

JGB Insight

Intermediate-term zone: preparation or sign of disturbance?

- ✓ In the intermediate-term zone of the JGB yield curve, yield spreads between JSs and JB or JLs with the same maturity have been widening partly due to BOJ's JGB purchases
- ✓ 5Y JGB auction may be held in a favorable relative-value situation
- ✓ If any, decent demand from investors for JS142 around the auction will correct its cheapness v. JB and JLs
- ✓ 10Y JGBi auction went well; solid demand confirmed at around 5bp BEI, but upside may be limited for the time being

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In the intermediate-term zone, yield spreads between JSs and JB or JLs with the same maturity are widening

Since the beginning of February, the JGB market has been volatile on risk-on/risk-off mode stemming from the spread of the new coronavirus. In such a situation, the intermediate-term zone of the JGB yield curve is distorted (Chart 1). Since late last week, on-the-run 5Y JGB (JS142) has been posting wider spreads vs. 10Y JGBs (JB336-337) and 20Y JGBs (JL73-74), all of which will be redeemed in December 2024 (Chart 2). This implies that 5Y JGBs are becoming undervalued vs. 10Y JGBs and 20Y JGBs with the same maturity around the belly of the curve. We think that the distortion is made by unstable market sentiment in 5Y JGBs (JSs) and also the BOJ JGB purchases.

Impact by BOJ JGB purchases

According to "Japanese Government Bonds Held by the Bank of Japan" released on February 13 and so on, we found that, of the purchase amount of 340.9bn yen in its operation in the 3-5Y zone on February 7, the purchase amount of JB336 came in at 110bn yen, while the amount of JS142 was only 24.4bn yen. As a result, our estimate for the BOJ's holding ratio of JB336 rose to around 71%, while the ratio of JS142 stood at around 5%.

As BOJ's holding ratio of 10Y JGBs with four to eight years left to maturity is quite high, market tends to be easily short

The comparison of the BOJ's holding ratio of JGBs to be redeemed in December 2024 (Chart 3) shows that the holding ratio is outstandingly high at above 70% for 10Y JGBs (JB336-337) vs. 5Y JGBs (JS142) and 20Y JGBs (JL73-74). As the BOJ's holding ratio of 10Y JGBs with four to eight years left to maturity (incl. JB336-337) is quite high (Chart 4), it appears that the market tends to be easily short in the zone. Regarding the JGB purchase list for JGB with mover than 5 to 10 years left to maturity, the BOJ has been excluding CTD and its neighboring issues. For recent years, however, the BOJ has expanded the issues to purchase amid increasing amount of JGBs the Bank holds. At the moment, of 20 eligible 10Y JGB issues for purchases, 10 issues with 6-8 years left to maturity are excluded from the purchase list. As a result, the purchase amount of the rest ten issues increases (if the offer amount is unchanged), alongside a rise in the holding ratio. Due to a change in the target zone (from the 5-10Y zone to the 3-5Y zone) as the time passes, the market is likely to continue to face the shortage of 10Y JGBs with around five years left to maturity. This could serve as a supportive factor for 5Y JGBs, depending on the situation.

Regarding 5Y JGBs, the adjustment mood may intensify toward the auction

Regarding JS142 (for which the BOJ's holding ratio is around 5%), the January auction (initial issuance of JS142) went well, implying that there was solid demand from investors at the primary stage. While the market sentiment of 5Y JGBs has been recently unstable, the 5Y JGB auction is scheduled for next week. In such a situation, the result of the BOJ's purchase operation in the 3-5Y zone was quite weak on February 13, suggesting that some participants rushed to sell to the BOJ in an aggressive stance. With many market participants appearing to have been unable to clear their positions at the operation, the adjustment mood may intensify toward the auction.

