%)



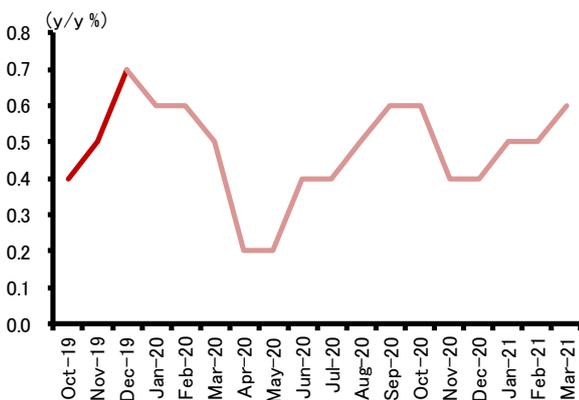
Source: Daiwa Securities

Chart 4: Correlation between JBI24 and JB354



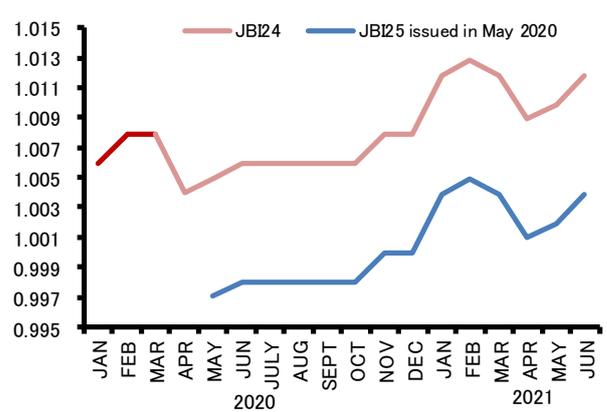
Source: Daiwa Securities

Chart 5: Nationwide Core-CPI Growth Outlook (y/y %)



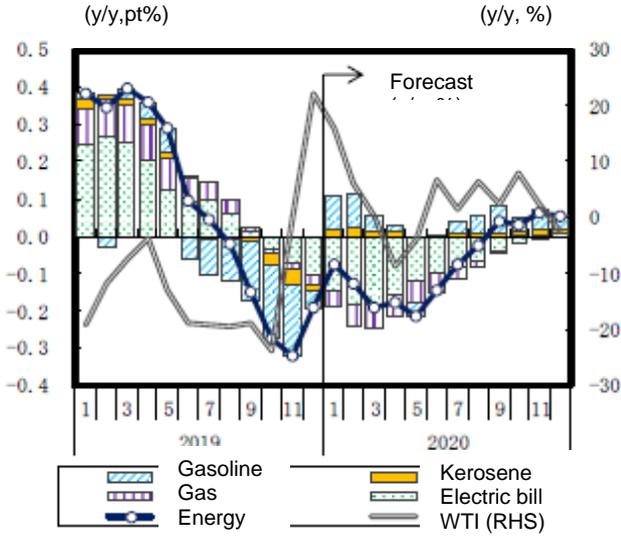
Note: Actual for Oct-Dec 2019
Source: Daiwa Securities

Chart 6: JBI24 Index Ratio Forecast



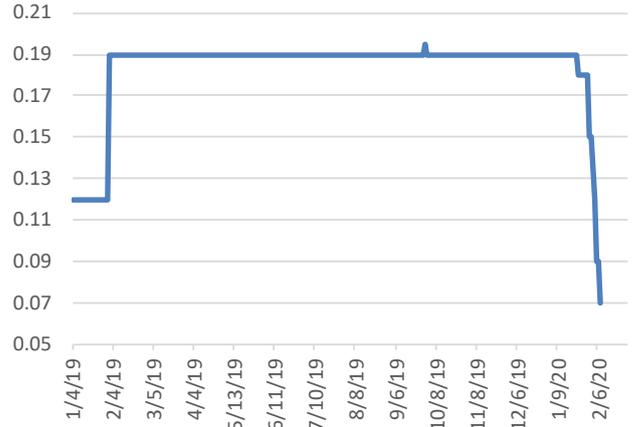
Note: Based on Chart 5, actual for Jan-Mar 2020
Source: Daiwa Securities

