

JGB Insight

Like a once-in-a-decade cataclysm

- ✓ Asset swap spreads tighten significantly: If this time is different from the 2008-09 financial crisis, for investors with long investment horizon, we recommend being ready to buy asset swaps
- ✓ BEI plunges sharply to -30bp: With crude oil prices also dropping sharply, investor sentiment is worsening. Given that the principal amount is guaranteed at redemption, however, when the market settles down we expect JGB linkers with positive yields to lure investors

[BOX1] Large-scale economic package: Difficult to count on an increase in issuance for market absorption on a calendar basis

[BOX2] BOJ's JGB purchases: What does "active JGB purchases" really mean?

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Financial markets are in great turmoil globally with plunging share prices and wildly fluctuating interest rates etc. amid the new coronavirus pandemic. In such an environment, JGBs and swaps also remain volatile with extremely low liquidity. These markets are experiencing a sort of great turmoil only seen once in a decade. Of special note has been the tightening of asset swaps (the cheapening of JGBs to swaps) and the breakeven inflation's plunge into negative territory in JGB linkers.

Needed to find proper opportunities, it will be worth starting to buy asset swaps in small lot

A comparison of the swap spread curve now (as of March 16) with that of January 20, around when the spread of the new coronavirus in Wuhan, China started grabbing headlines, shows a significant decline in swap spreads (cheapening of JGBs to swaps), particularly in the superlong zone (Chart 1). That, combined with a tightening of the LCH/JSCC spread during the same period (Chart 2), suggests that declines (or tightening) occurred in part owing to strong receiving pressure from overseas. Spreads are now at their tightest levels going back for the past several years. In the current market environment, however, the experience of the 2008-09 global financial crisis, so-called the Lehman shock, suggests there may be still reasons to be concerned over a further tightening (Chart 3). Nevertheless, as BOJ Governor Kuroda repeatedly emphasized at his press conference following the Monetary Policy Board meeting held yesterday (March 16), with the understanding that this time is different from the Lehman shock, there has been a globally coordinated policy response on both the fiscal and monetary sides from an early stage. It is expected that the excessive tightening in asset swaps will be corrected as the financial market instability improves. Although it is necessary to carefully find proper opportunities, given also the improvement in carry and rolldown effects expected from asset swap positions, we recommend that investors especially with long investment horizon start purchasing JGB linkers in small lot.

JGB Linkers: BEI is about -35bp, under par and the yield level about the same with 20Y JGB yield

As of the market close yesterday (March 16), the breakeven inflation (or BEI) of the on-the-run JGB linker, JBI24, was around -35bp, the lowest since the Ministry of Finance started reissuing JGB linkers (or JGBis) in October 2013 (Chart 4 and Appendix). Prices of all JGBis, which will be redeemed at par, have declined to the level under par, and the yield of JBI24 has risen to 0.290%, about the same level with the 20-year JGB yield (Chart 5). This can be attributed to a significant deterioration in investor sentiment on JGBis, triggered by the sharp decline in oil prices and declining BEIs in Europe and the US as a consequence (Chart 6).

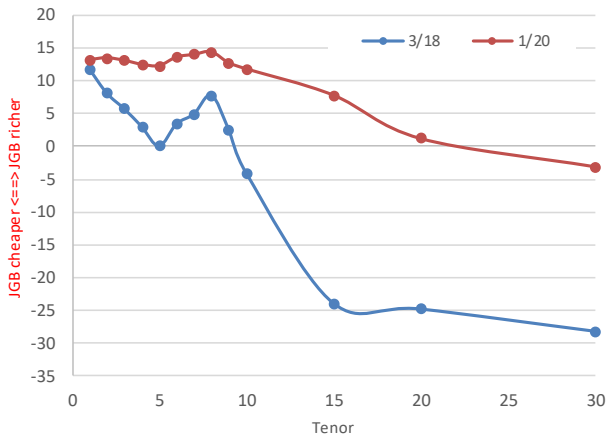
The collapse of the JGBi market during the Lehman shock financial crisis is still a fresh memory. Back then, the Ministry of Finance did not guarantee the principal amount at redemption on JGBis. That further fueled investor unease, causing JGB linker yields to momentarily rise above 4% and BEI to decline to around -300bp, and the MOF was driven to give up issuance (Appendix).