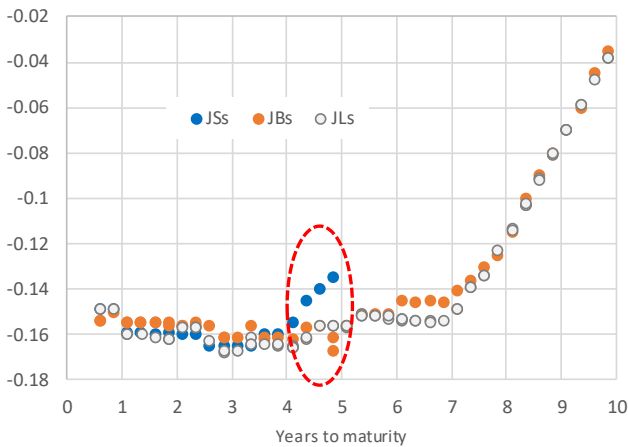
5Y JGB auction may be held in a favorable relative-value situation

In addition to the cheapness of 5Y JGBs vs. 10Y and 20Y JGBs with the same maturity (Chart 5), the richness of 5Y JGBs v. 2Y JGBs, which gained recently, has been revised amid solid performance of 2Y JGBs. The 5Y/7Y spread is at around the lower end of the recent range, showing no overvaluation against the futures (Chart 5). 5Y JGBs have been becoming undervalued against the 2Y/7Y barbell (Chart 6). Even from the viewpoint of asset swaps, it can be said that 5Y JGBs are undervalued vs. 10Y and 20Y JGBs with the same maturity (Chart 7). The possibility is increasing that the auction will be held in a favorable relative-value situation. After the 5Y JGB auction on February 18, the BOJ is scheduled to conduct purchase operations in the 3-5Y zone twice by the end of the month, which can be also a supportive factor.

Decent demand for JS142 around the auction needed for correction

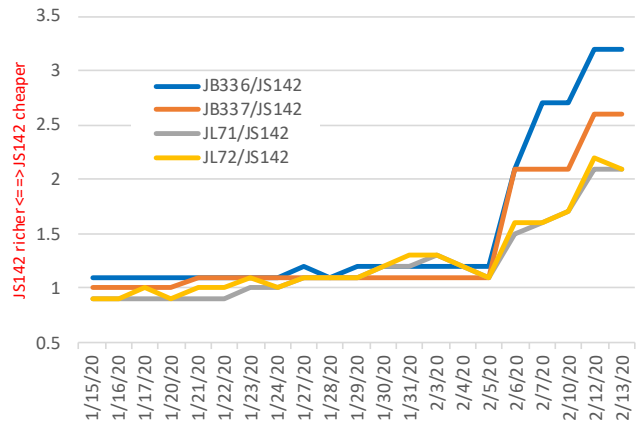
All in all, for correction of the cheapness of JS142 vs. JB336-337 and JL74-74, decent demand for JS142 around the 5Y JGB will be needed. We would like to think about our bidding stance at the auction, keeping in mind these factors.

Chart 1: JGB Yield Curve (%)



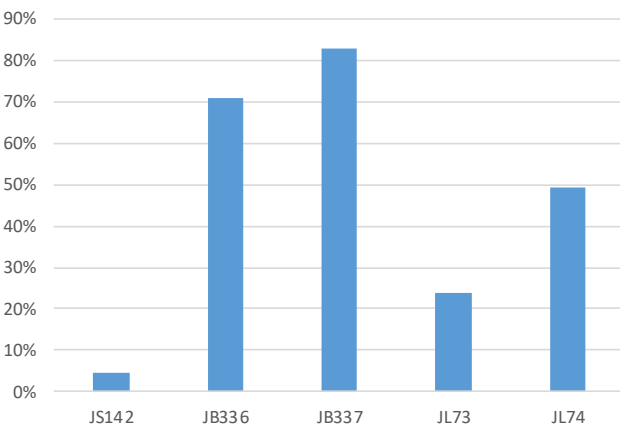
Note: as of Feb.13
Source: Daiwa Securities

Chart 2: Yield Spreads between JS142 and other December 2024 JGBs (bp)



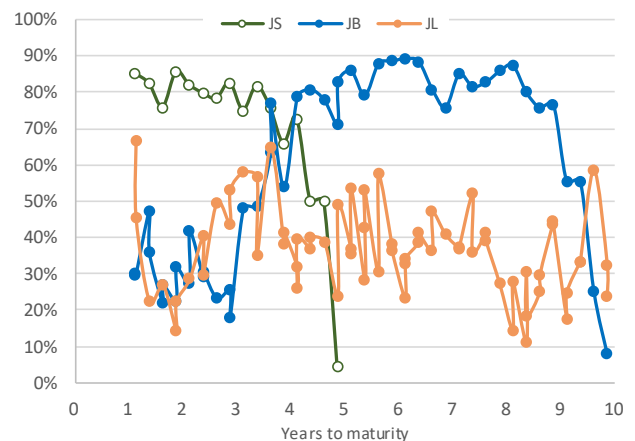
Note: Based on TY1 and JB1
Source: Bloomberg