Appendix 1: Impact on Core-CPI by Energy Price



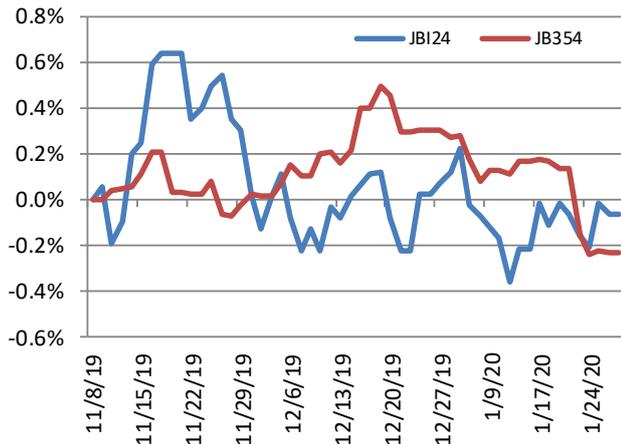
Note: Assuming oil price and FX rates unchanged
Source: Daiwa Research Institute

Appendix 2: 10Y JPY Inflation Swap (%)



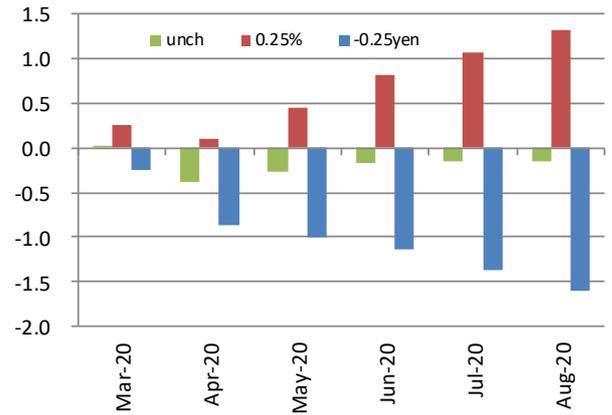
Source: Bloomberg

Chart 7: Realized Return on JBI24 and JB354 (%)



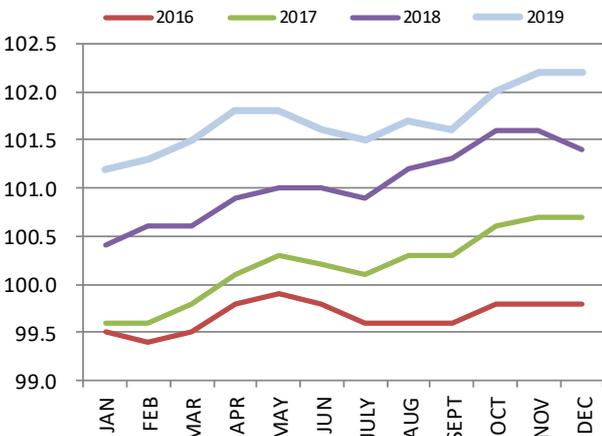
Note: From Nov. 2019 to each point
Source: Daiwa Securities

Chart 8: Holding Period Return on JBI24 (%)



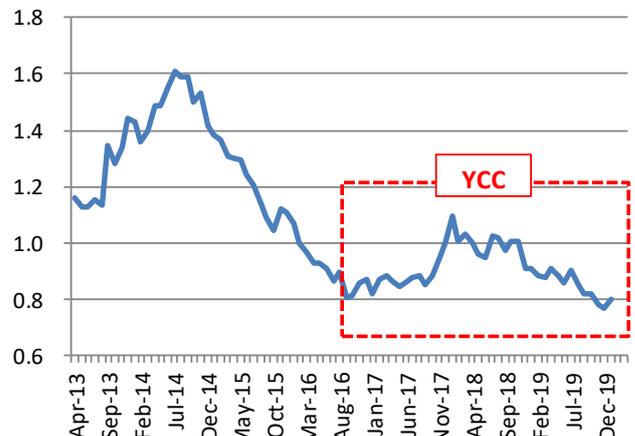
Note: from Feb. 13 to each point assuming the price is (1) unchanged, (2) increased by 0.25 yen every month and (3) decreased by 0.25 yen
Source: Daiwa Securities

Chart 9: Seasonality of Nationwide Core-CPI



Source: Ministry of Internal Affairs and Communications, Daiwa Securities

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



Source: QUICK

Table 1: Results of BOJ Purchase and MOF Buyback

	Previous Day's Close (Yen)	Pro-rata Price Spread (Yen)	Average Successful Price Spread (Yen)	Allotment on Pro-rata (%)	B/C	Close Price (Yen)
10/4/19	104.30	-0.080	-0.148	10.6	7.45	104.15
10/16/19	103.95	-0.110	-0.134	74.2268	4.90	103.95
10/28/19	103.85	0.050	-0.060	26.7	4.05	103.85
11/1/19	103.95	0.350	0.288	87.5	4.39	104.35
11/15/19	103.30	0.080	0.027	33.3333	4.88	103.35
11/27/19	103.50	-0.010	-0.098	34.4	5.03	103.55
12/6/19	103.00	-0.080	-0.112	65.7	4.88	102.80
12/13/19	102.85	-0.110	-0.139	82.8	4.54	102.80
12/18/19	102.95	-0.008	-0.083	98.8023	4.27	103.00
1/10/20	102.65	-0.070	-0.103	11.5	5.95	102.60
1/16/20	102.55	0.010	-0.012	8.0645	6.61	102.55
1/23/20	102.60	-0.100	-0.127	90.7	6.22	102.50
2/7/20	102.25	-0.020	-0.059	32.1	4.99	102.30