Currently, the BOJ carries out a bold program of monetary easing with 2% price stability target. While JGBis are issued four times a year, both the BOJ and the MOF purchase

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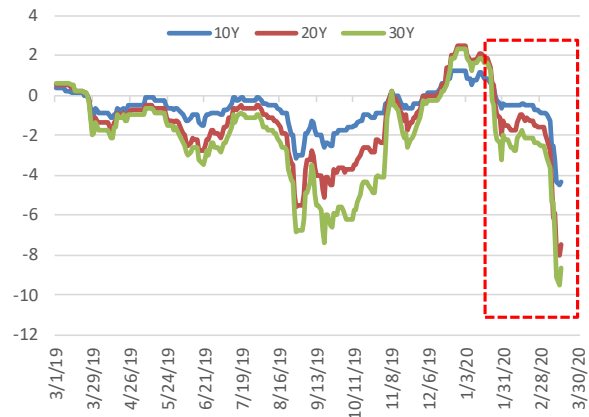
JGBs from the market in 80 billion yen every month. The amount of those purchases could be increased if deemed necessary. There is also a possibility that issuance reductions will be debated in step with the formation of a supplementary budget, which could happen as early as April. When the market settles down, we expect JGB linkers with positive yields to lure investors. Particularly for investors with long investment horizon, we recommend looking for opportunities to buy JGBs on proper dips unless deflation on average over the next 10 years is expected.

Chart 1: Swap Spread Curve (bp)



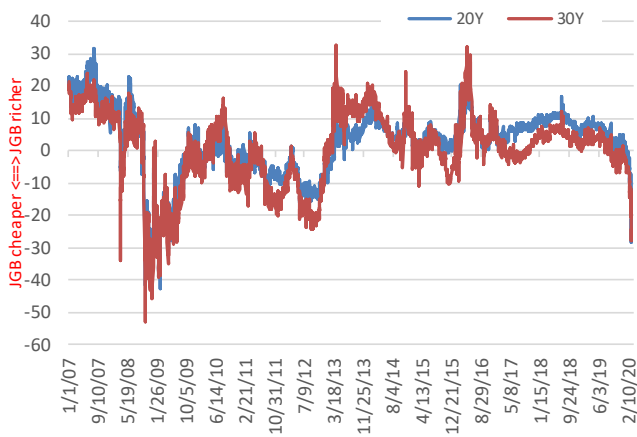
Source: Bloomberg

Chart 2: Yen Swap LCH-JSCC Spread (bp)



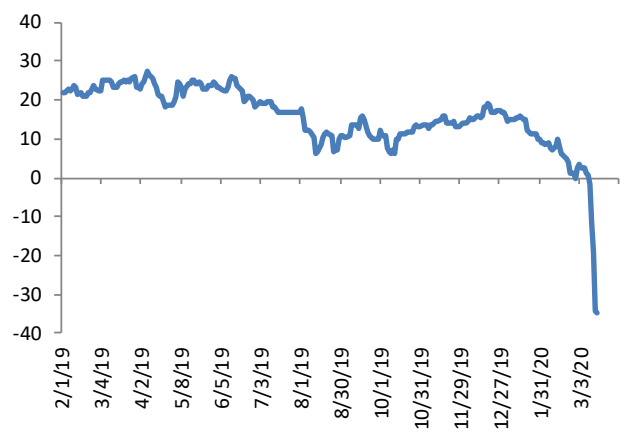
Note:
Source: Bloomberg

Chart 3: 20Y and 30Y Swap Spreads (bp)