Chart 3: BOJ Holding % of Dec. 2024 JGBs



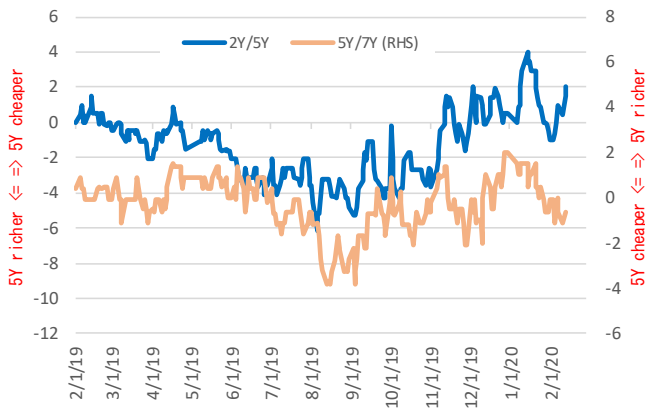
Note: % to issue size
Source: Daiwa Securities

Chart 4: BOJ Holding % in 1-10Y zone



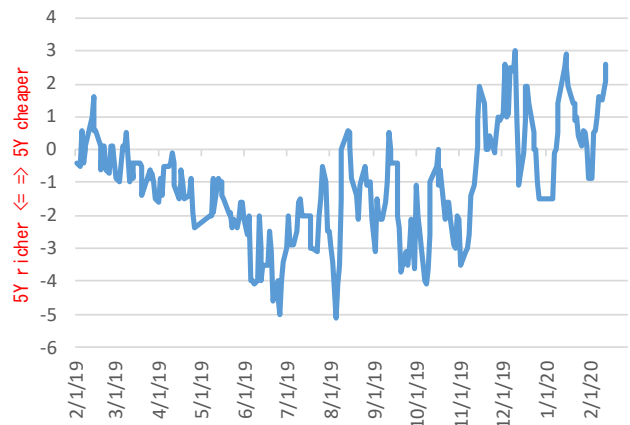
Note: % to issue size
Source: Daiwa Securities

Chart 5: JGB 2Y/5Y and 5Y/7Y Spreads (bp)



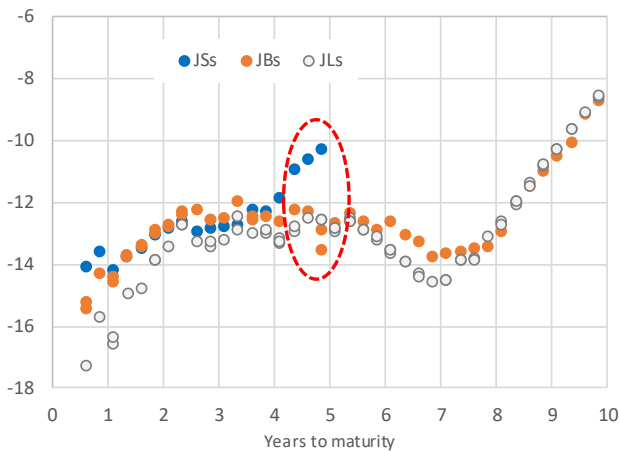
Note: On-the-run and CTD
Source: Daiwa Securities

Chart 6: JGB 2Y/5Y/7Y Butterfly Spread (bp)



Note: On-the-run and CTD; 50%/50% trade basis
Source: Daiwa Securities s

Chart 7: Asset Swap Curve (bp)



Source: Daiwa Securities

10Y JGBi auction went well; solid demand confirmed at around 5bp BEI, but upside may be limited

The Ministry of Finance (MOF) conducted 10Y JGBi auction on February 12 (final reopening of JBI24). The auction was held at the lowest BEI level since the MOF restarted issuing JGBis in October 2013. However, the auction went well, supported by solid demand at around the 5bp BEI level. The BEI trended down toward the auction, but it started to lose downward momentum (as of 13:00 on Feb 14). Meanwhile, the upside of JGBis may be limited especially in the near term.

