

Outlook for 5Y JGB Auction

Bidding cautiously

- ✓ Ahead of BOJ's MPM, the current yield level may discourage market participants from aggressively buying 5Y JGBs for potential capital gain.
- ✓ Primary demand from overseas investors should be watched.
- ✓ We think about our bidding stance to take only the minimum necessary amount, assuming that tomorrow's auction will go poorly with a high probability.
- ✓ Considering 5Y/7Y/10Y butterfly position—a strong reversal would be more likely partly because of the distortion of the 7Y sector in the 5-10Y zone of the curve, which has become notable over the past several days. Good positive carry can be also expected from the position.

Strategic Memorandum DSTE366
FICC Research Dept.

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

Auction Details

Auction Date: March 10, 2020
Issue Date: March 11, 2020
Maturity Date: December 20, 2024
Offering Amount: About 1.9 trillion yen

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

** On March 9, JS142 traded at -0.330 - -0.300% (-5.5 - -2.5bp v. previous day's close) and closed at -0.305% (-3.0bp).

Exp. Rating on Auction Results

| | | | | |
|--------|------|---------|------|-------------|
| 1 | 2 | 3 | 4 | 5 |
| Failed | Poor | Average | Good | Outstanding |

Tomorrow's auction will likely be held at the -0.3% bidding yield level for the fourth time in the 5Y auction history

Since the previous 5Y JGB auction went well at the -0.145 - -0.140% level (-1.0 - -0.5bp vs. previous day's close), the bond markets have surged around the globe amid growing concerns about the global outbreak of the new coronavirus and also due to the monetary easing trend in major nations. In such a situation, the 5Y JGB yield temporarily declined to -0.330% on an intraday basis today (Mar 9). The possibility is increasing that tomorrow's auction will be held at the -0.3% bidding yield level for the fourth time in the 5Y JGB auction history (see table on page 2).

Market eyes are on BOJ's policy action

JGBs have been quite volatile. Amid the global outbreak of the COVID-19, expectations on global monetary easing are mounting triggered by the February 28 announcement of Fed chair Jerome Powell's statement. In the US, the Fed decided to lower the target range for the federal funds rate by 0.5 percentage point on March 3 immediately after the announcement of G7 statement that "we reaffirm our commitment to use all appropriate policy tools to achieve strong, sustainable growth and safeguard against downside risks" following an emergency teleconference. Reflecting the cut, the BOJ's policy action is also garnering attention especially in the Japanese financial markets.

Under the global trend of monetary easing, the BOJ is scheduled to hold its Monetary Policy Meeting (MPM) on March 18-19. Today (Mar 9), the yen is sharply appreciating to the 100-105 level vs. the dollar, the first time since Sep.-Oct. 2016, around the introduction of

In a fresh memory of last autumn's JGB market movements, the current 5Y JGB yield level may discourage market participants from aggressively buying 5Y JGBs for potential capital gain ahead of MPM

the BOJ's yield curve control policy. Ahead of the end of the fiscal year, the Nikkei Stock Average fell below 20,000 yen, marking a new record low for FY19. Amid deep-rooted speculations on additional rate cuts by the Fed, expectations are lingering for additional easing by the BOJ. With growing worries about the domestic economy, however, we think that it may be difficult for the Japanese central bank to cut the short-term policy rate deeper in negative territory, given anticipated negative impact on regional financial institutions. Considering the BOJ's four options for additional easing, we think that an increase in the ETF purchase amount would be realistic. As the Bank's ETF purchases could bolster stock prices, this is in line with the BOJ governor's statement on March 2. That said, in a fresh memory of last autumn's JGB market movements, the current level may discourage market participants from aggressively buying 5Y JGBs for potential capital gain ahead of the MPM.

Demand from overseas investors should be watched

Meanwhile, 5Y JGBs have become substantially undervalued vs. US and European government bonds on a cross currency basis partly because the USD/JPY basis swap is widening under the current situation (Appendix 10). We should watch for demand from overseas investors.

