

Outlook for 5Y JGB Auction

Bidding with -0.155 - -0.125% range to continue in mind

- ✓ With the coronavirus spreading, the market is unlikely to expect interest rates to move higher, but it is also unlikely that the BOJ will further lower negative rates at this juncture.
- ✓ We think about our bidding stance with the idea that the 5Y JGB yield could remain around a range of -0.155 to -0.125% until the March auction.
- ✓ Although the 5Y JGB is neither undervalued nor overvalued in terms of relative value, building new positions on the curve or against swaps can be difficult. Where possible, we recommend switching from 10Y JGBs with the same maturity or JNs and/or JSs in the 2-3Y zone.

Strategic Memorandum DSTE361
FICC Research Dept.

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Auction Details

Auction Date: February 18, 2020
Issue Date: February 19, 2020
Maturity Date: December 20, 2024
Offering Amount: About 2.1 trillion yen

* New 5Y JGBs will be the first reopening of the December 2024 notes carrying a 0.1% coupon, JS142.

** On Feb. 17, JS142 traded at -0.135 - -0.130% (-0.5bp - unch v. previous day's close) and closed at -0.135% (-0.5bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Mostly moving in a -0.155 - -0.125% range

After the previous 5Y JGB auction went well at the -0.090 - -0.085% level (v. -0.090% as of the previous day's WI close) on January 15, the 5Y JGB yield faced downward pressure amid an uptrend in the JGB market, declining to -0.185% during intraday trading in early February. Since then, with risk appetites having alternated between risk-on and risk-off moves, the JGB market has been moving in a volatile way. In such a situation, the 5Y JGB yield temporarily rose to -0.125%, then has been moving in a -0.155 to -0.125% range.

Few factors to lead JGB yields up, but expectations on a rate cut in negative territory by the BOJ unlikely to grow

Let's look at the conditions surrounding JGBs. The Japan cabinet office today (February 17) announced real GDP for Oct-Dec 2019, and the growth worsened more than the market expected, declining to 1.6% q/q, which equates to an annualized decline of 6.3%. Impacts from the consumption tax hike and major typhoons in October led to weaker private consumption, while automobile and machinery exports weakened on the global economic slowdown, resulting in the first bout of negative growth in five quarters. It is becoming more likely that the growth will remain negative in Jan-Mar on impacts from the spread of the coronavirus. With no fundamental solution to stop the virus from spreading, it is becoming more difficult to monitor the negative economic impacts over time, and anxiety over the global economy, Japan's economy included, looks likely to simmer for a while. With the world already in a low-inflation environment, central banks in the US, Europe and Japan should maintain monetary policy accommodation, and depending on circumstances there is still a possibility they will further loosen policy. The fundamentals suggest that a rise in

interest rates is unlikely. When it comes to Japan's monetary policy, however, it is also possible that there are unlikely to be expectations of negative interest rates being lowered further. In such an environment, key points to think about the bidding stance at tomorrow's auction are as follows:

- ✓ **Short-covering by primary dealers expected to be relatively strong:** low possibility that the auction will tail
- ✓ **5Y JGBs neither overvalued nor undervalued in terms of relative value:** the data from the January auction show that the 5Y sector is currently overvalued vs. the 6Y sector (Appendix 3). Within the sector, however, 5Y JGBs look very cheap relative to 10Y and 20Y JGBs with the same maturity (Appendix 6)¹. The 5-year JGB now looks cheap, even relative to swaps (Appendix 4).
- ✓ **BOJ is very unlikely to adjust its purchases:** With the 10-year JGB yield moving in a range that is about double a $\pm 0.1\%$ band, the BOJ looks unlikely to increase or decrease its purchases in the over-3-year to 5-year sector, given differences in atmosphere between sectors and between JS and JB with the same maturity. We currently see a very low probability of the BOJ adjusting its purchase amounts.
- ✓ **Expecting demand from overseas investors:** the 5-year JGB is currently trading at about the same level as it did around the previous auction, which went well most likely on solid demand from overseas investors on a cross currency basis and hedged basis (Appendix 10-11). With the tightening trend in USD/JPY basis swaps having paused recently, we would likely to pay close attention to possible impact on bidding by demand from overseas investors.

