

Outlook for 5Y JGB Auction

Solid bidding expected only at the yield level above -0.1%

- ✓ Despite 600bn yen increase in issuance amount, tomorrow's auction for fresh 5Y JGBs, JS144, is expected to go well if it is held at the yield level above -0.1%.
- ✓ In terms of relative value, we think of switching out from 2Y sector and/or trading 2Y/5Y/7Y butterfly.

Strategic Memorandum DSTE390
FICC Research Dept.

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Auction Details

Auction Date:	July 9, 2020
Issue Date:	July 10, 2020
Maturity Date:	June 20, 2025
Offering Amount:	About 2.5 trillion yen

* New 5Y JGBs, JS144, will likely carry a 0.1% coupon.

** On July 8, WI barely traded, and closed at -0.095% (-1.0bp v. previous day's close). JS143 traded at -0.105 - -0.100% (-1.0 - -0.5bp) and closed at -0.105% (-1.0bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Solid bidding expected only at the yield level above -0.1%

After the previous 5Y JGB auction went smoothly at the -0.120 - -0.115% level (-1.0 - -0.5bp vs. previous day's close), the 5Y JGB yield (conventional yield of JS143) temporarily rose to -0.085% on an intraday basis in early July amid the JGB market's downturn. Since then, the yield is largely moving in a narrow range at around -0.100% (Chart 1a).

In the midst of the supply/demand rebalancing due to the significant increase in JGB issuance from July and increased purchase amounts by the BOJ, the upside of 5Y JGBs appears to be getting limited from -0.1%. On the other hand, it seems difficult to expect stronger upward pressure on 5Y JGB yields. While cautions about a COVID-19 second wave are growing, worries about the economic outlook remain strong. In the near term, the BOJ is likely to maintain the current yield curve control (YCC) policy persistently. Given the framework of the short-term policy rate of -0.1% and the long-term policy rate of around 0%, -0.05% can serve as an easy-to-understand support level for 5Y JGBs. In fact, 5Y JGBs have been solidly supported around -0.05% under the YCC policy (Chart 1b). In such an environment, we summarize key points to think about the bidding stance at tomorrow's auction as follows:

- ✓ **Fresh June-2025 notes, JS144, with 600bn yen increase in issuance amount:** Tomorrow, the issuance amount will be increased by 600bn yen to 2.5 trillion yen from the previous 5Y JGB auction in June, but the auction will be held for fresh 5Y JGBs, JS144. The results of auctions for fresh 2Y JGBs, 10Y JGBs and 30 JGBs, all of which belong to a new maturity basket, were average to good;
- ✓ **Not overvalued in terms of the relative value:** Our analysis based on data since the previous 5Y JGB auction and that in the past three months show that the 5Y sector is not expensive on the curve at the current level. Rather it is noticeably undervalued vs. the 4Y sector (Appendix 3). In addition, the sector is more undervalued against swaps than it was in the previous auction (Appendix 6);
- ✓ **Good support is expected from the BOJ's purchase operations:** The next 5Y JGB auction is scheduled for August 20. In the period from tomorrow to the auction, there is a possibility that the BOJ will conduct at least six purchase operations in the 3-5Y zone (three times in July and we expect at least three times in August). The purchase amount is expected at around 2.1tn yen (= 350bn yen x 6 times) vs. tomorrow's issuance amount;
- ✓ **Collateral demand associated with the BOJ's special fund-supply operations in response to the COVID-19 pandemic is expected to grow.**

2Y/5Y flattener or 2Y/5Y/7Y butterfly

All in all, we would like to place solid bids at the yield level above -0.1%, assuming that the 5Y JGB yield will remain in the range centered at -0.105 to -0.085% until the next 5Y JGB auction in August. In terms of the relative value, it would be worth considering 2Y/5Y flattening position (Appendix 7) or 2Y/5Y/7Y butterfly position (buying 5Y/selling 2Y and 7Y, Appendix 8). Regarding 2Y/5Y flattener, we can expect higher return than the 5Y outright position, even if it is built in a delta-long balance. The BOJ will conduct a purchase operation in the 1-3Y zone on the following day of the auction (July 10), which will help building the position. Since April, the 2Y/5Y/7Y butterfly spread has been moving stably in a range of about 5bp (Appendix 8). In addition, positive carry is expected from the butterfly position even if the shape of the 2Y/5Y/7Y curve does not change. It would be worth considering building the butterfly position if we can trade around the upper end of the range.

