

Outlook for 20Y JGB Auction

Bidding with a yield range of 0.22-0.26% in mind

- ✓ Although fundamentals suggest yields are unlikely to trend upward, we may find some opportunities to buy on dips especially in the near term.
- ✓ Placing bids under the assumption that the 20Y JGB yield will move around a range of 0.22 to 0.26% until the March auction.
- ✓ In terms of relative value, we would like to think about a 5Y/10Y/20Y butterfly (selling 10Y and buying 5Y and 20Y). It is also worth considering buying on asset swap for investors with a longer investment horizon.

Strategic Memorandum DSTE362
FICC Research Dept.

Senior JGB Strategist
Keiko Onogi
+813 5555 8788
keiko.onogi@daiwa.co.jp
Daiwa Securities Co. Ltd.

Auction Details

Auction Date: February 20, 2020
Issue Date: February 21, 2020
Maturity Date: December 20, 2039
Offering Amount: About 900 billion yen

* New 20Y JGBs will be the first reopening of the December 2039 bonds carrying a 0.3% coupon, JL171.

** On Feb. 19, JL171 traded at 0.235-0.240% (+1.0 - +1.5bp v. previous day's close) and closed at 0.235% (+1.0bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Mainly trading around 0.23-0.25% range since the Jan. auction

After the previous 20Y JGB auction on January 17, which went smoothly at the 0.295-0.300% level (vs. WI close of 0.315% on the previous day), the JL171 yield momentarily dropped as low as 0.210% during intraday trading on January 30 amid an uptrend in the JGB market. With risk appetites having alternated between risk-on and risk-off moves in response to the COVID-19 outbreak, JGBs became volatile in early February, leading the 20Y JGB yield up to 0.290%. It was mostly flat since then in a range of 0.230 to 0.260%. With the start of this week, the market sentiment around the long end of the curve improved and the 20Y JGB yield temporarily dropped to 0.220% yesterday. Today, superlong JGBs softened, and JL171 traded at 0.235-0.240% (+1.0 - +1.5bp vs. the previous day's close).

Expecting 20Y JGBs to trade in a range centered at 0.28-0.32% over the next one month, we would like to think about our bidding stance

Let's look at the conditions surrounding JGBs. The Japan cabinet office announced real GDP for Oct-Dec 2019 on February 17, 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:** The auction is unlikely to tail;
- ✓ **Potential demand for 20Y JGBs from investors remaining strong:** 20Y JGBs have a broader investor base and a larger market in outstanding amount than 30Y and 40Y JGBs. Also 20Y JGBs are less influenced by the BOJ monetary policy than 10Y JGBs, which the central bank has been directly controlling. Those favorable factors tend to attract investors to 20Y JGBs. Nevertheless, as JL171 is not included in the BOJ purchase list, primary dealers are cautious about keeping a larger inventory than needed. They will need to scrutinize demand from investors for 20Y JGBs at the current yield level;
- ✓ **Tight issuance schedule:** Supply in the superlong zone will be abundant from this auction until the 30Y JGB auction scheduled for March 5, while it is likely that the BOJ will offer only one purchase operation for JGBs with over 10 years left to maturity during that time. This expected looseness of the supply-and-demand balance around the long end of the curve may present some opportunities to buy on dips in the near future;
- ✓ **Also looks attractive based on relative value:** Based on the curve from the intermediate to the superlong zone since the previous auction, the 20-year sector now looks undervalued relative to the 25-year, 30-year, and 40-year sectors (Appendix 3). It has also been gaining cheapness against swaps since the previous auction, as witnessed by the asset swap having been tightening (Appendix 6).

Placing bids under the assumption that the 20Y JGB yield will move around a range of 0.22 to 0.26% until the March auction.