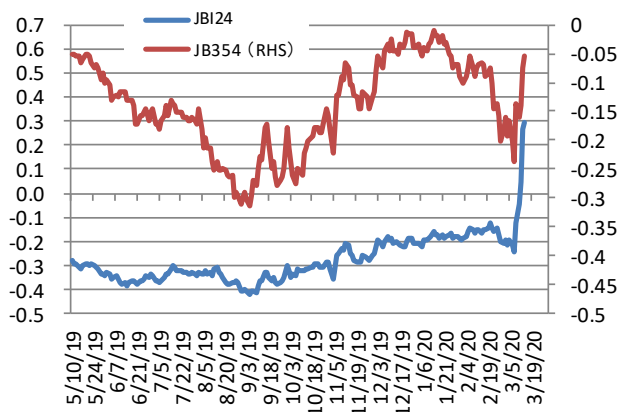
Source: Bloomberg

Chart 4: BEI (bp)



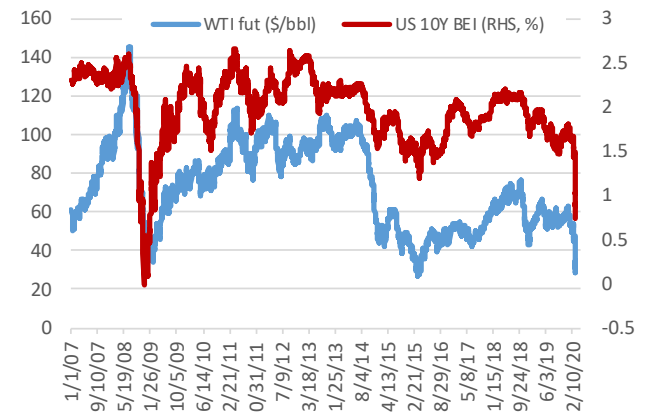
Source: Daiwa Securities

Chart 5: JBI24 and JB354 Yields (%)