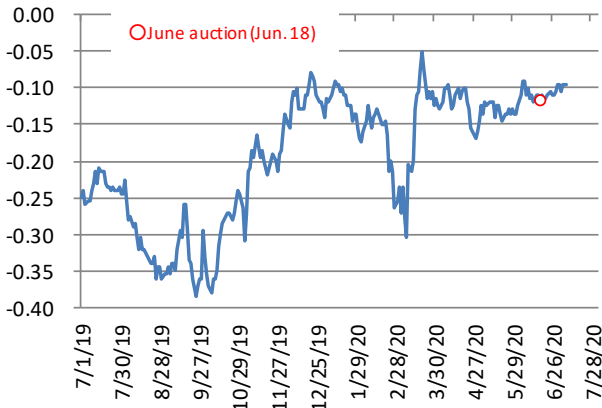
5Y JGB Auction Results

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 (%)	
7/9/20	144	6/20/25	0.1*	2.5**									
6/18/20	143R	3/20/25	0.1	1.9	3.78	101.05	101.04	0.01	-0.119	-0.117	0.002	37.4921	Avg
5/18/20	143R	3/20/25	0.1	2.0	4.49	101.07	101.05	0.02	-0.122	-0.119	0.003	49.2132	Good
4/9/20	143	3/20/25	0.1	2.1	4.98	100.97	100.96	0.01	-0.095	-0.093	0.002	43.4187	Good
3/10/20	142R	12/20/24	0.1	1.9	2.73	101.55	101.37	0.18	-0.220	-0.184	0.036	21.4893	Poor
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

* Daiwa forecast (as of July 8) ** Amount the MOF plans to issue

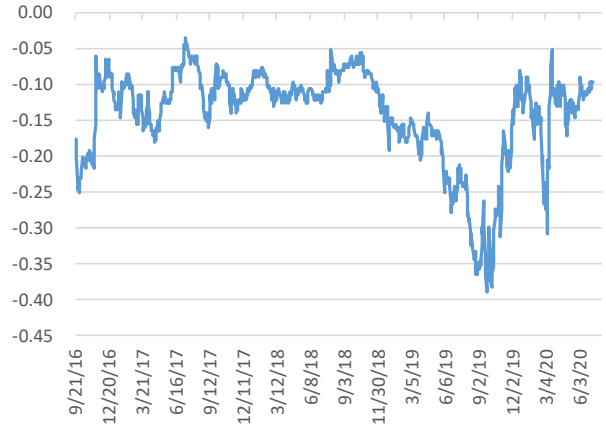
Source: Ministry of Finance, Daiwa Securities.

Appendix 1a: 5Y JGB Yield (%)



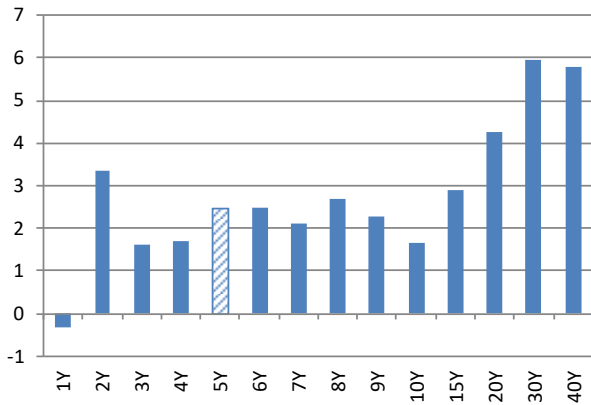
Note: On-the-run issue
Source: Daiwa Securities.