Note: Previous Day's Close and Close Price are based on JBI24; Buyback by the Ministry of Finance for October 16, November 15, December 18 and January 16.
Source: Bank of Japan, Ministry of Finance, Daiwa Securities

Table 2: Market Outstanding of JBIs (Yen billions)

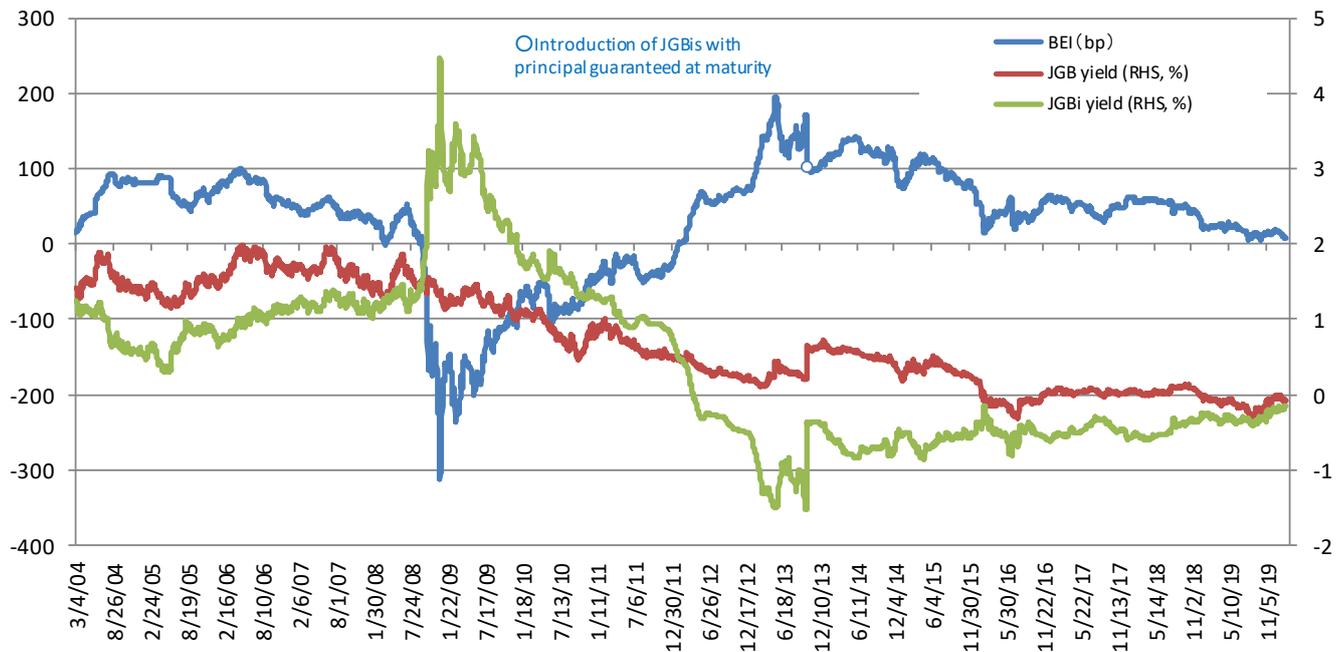
(Yen billions)

	Issue Size	MoF Buyback	BoJ Outright Purchase	Market Outstanding
JBI17	646.7	41.5	261.6	343.6
JBI18	821.7	26.3	234.1	561.3
JBI19	1,091.8	19.0	174.3	898.5
JBI20	2,139.4	90.7	398.4	1,650.3
JBI21	1,727.2	114.0	401.0	1,212.2
JBI22	1,760.4	144.4	700.3	915.7
JBI23	1,722.7	66.5	184.2	1,472.0
JBI24	1,254.8	19.6	129.6	1,105.6
TOTAL	11,164.7	522.0	2,483.5	8,159.2
%	100.0%	4.7%	22.2%	73.1%

(As of Jan. 31 on BOJ start basis)