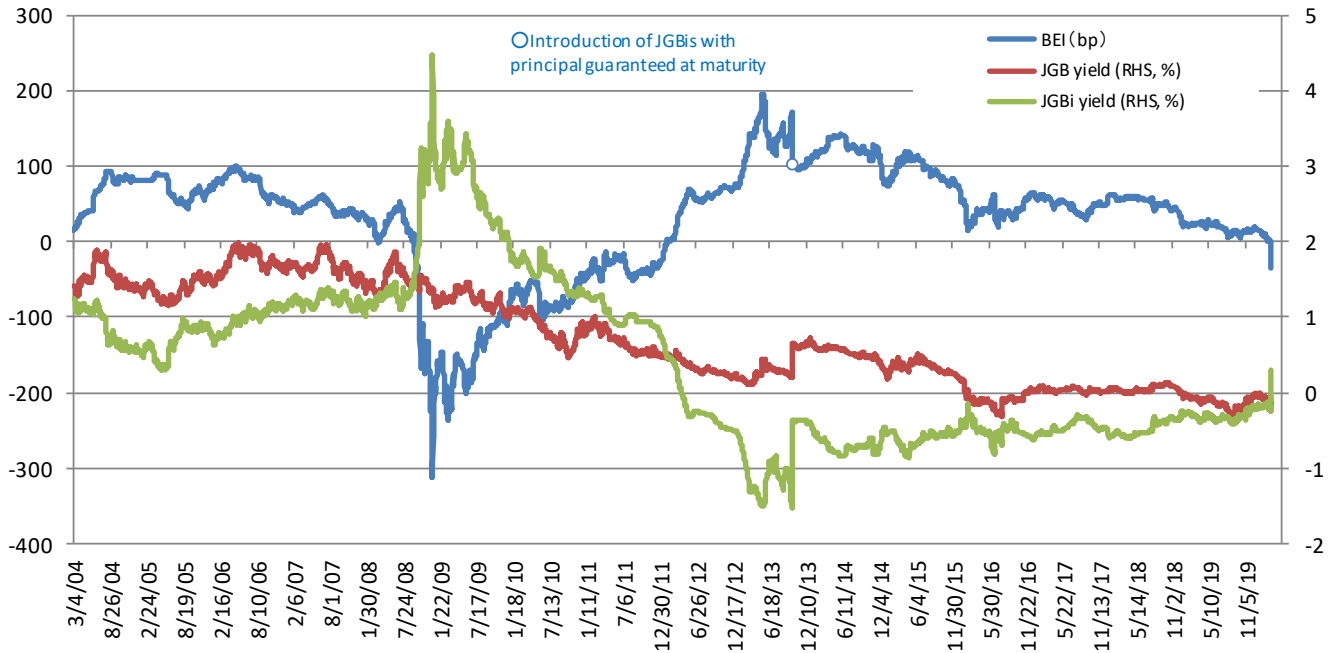
Source: Daiwa Securities

Chart 6: Oil Price (WTI fut) and US 10Y BEI



Source: Bloomberg

[Appendix] JGBi BEI (March 2005 to present)



Source: Daiwa Securities.

[BOX1] Large-scale economic package:

Difficult to count on an increase in issuance for market absorption on a calendar basis

At his press conference on March 14, Prime Minister Abe indicated he was considering a large economic package to counter the economic slowdown caused by the spread of the new coronavirus. According to some sources, he would instruct the drafting of such a package immediately after passage of the FY20 budget in April. The size of the package being considered is on par with the economic package (worth Y56.8 trillion) implemented in the aftermath of the global financial crisis in April 2009. That package included government spending of about Y15 trillion and an increase in JGB market issuance on a calendar basis of about 17 trillion yen (see the table on the following page). At the time, front-loaded issuance amounted only to around 5.3 trillion yen. This economic package, if positioned as an add-on to the roughly 26 trillion yen economic package passed in December 2019, could amount to around 30 trillion yen (both figures on an all-projects basis). There are proposals within the LDP for a 30 trillion yen supplementary budget or government spending of 20 trillion yen, while the opposition parties appear to be discussing economic stimulus of 30 trillion yen including tax cuts. Given that the initial budget is planned to be over Y100 trillion for FY2020, however, there will probably be significant hurdles to clear before a large supplementary budget can be formed. Expectations of a large supplementary budget had also been gaining ground when the economic package was decided in December 2019, but the additional general account spending in the supplementary budget wound up only amounting to 4.3 trillion yen. Although it is important to keep a close eye on the direction that this debate takes, at this point it is difficult to count on any increase in JGB market issuance on a calendar basis tied to an expected supplementary budget. This is particularly true when considering that there is still a large amount of front-loaded JGB issuance.

Economic Stimulus Package and Additional JGB Issuance (Yen 100M)

FY	Decided by the Cabinet*	Economic Stimulus Packages (Business basis)	Total JGB Issuance	Market Issuance			Total	Front-loading Issuance
				Market Issuance on Calendar basis	II Auction	Adjustment between fiscal years		
2019	12/13/19	260,000	61,303	-	8,703	51,600		52.5
2020	April?							53.0
2009	4/27/09 (First)	568,000	169,190	169,000	-	190	169,190	5.3
	10/16/09 (First modified)	-	169,190	190,000	-	-	190,190	
	12/15/09 (Second)	244,000	261,195	242,000	14,053	26,142	282,196	

* The day submitted to the Diet for FY2019

Note: Front-loading Issuance for FY2019 and FY2020 are estimated.

Source: Ministry of Finance

[BOX2] BOJ's JGB purchases: What does "active JGB purchases" really mean?

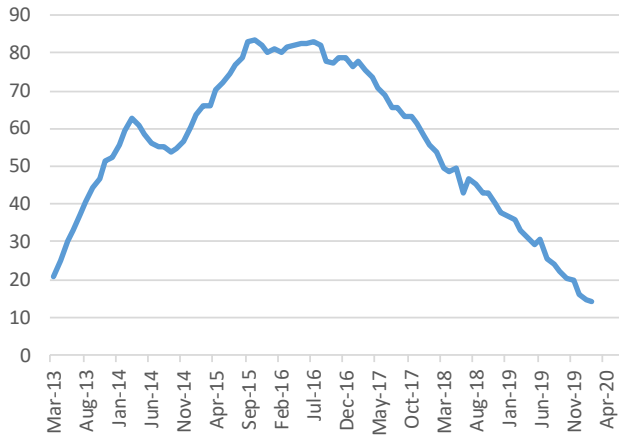
After the BOJ announced its policy decision, there was increased uncertainty in the JGB market over what the BOJ commitment to supply more ample funds through "active purchases of JGBs" really meant. Would the BOJ increase the offer amounts in its already-planned operations, or would it offer more unscheduled operations and/or increase the frequency of its fixed-rate purchase operations?