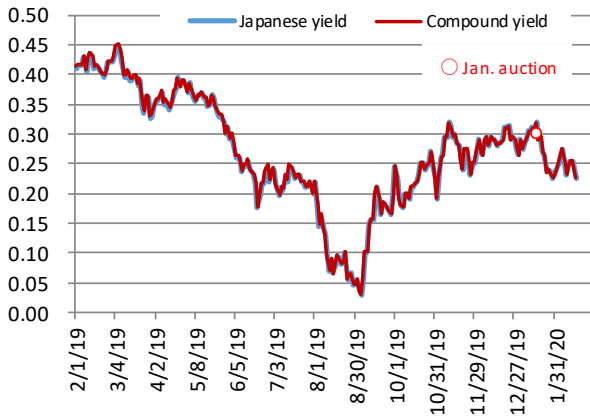
Overall, we would like to think about our bidding stance at tomorrow's auction under the assumption that the 20-year yield will move in a range of 0.22 to 0.26% until the next auction on March 12. In terms of relative value, we would like to build a 5-year/10-year/20-year butterfly (selling the 10-year and buying the 5-year and 20-year) position. That butterfly spread has generally followed an upward trend over the past year (Appendix 5). That implies that, irrespective of the direction of the market (or JGB yields) and the shape of the curve, the 10-year bullet has a strong tendency to underperform the 5-year/20-year barbell. The position is most likely to earn positive carry with lower risk. In addition, it can be worth considering buying JL171 on asset swap especially for investors with a longer investment horizon. The asset swap is currently at the most attractive level since the BOJ began the yield curve control policy and we can expect positive carry as well. For liquidity considerations, we recommend positioning against 6-month LIBOR rather than OIS.

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
2/20/20	171R	0.3	12/20/39	900.0*									
1/17/20	171	0.3	12/20/39	899.1	3.83	99.99	99.90	0.09	0.300	0.305	0.005	93.4722	Good
12/17/19	170R	0.3	9/20/39	1,027.5	4.10	100.25	100.20	0.05	0.286	0.289	0.003	30.5611	Good
11/20/19	170R	0.3	9/20/39	1,032.8	4.21	100.63	100.60	0.03	0.266	0.268	0.002	43.6701	Good
10/24/19	170	0.3	9/20/39	899.3	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	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	1,018.7	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	1,018.1	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	1,017.0	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	1,007.2	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	989.4	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	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	1,117.5	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	1,133.3	4.57	100.59	100.55	0.04	0.467	0.469	0.002	24.2842	Good

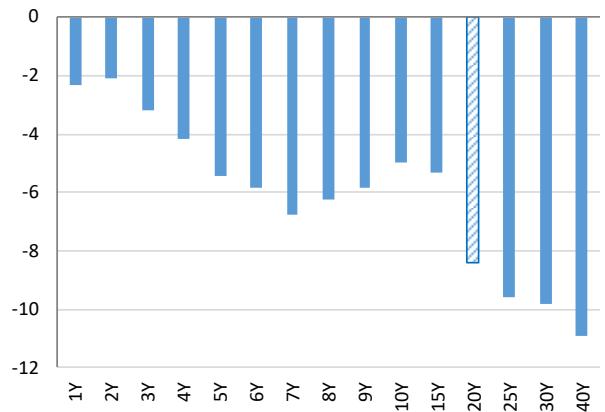
* Amount the Ministry of Finance plans to issue
 Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 20Y JGB Yield (%)



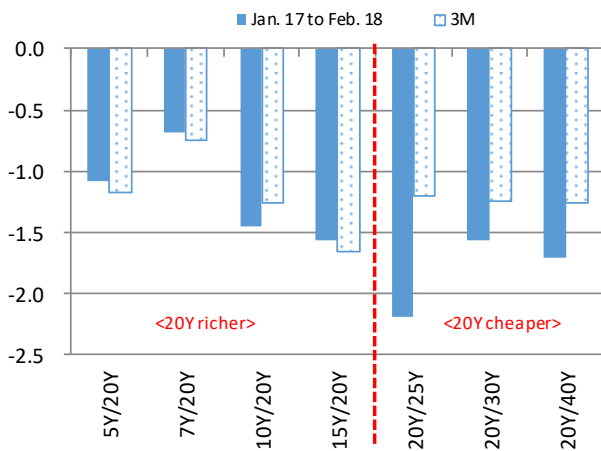
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Jan. 17 v. Feb. 18



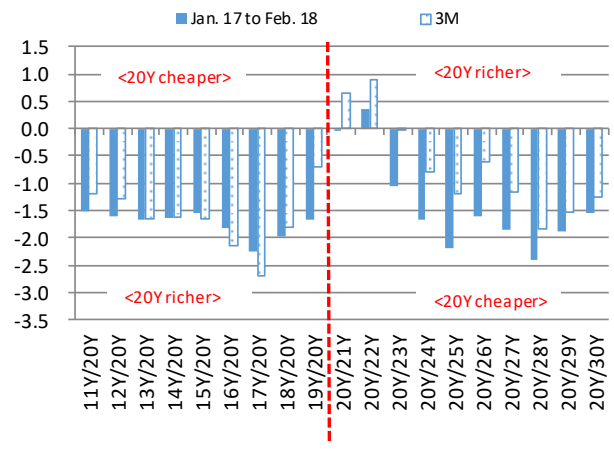
Source: Daiwa Securities.