**Bidding with a -0.155 -
-0.125% range to
continue in mind**

Our overall stance this time around assumes that the 5-year JGB yield could possibly stay within its current range (-0.155 to -0.125%) until the next auction scheduled on March 10. With it looking as if the curve is becoming more likely to flatten over the near term, recent concerns about the short to intermediate zone make it more difficult to build new relative-value positions. Where possible, we recommend switching out from 10Y JGBs with the same maturity or JNs and/or JSs in in the 2-3-year sectors.

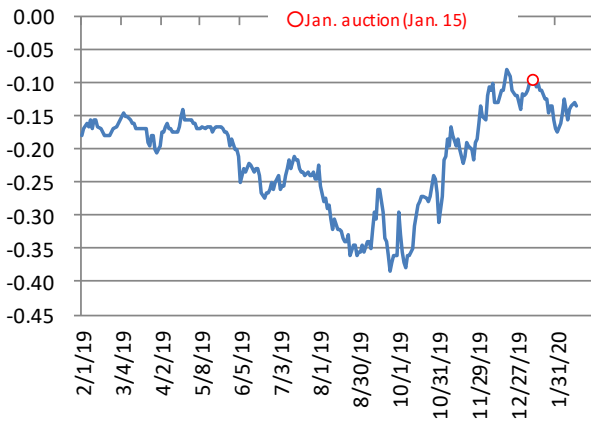
5Y JGB Auction Results

Auction Date	Issue #	Maturity Date	Coupon %	Issue Size (trillion yen)	B/C	Average Price	Lowest Price	Price Tail (yen)	Average Yield	Highest Yield	Yield Tail (%)	Allotment (%)	
1/15/20	142	12/20/24	0.1*	1.9**									
12/10/19	141R	9/20/24	0.1	2.2	4.02	100.88	100.80	0.08	-0.083	-0.066	0.017	43.9215	Poor
11/14/19	141R	9/20/24	0.1	2.2	4.03	101.42	101.41	0.01	-0.190	-0.188	0.002	76.6232	Good
10/17/19	141	9/20/24	0.1	1.9	3.69	101.90	101.87	0.03	-0.280	-0.274	0.006	45.4644	Poor
9/11/19	140R	6/20/24	0.1	1.9	3.61	100.98	100.95	0.03	-0.308	-0.302	0.006	47.6063	Poor
8/15/19	140R	6/20/24	0.1	2.2	4.68	102.04	102.02	0.02	-0.314	-0.310	0.004	37.9896	Avg
7/9/19	140	6/20/24	0.1	1.9	4.34	101.67	101.66	0.01	-0.233	-0.231	0.002	89.1730	Avg
6/18/19	139R	3/20/24	0.1	2.1	4.51	101.58	101.57	0.01	-0.228	-0.226	0.002	97.7373	Avg
5/16/19	139R	3/20/24	0.1	2.1	4.94	101.32	101.31	0.01	-0.170	-0.168	0.002	16.6556	Good
4/9/19	139	3/20/24	0.1	1.9	5.31	101.32	101.31	0.01	-0.164	-0.162	0.002	5.2806	Good
3/12/19	138R	12/20/23	0.1	2.3	4.71	101.24	101.23	0.01	-0.157	-0.156	0.001	29.8196	Avg
2/13/19	138R	12/20/23	0.1	2.3	4.84	101.23	101.22	0.01	-0.151	-0.149	0.002	15.4016	Avg
1/16/19	138	12/20/23	0.1	2.3	5.15	101.21	101.21	0.00	-0.144	-0.144	0.000	85.4629	Good
12/13/18	137R	9/20/23	0.1	2.2	3.84	101.02	101.00	0.02	-0.112	-0.108	0.004	13.0155	Poor

* Daiwa forecast as of Jan. 14 ** Amount the MOF plans to issue
Source: Ministry of Finance, Daiwa Securities.