Appendix 1b: 5Y JGB Yield under YCC (%)



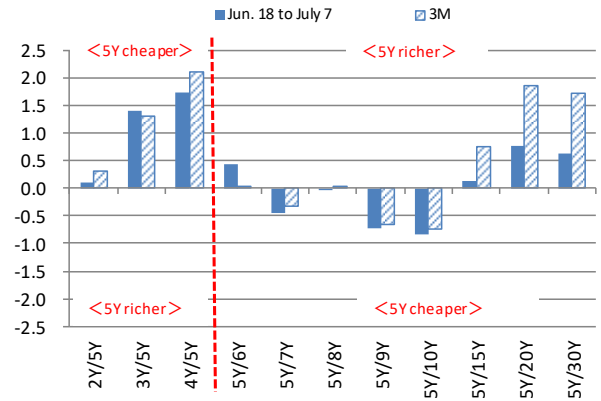
Note: On-the-run issue
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Jun. 18 vs. July 7



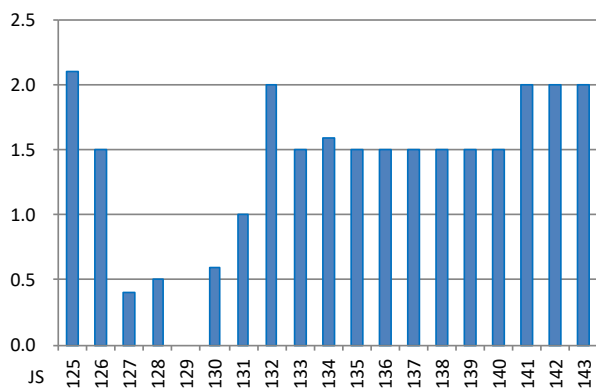
Source: Daiwa Securities.

Appendix 3: Z-scores of JGB Yield Spreads



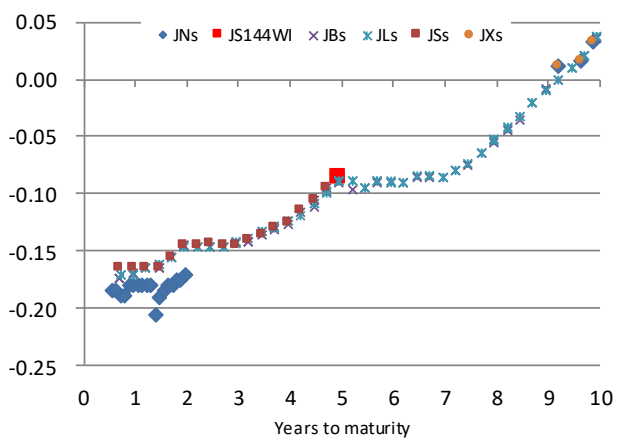
Source: Daiwa Securities.

Appendix 4: JS Yield Change (bp): Jun. 18 vs. July 7



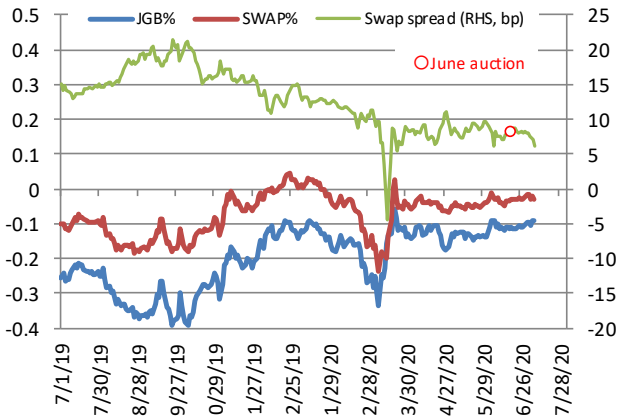
Source: Daiwa Securities.

Appendix 5: JGB Yield Curve (% as on July 7)



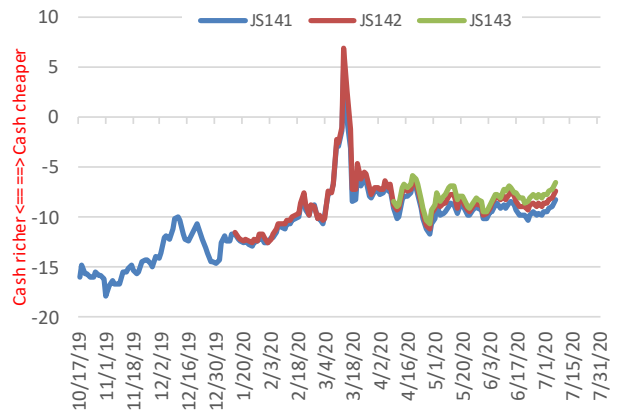
Source: Daiwa Securities.