Appendix 3a: Z-score I



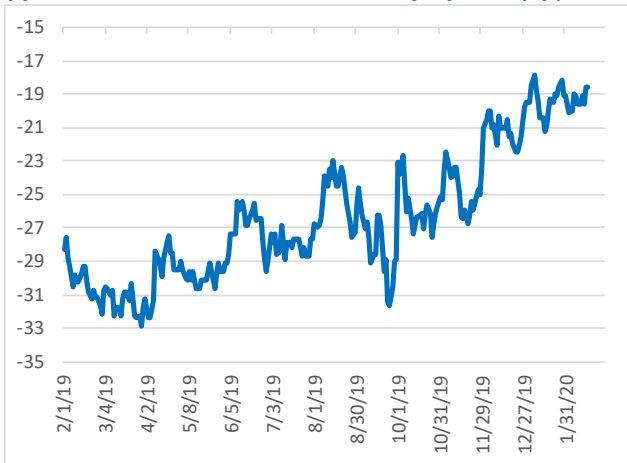
Source: Daiwa Securities.

Appendix 3b: Z-score II



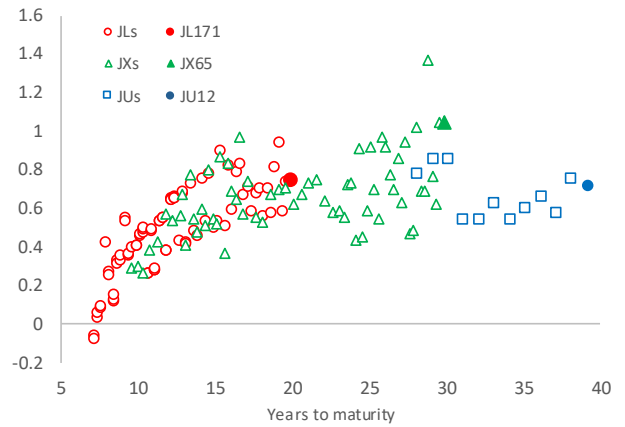
Source: Daiwa Securities.

Appendix 4: JGB 5Y/10Y/20Y Butterfly Spread (bp)



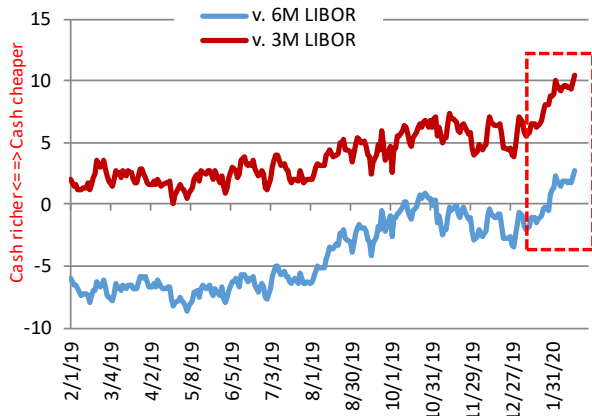
Note: 50%/50% trade, DV01 weighted
Source: Daiwa Securities.

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



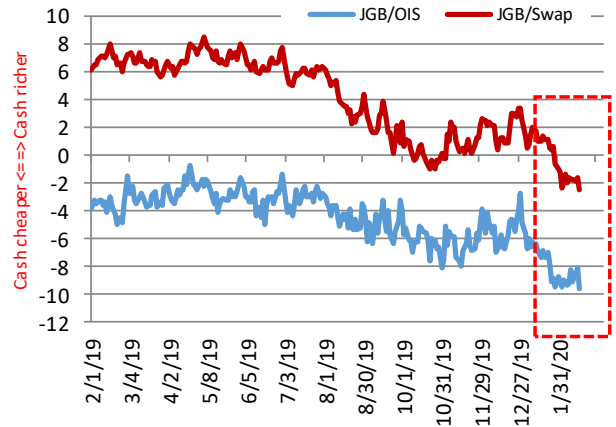
Note: Based on the Feb. 18 JGB yield curve; factoring in roll-down effect etc.
Source: Daiwa Securities.