Tomorrow's auction to tail with a high probability

All in all, we think about our bidding stance to take only the minimum necessary amount, assuming that tomorrow's auction will go poorly with a high probability. In terms of relative value, switching out from the 7Y sector may become active. For example, we think of the 5Y/7Y/10Y butterfly position (selling 7Y/buying 5Y and 10Y). A strong reversal would be more likely partly because of the distortion of the 7Y sector in the 5-10Y zone of the curve, which has become notable over the past several days (Appendix 8). In addition, good positive carry can be expected from the position even if the shape of the curve is unchanged in the investment horizon.

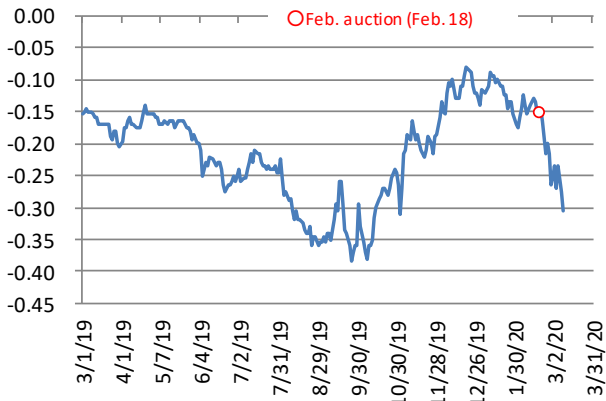
5Y JGB Auction Results

| 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 (%) | |
|--------------|---------|---------------|----------|---------------------------|------|---------------|--------------|------------------|---------------|---------------|----------------|---------------|------|
| 3/10/20 | 142R* | 12/20/24 | 0.1* | 1.9** | | | | | | | | | |
| 2/18/20 | 142R | 12/20/24 | 0.1 | 2.1 | 4.49 | 101.19 | 101.18 | 0.01 | -0.144 | -0.142 | 0.002 | 13.8811 | Good |
| 1/15/20 | 142 | 12/20/24 | 0.1 | 2.1 | 4.48 | 100.93 | 100.93 | 0.00 | -0.087 | -0.087 | 0.000 | 90.2740 | Good |
| 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 |
| 7/14/16 | 128R | 6/20/21 | 0.1 | 2.4 | 3.45 | 102.33 | 102.31 | 0.02 | -0.365 | -0.361 | 0.004 | 93.3874 | Avg |

* Daiwa forecast as of Mar. 9 ** Amount the MOF plans to issue

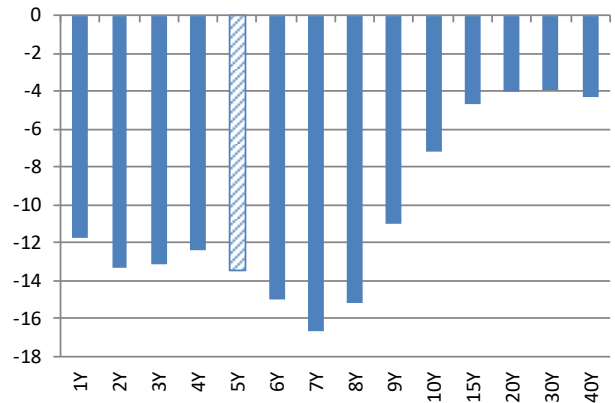
Source: Ministry of Finance, Daiwa Securities.

Appendix 1: 5Y JGB Yield (%)



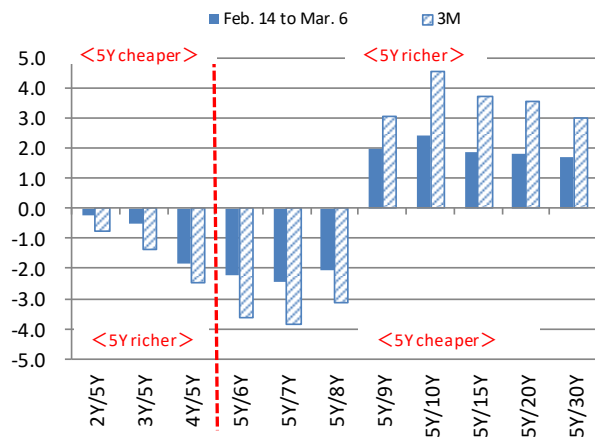
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Feb. 18 v. Mar. 6