Source: Bank of Japan, Ministry of Finance, Daiwa Securities

Appendix 3: BEI (March 2004 to present)



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

Appendix 4: Image of Bidding Price at Auction and BEI

(Unit: bp)

		Nominal Yield (% JB354)									
		-0.105	-0.100	-0.095	-0.090	-0.085	-0.080	-0.075	-0.070	-0.065	-0.060
Bidding Price (Yen)	102.90	11.1	11.6	12.1	12.6	13.1	13.6	14.1	14.6	15.1	15.6
	102.85	10.6	11.1	11.6	12.1	12.6	13.1	13.6	14.1	14.6	15.1
	102.80	10.1	10.6	11.1	11.6	12.1	12.6	13.1	13.6	14.1	14.6
	102.75	9.5	10.0	10.5	11.0	11.5	12.0	12.5	13.0	13.5	14.0
	102.70	9.0	9.5	10.0	10.5	11.0	11.5	12.0	12.5	13.0	13.5
	102.65	8.5	9.0	9.5	10.0	10.5	11.0	11.5	12.0	12.5	13.0
	102.60	7.9	8.4	8.9	9.4	9.9	10.4	10.9	11.4	11.9	12.4
	102.55	7.4	7.9	8.4	8.9	9.4	9.9	10.4	10.9	11.4	11.9
	102.50	6.8	7.3	7.8	8.3	8.8	9.3	9.8	10.3	10.8	11.3
	102.45	6.3	6.8	7.3	7.8	8.3	8.8	9.3	9.8	10.3	10.8
	102.40	5.8	6.3	6.8	7.3	7.8	8.3	8.8	9.3	9.8	10.3
	102.35	5.2	5.7	6.2	6.7	7.2	7.7	8.2	8.7	9.2	9.7
	102.30	4.7	5.2	5.7	6.2	6.7	7.2	7.7	8.2	8.7	9.2
	102.25	4.1	4.6	5.1	5.6	6.1	6.6	7.1	7.6	8.1	8.6
	102.20	3.6	4.1	4.6	5.1	5.6	6.1	6.6	7.1	7.6	8.1
	102.15	3.1	3.6	4.1	4.6	5.1	5.6	6.1	6.6	7.1	7.6
	102.10	2.5	3.0	3.5	4.0	4.5	5.0	5.5	6.0	6.5	7.0
	102.05	2.0	2.5	3.0	3.5	4.0	4.5	5.0	5.5	6.0	6.5
	102.00	1.4	1.9	2.4	2.9	3.4	3.9	4.4	4.9	5.4	5.9
	101.95	0.9	1.4	1.9	2.4	2.9	3.4	3.9	4.4	4.9	5.4
101.90	0.3	0.8	1.3	1.8	2.3	2.8	3.3	3.8	4.3	4.8	
101.85	-0.2	0.3	0.8	1.3	1.8	2.3	2.8	3.3	3.8	4.3	
101.80	-0.7	-0.2	0.3	0.8	1.3	1.8	2.3	2.8	3.3	3.8	
101.75	-1.3	-0.8	-0.3	0.2	0.7	1.2	1.7	2.2	2.7	3.2	
101.70	-1.8	-1.3	-0.8	-0.3	0.2	0.7	1.2	1.7	2.2	2.7	

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

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- 2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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[Standard & Poor's]

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[Moody's]

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[Fitch]

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IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

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Daiwa Securities Co. Ltd. and Daiwa Securities Group Inc.: Daiwa Securities Co. Ltd. is a subsidiary of Daiwa Securities Group Inc.

Other Disclosures Concerning Individual Issues:

- 1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies. As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter's outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.
- 2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Nippon Healthcare Investment Corporation (3308), Japan Rental Housing Investments (8986).
- 3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.
- 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%.
- 5) Daiwa Securities Group and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group is to acquire up to 5.01% of Credit Saison's total common shares outstanding (as of 31 Jul 2019), while Credit Saison is to purchase up to ¥2bn worth of Daiwa Securities Group's common stock.
- 6) NEC (6701): NOTICE REGARDING U.S. PERSONS: This report is not intended for distribution to or use by any person in the United States. Securities issued by NEC Corporation have been suspended from registration in the U.S. and are subject to an order of the U.S. Securities and Exchange Commission dated June 17, 2008, pursuant to Section 12(j) of the Securities Exchange Act of 1934. This document is not a recommendation or inducement of any purchase or sale of such securities by any person or entity located in the U.S. Daiwa Securities Co. Ltd. disclaims any responsibility to any such person with respect to the content of this document. Any U.S. person receiving a copy of this report should disregard it.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- 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 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

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