Appendix 6a: 20Y JGB Asset Swap Spread (bp)



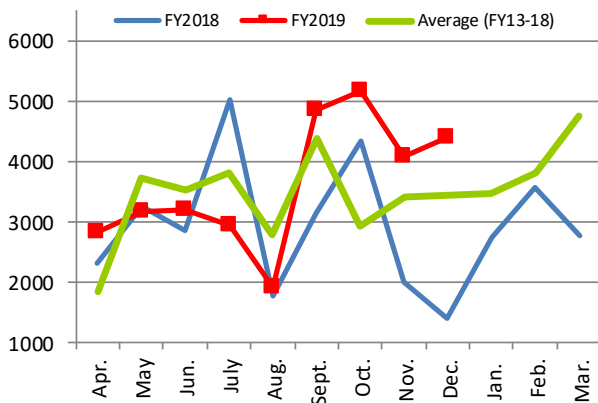
Note: since the Jan. auction
Source: Daiwa Securities.

Appendix 6b: 20Y JGB/Swap and JGB/OIS Spreads (bp)



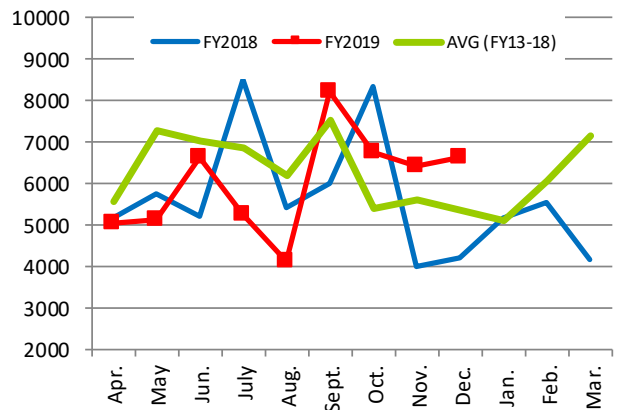
Note: since the Jan. auction
Source: Daiwa Securities.

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



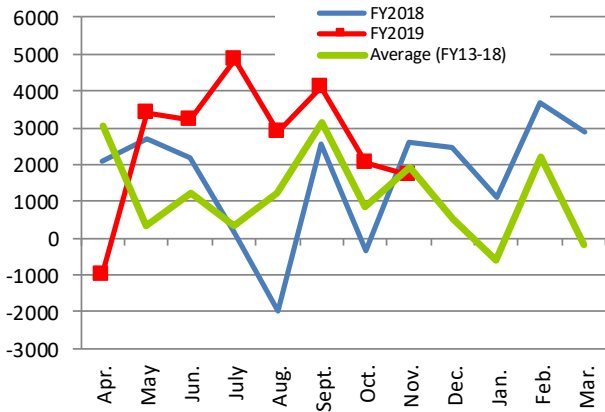
Source: JSDA

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



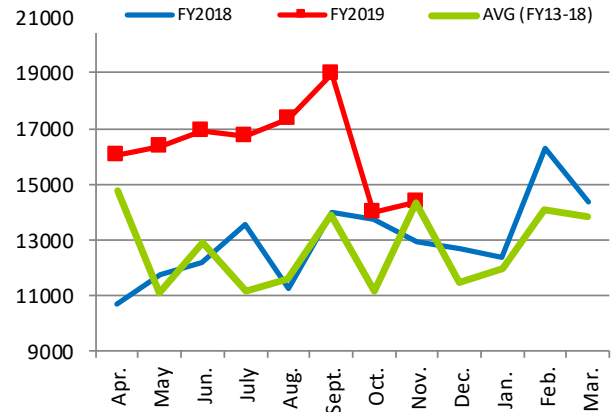
Source: JSDA

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

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[Standard & Poor's]

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[Moody's]

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