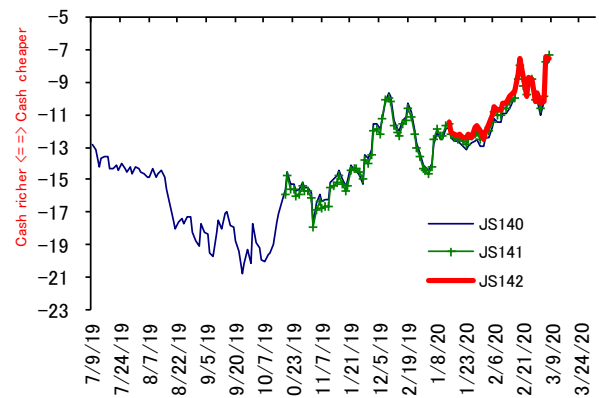
Source: Daiwa Securities.

Appendix 3: Z-scores of JGB Yield Spreads



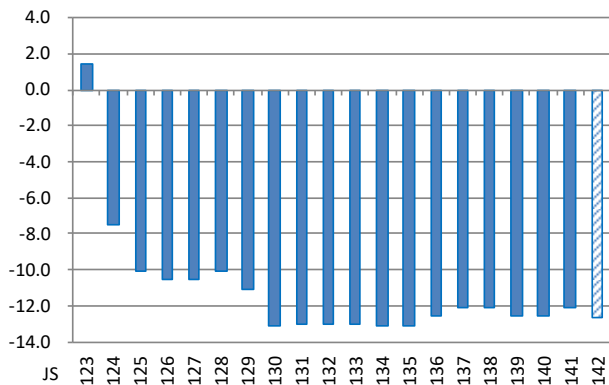
Source: Daiwa Securities.

Appendix 4: 5Y Swap Spread



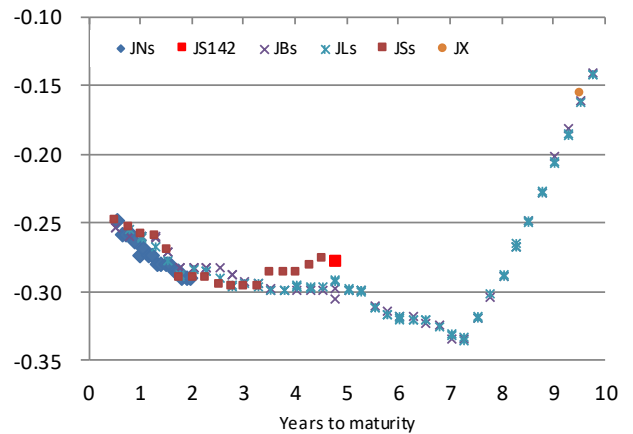
Source: Daiwa Securities.

Appendix 5: JS Yield Change (bp): Feb. 18 v. Mar. 6



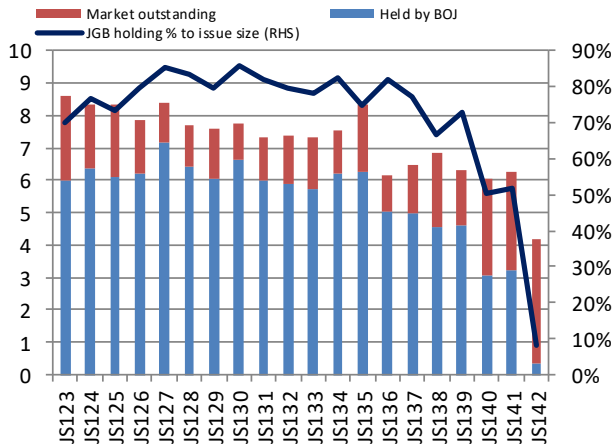
Source: Daiwa Securities.

Appendix 6: JGB Yield Curve (% as on Mar6)



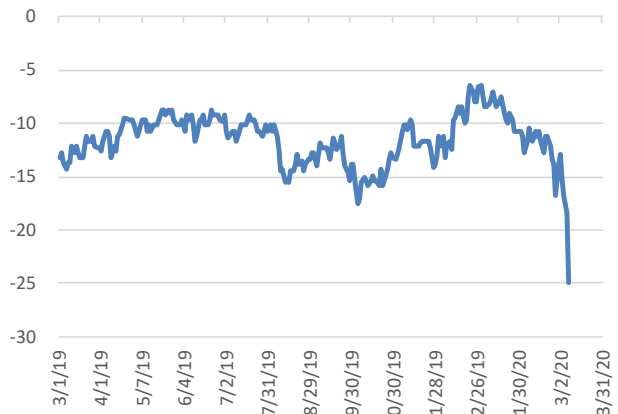
Source: Daiwa Securities.