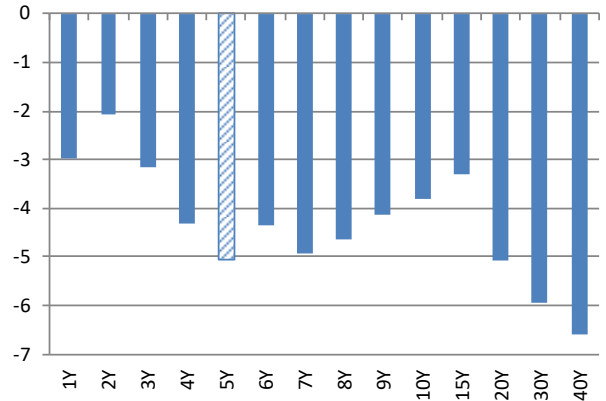
¹ See "[JGB Insight: Intermediate-term zone, preparation or sigh of disturbance? \(DSTE360\)](#)" for details

Appendix 1: 5Y JGB Yield (%)



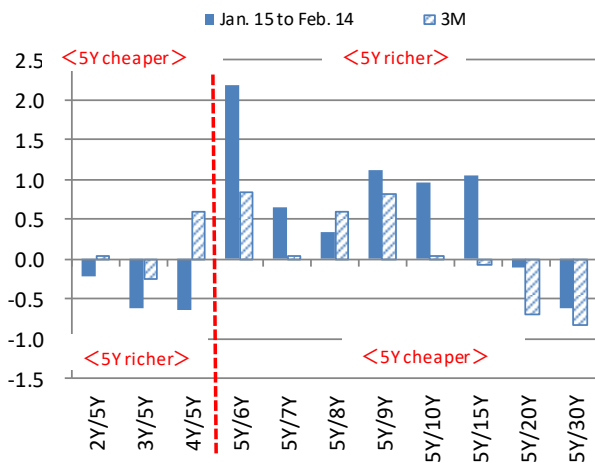
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Jan. 15 v. Feb. 14



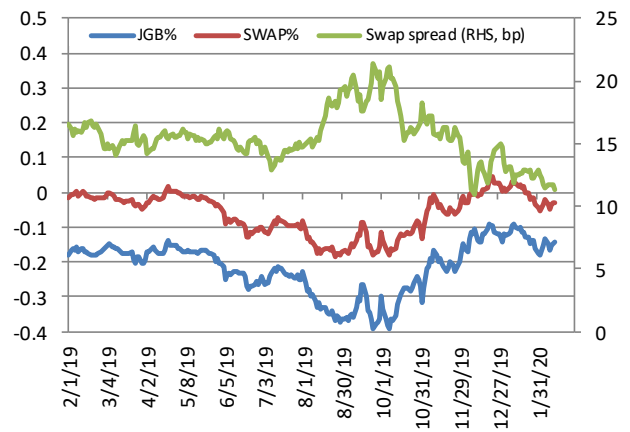
Source: Daiwa Securities.

Appendix 3: Z-scores of JGB Yield Spreads



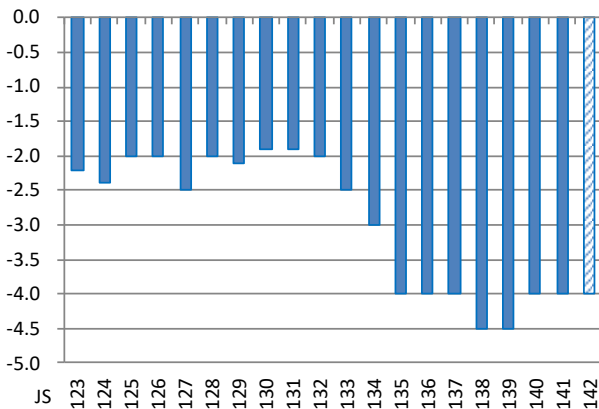
Source: Daiwa Securities.