Appendix 6a: 5Y Swap Spread (bp)



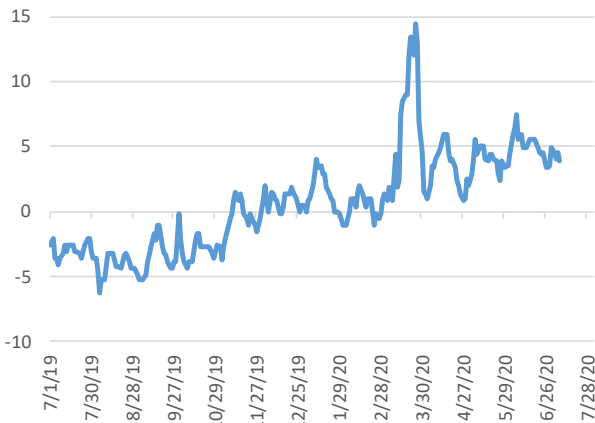
Source: Daiwa Securities.

Appendix 6b: JS Asset Swap (bp)



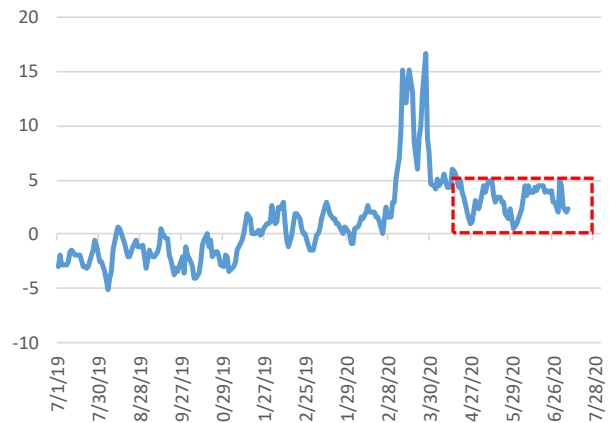
Note: Yen-Libor basis
Source: Daiwa Securities.

Appendix 7: JGB 2Y/5Y Spread (bp)



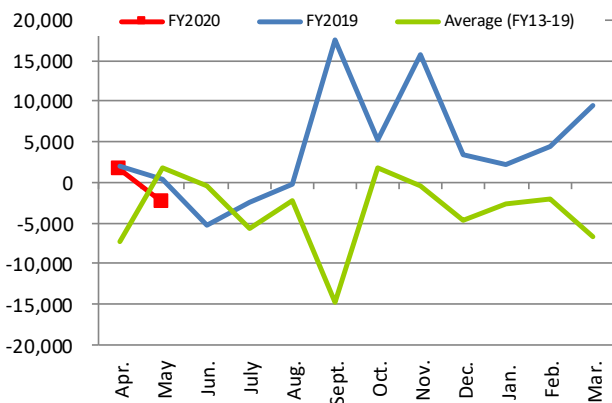
Note: On-the-run compound yield basis
Source: Daiwa Securities.

Appendix 8: JGB 2Y/5Y/7Y Butterfly Spread (bp)



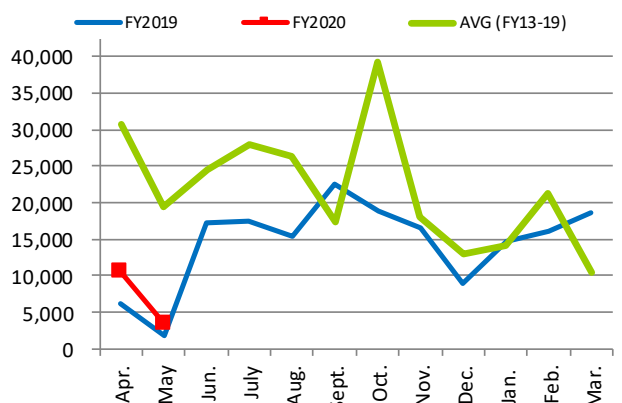
Note: On-the-run and CTD compound yield basis
Source: Daiwa Securities.