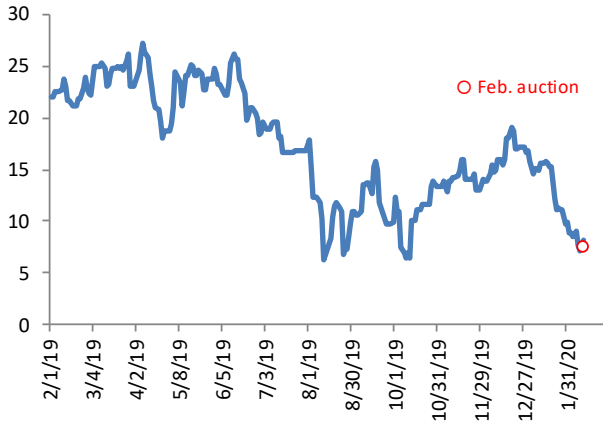
First, the nationwide core-CPI growth is expected to move in the 0.5-1.0% range over the next several months. Then, it is likely to hover around 0.5% again. It is highly possible that (1) negative contributions from energy prices will continue (although the degree of decline may narrow) and (2) the growth 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.

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 11). 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 12). Unless a surge in JGBi prices is expected, it is not a good timing now to buy JGBis in an aggressive stance.

BEI expected to move in the range centered at 5-10bp

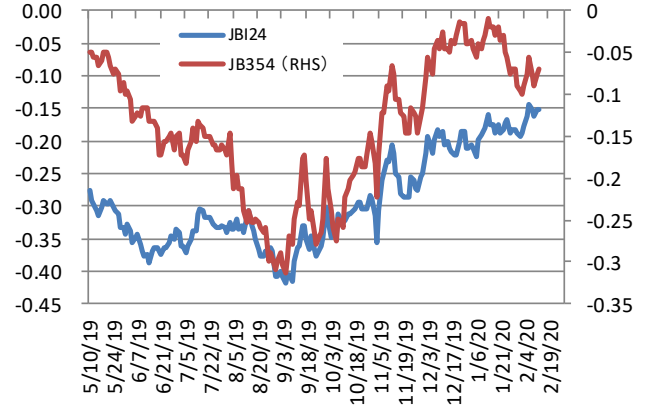
Amid lingering concerns about the global economy due to the ongoing spread of the new coronavirus, a recent drop in crude oil prices as well as the BEI in Europe and the US are preventing us from expecting a big rise in inflation expectations. For the time being, the BEI is expected to move in the range centered at 5-10bp.

Chart 8: BEI (bp)



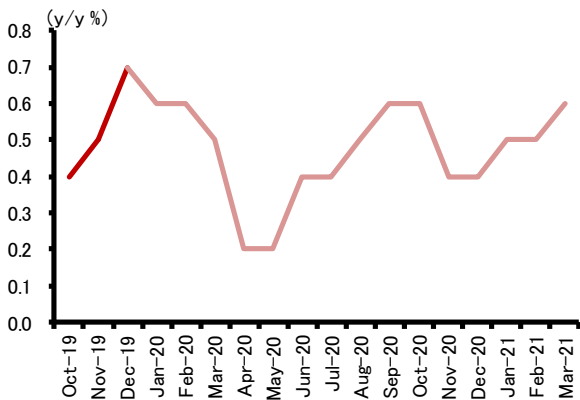
Note: On-the-run basis
Source: Daiwa Securities

Chart 9: JBI24 and JB354 Yields (%)



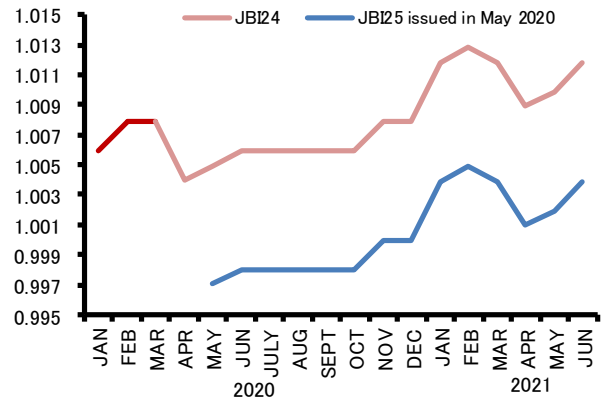
Source: Daiwa Securities

Chart 10: Nationwide Core-CPI Growth Outlook (y/y %)