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



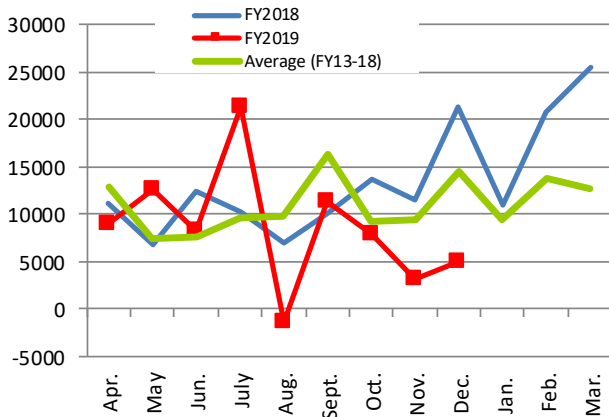
Note: as of Feb. 28 on BOJ start basis
Source: Daiwa Securities.

Appendix 8: JGB 5Y/7Y/10Y Butterfly Spread (bp)



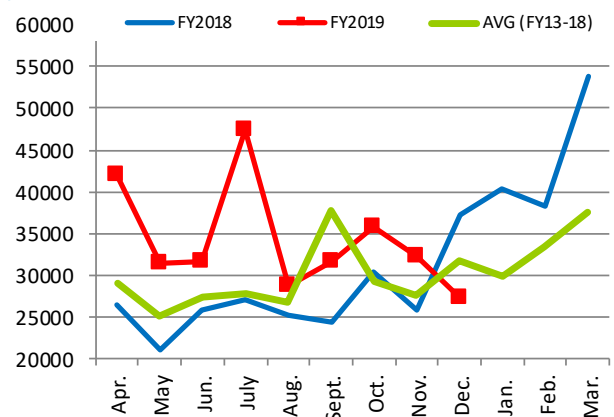
Note: On-the-run compound yield basis, as of Mar. 6 close
Source: Daiwa Securities.

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



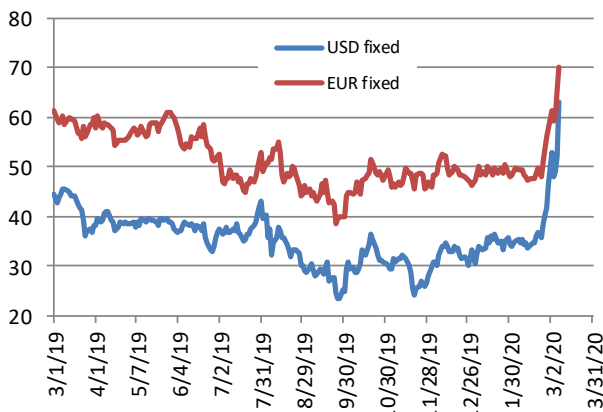
Source: JSDA

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



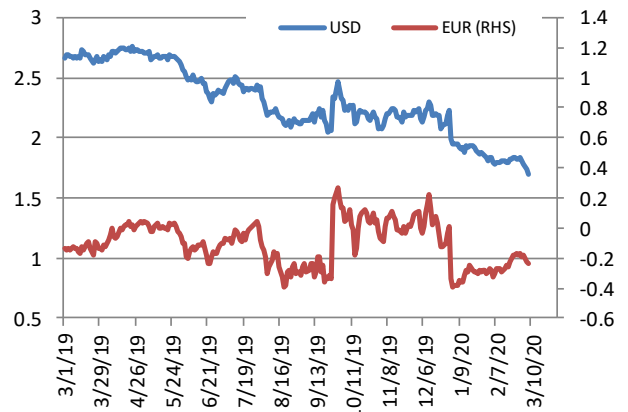
Source: JSDA

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

Explanatory Document of Unregistered Credit Ratings

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[Standard & Poor's]

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[Moody's]

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February 2020

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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%.

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