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



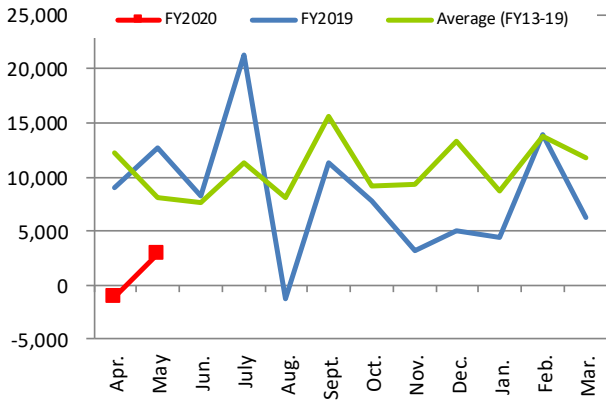
Source: JSDA

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



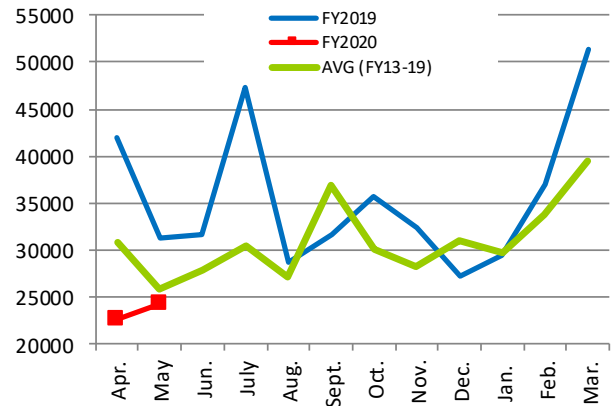
Source: JSDA

Appendix 10a: Net Purchase of Intermediate-term JGBs by Overseas Accounts (Yen 100 millions)



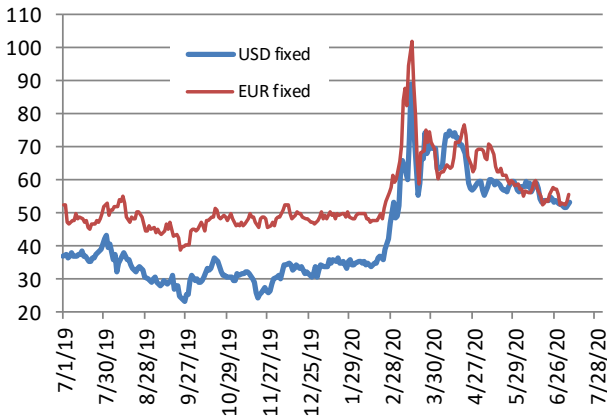
Source: JSDA

Appendix 10b: Gross Purchase of Intermediate-term JGBs by Overseas Accounts (Yen 100 millions)



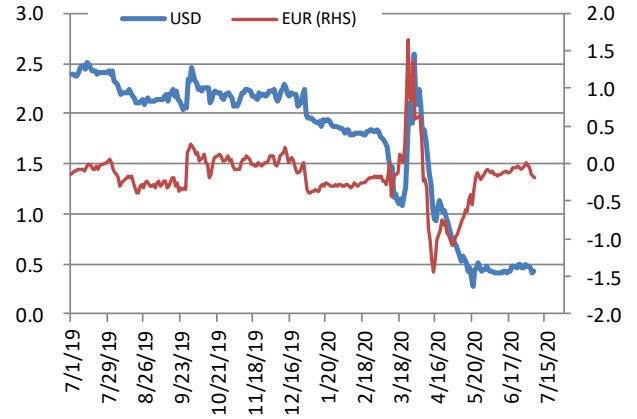
Source: JSDA

Appendix 11a: 5Y JGB Benchmark Spreads (bp)



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

Appendix 11b: 5Y Hedged JGB Return (%)



Source: Daiwa Securities

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[Standard & Poor's]

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February 2020

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* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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