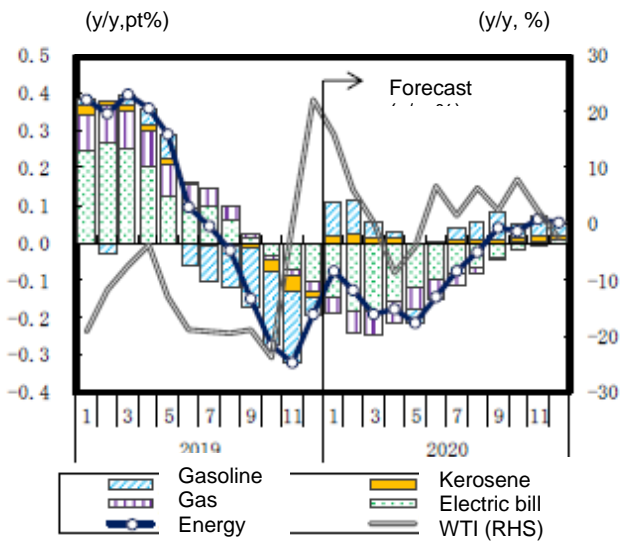
Note: Actual for Oct-Dec 2019
Source: Daiwa Securities

Chart 11: JBI24 Index Ratio Forecast



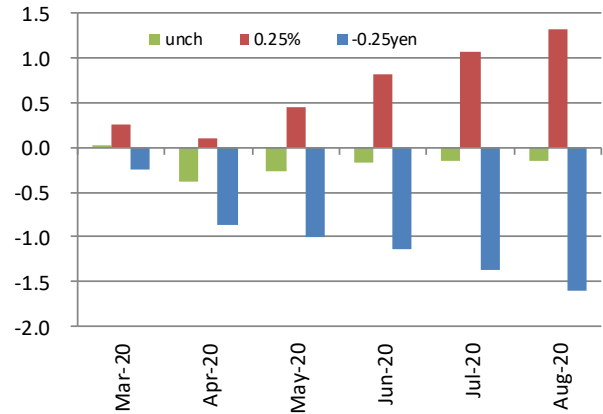
Note: Based on Chart 10, actual for Jan-Mar 2020
Source: Daiwa Securities

Appendix: Impact on Core-CPI by Energy Price



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

Chart 12: 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

Appendix: February 2020 Calendar for BOJ JGB Purchases etc. (Yen billions)

BOJ offer day / JGB auction day	(BOJ start day/ MOF settlement day)	Up to 1 year	Over 1 to 3 years	Over 3 to 5 years	Over 5 to 10 years	Over 10 to 25 years	Over 25 years	JGB Linker	JGB Floater	TDBs	MOF Buyback	
2/3/20	M 2/4/20											
2/4/20	T 2/5/20	10Y JGB Auction									750.2	
2/5/20	W 2/6/20											
2/6/20	TH 2/7/20	30Y JGB Auction									6M	
2/7/20	F 2/10/20		420.0	340.9	350.6			30.1		3M		
2/10/20	M 2/12/20	50.0				120.8	30.7					
2/11/20	T -	Public Holiday (National Foundation Day)										
2/12/20	W 2/13/20	10Y JGB Linker Auction									750.3	
2/13/20	TH 2/14/20		420.4	340.4	350.1				100.6			
2/14/20	F 2/17/20	AEL (10Y and 20Y JGBs with over 5 to 15.5 years to maturity)									3M	
2/17/20	M 2/18/20										○	
2/18/20	T 2/19/20	5Y JGB Auction									○	
2/19/20	W 2/20/20	20Y JGB Auction									1Y	
2/20/20	TH 2/21/20											
2/21/20	F 2/25/20		◎	◎						3M		
2/24/20	M -	Public Holiday (Emperor's Birthday obs.)										
2/25/20	T 2/26/20	○				◎	◎		○			
2/26/20	W 2/27/20	AEL (20Y, 30Y and 40Y JGBs with over 15.5 less than 39 years to maturity)									○	
2/27/20	TH 2/28/20		◎	◎	◎							
2/28/20	F 3/2/20	2Y JGB Auction									3M	

Note: ◎ Announced by BOJ on Jan. 31, ○ Daiwa Forecast as of Feb. 14
Source: Ministry of Finance, Bank of Japan, Daiwa Securities

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