After the BOJ introduced its policy of quantitative and qualitative monetary easing (QQE) with yield curve control in September 2016, it kept the language in its written statement about its long-term JGB purchases, "so that their amount outstanding will increase at an annual pace of about 80 trillion yen," but more recently its purchases have been at a pace that increases those holdings at an annual rate of less than 14 trillion yen (as of February 2020), which is a slower pace than it maintained prior to its initial introduction of QQE (see Chart on next page). There appears to be considerable room for increasing the amount of purchases with this latest enhancement of monetary easing. Nevertheless, in part because the BOJ shifted its policy focus from quantities to interest rates when it introduced its yield curve control policy, with the 10-year JGB yield currently trading in a range "about double the $\pm 0.1\%$ long-term rate target" of its yield curve control policy, it could prove difficult for it to substantially increase its purchases uniformly across all maturity zones eligible for purchase.

Expecting the BOJ to offer unscheduled operations frequently

Last week, it did not increase the amounts of its already scheduled operations but conducted an unscheduled operation on March 13. Additionally, at 18:00 yesterday (March 16) it announced additional buying operations for today (March 17) targeting JGBs in the over-3-year to 5-year zone (100 billion yen) and the over-5-year to 10-year zone (also 100 billion yen). It appears that the Bank will likely increase frequencies of unscheduled purchases by watching market conditions closely.

Annual Increase Amount of BOJ's JGB Holding (Yen trillions)



Source: Bank of Japan

BOJ JGB Purchase Schedule in March 2020 (as of Mar. 17)

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	TDBs	MOF Buyback
3/2/20 M	3/3/20									
3/3/20 T	3/4/20	10Y JGB Auction							500.2	
3/4/20 W	3/5/20	50.2	420.1	340.5						20.1
3/5/20 TH	3/6/20	30Y JGB Auction								
3/6/20 F	3/9/20				350.2				3M	
3/9/20 M	3/10/20		420.4	340.1		120.4	30.1		6M	
3/10/20 T	3/11/20	5Y JGB Auction								
3/11/20 W	3/12/20	50.1			350.1			30.2	500.1	
3/12/20 TH	3/13/20	20Y JGB Auction								
3/13/20 F	3/16/20				200.2				3M	
3/16/20 M	-	BOJ MPM (Day 2)								
3/17/20 T	3/18/20			100.2	100.2				1Y	
3/18/20 W	3/19/20		420.2	340.3	350.2			50.1	3M	
3/19/20 TH	3/23/20	BOJ MPM (Day 2)								
3/20/20 F	-	Public Holiday (Vernal Equinox Day)							-	
3/23/20 M	3/24/20					◎	◎			
3/24/20 T	3/25/20	AEL for 2Y, 5Y, 10Y and 20Y JGBs with over 1 to 5 years left to maturity							○	
3/25/20 W	3/26/20									
3/26/20 TH	3/27/20	40Y JGB Auction								
3/27/20 F	3/30/20		◎	◎	◎				3M	
3/30/20 M	3/31/20									
3/31/20 T	4/1/20	20Y JGB Auction							○	

* BOJ MPM on March 16 was initially scheduled on March 18-19. On March 16, the Ministry of Finance conducted AEL for JGBs with over 5 to 15.5 years left to maturity.

Note: ◎ Announced by the BOJ on Feb. 28, ○ Daiwa forecast as of Mar. 17; Yellow-shaded for unscheduled operations

Source: Ministry of Finance

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[Standard & Poor's]

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

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February 2020

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