Appendix 4: 5Y Swap Spread



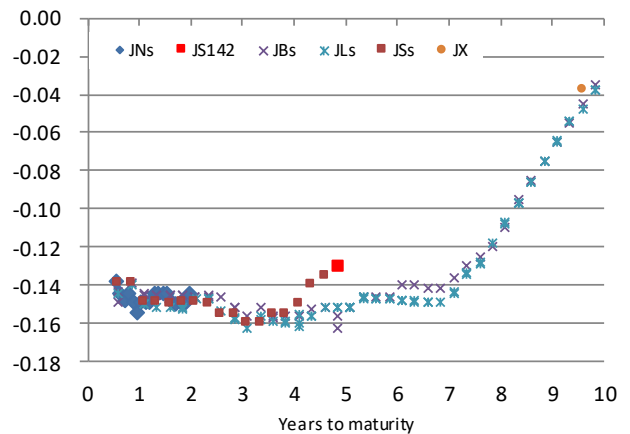
Source: Daiwa Securities.

Appendix 5: JS Yield Change (bp): Jan. 15 v. Feb. 14



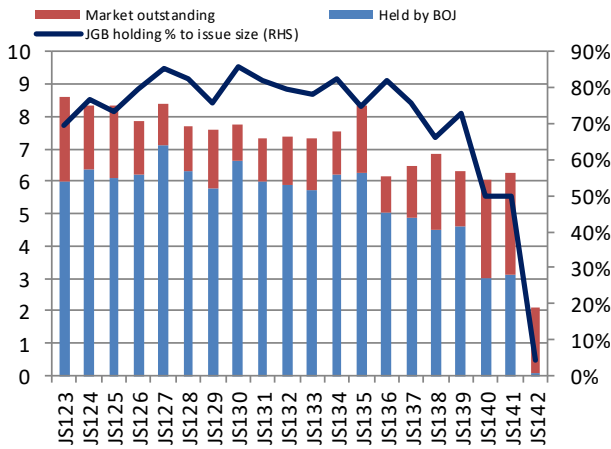
Source: Daiwa Securities.

Appendix 6: JGB Yield Curve (%), as on Feb. 14



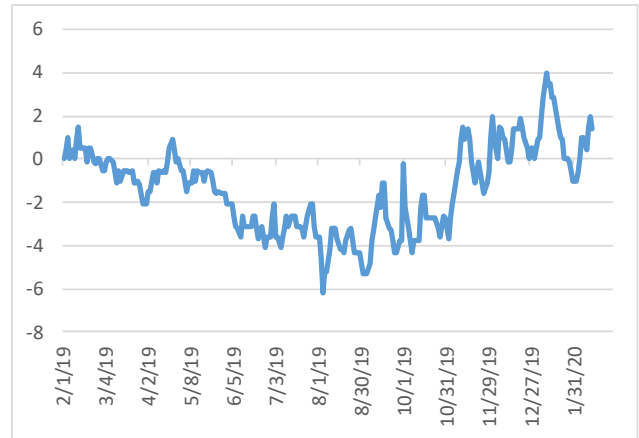
Source: Daiwa Securities.

Appendix 7: JS Market Outstanding and BOJ Holding Amount (exp. Yen trillions)



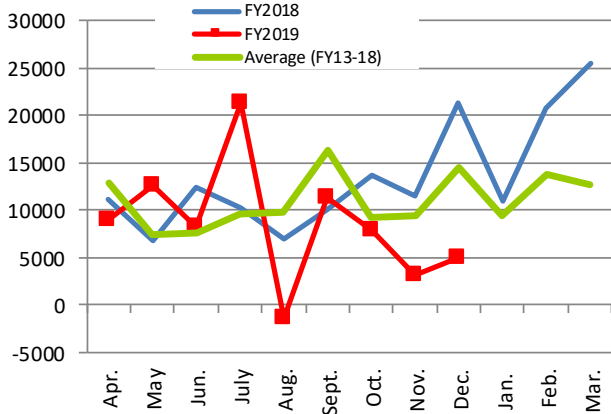
Note: as of Feb. 10 on BOJ start basis
Source: Daiwa Securities.

Appendix 8: JGB 2Y/5Y Spread (bp)



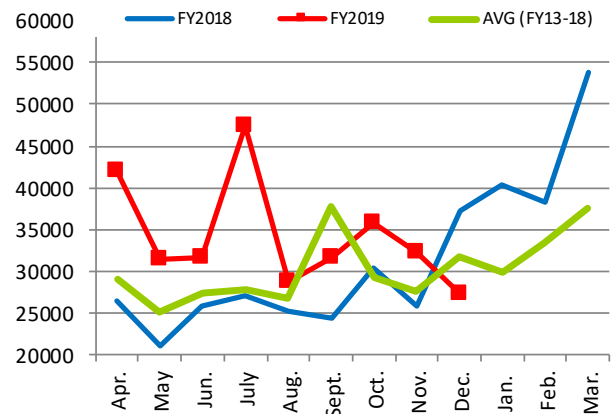
Note: On-the-run compound yield basis
Source: Daiwa Securities.

Appendix 9a: Net Purchase of Intermediate-term JGBs by Overseas Accounts (Yen 100 millions)



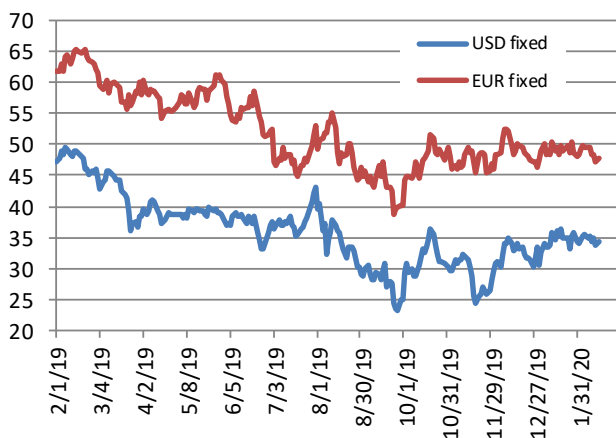
Source: JSDA

Appendix 9b: Gross Purchase of Intermediate-term JGBs by Overseas Accounts (Yen 100 millions)



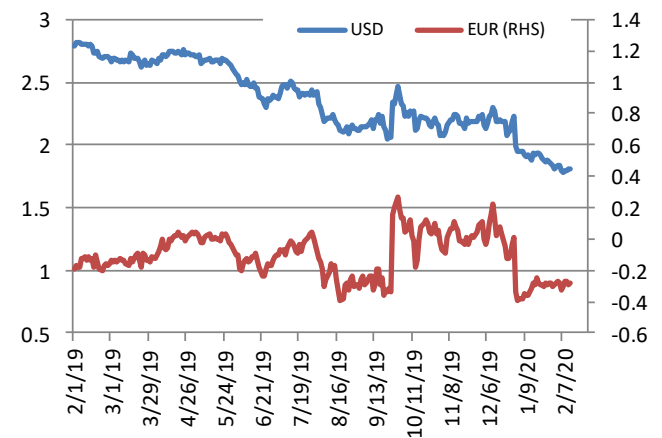
Source: JSDA

Appendix 10: 5Y JGB Benchmark Spreads (bp)



Note: against 5Y UST and 5Y OBL
Source: Daiwa Securities

Appendix 11: 5Y Hedged JGB Return (%)



Source: Daiwa Securities

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[Standard & Poor's]

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[Moody's]

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