

Outlook for 20Y JGB Auction

Thinking about bidding stance assuming 20Y JGB yield will stay in 0.40-0.45% range

- ✓ Despite additional issuance of Y300 billion, we expect primary sale of fresh 20Y JGBs to go smoothly. We think about our bidding stance, assuming the 20-year yield will stay in the range of 0.40-0.45% over the next month.
- ✓ Based on relative value, we see room to consider buying asset swaps and, with a further correction, trading 10Y/20Y/30Y butterfly.

Strategic Memorandum DSTE391
FICC Research Dept.

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Auction Details

Auction Date:	July 21, 2020
Issue Date:	July 22, 2020
Maturity Date:	June 20, 2040
Offering Amount:	About 1.2 trillion yen

* New 20Y JGBs, JL173, will likely carry a 0.4% coupon.

** On July 20, WI barely traded, and closed at 0.425% (+1.5bp v. previous day's close). JL172 traded at 0.410-0.420% (+0.5 - +1.0bp) and closed at 0.415% (+1.0bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

This will likely be the first auction since February 2019 to be held at the yield level above 0.4%

The last auction, which was preceded with yields in the range of 0.385-0.390% (down 0.5bp to unch v. previous day's close), was a successful one, and after that fading expectations of the BOJ increasing its purchases in the over-10-year zone to accommodate the large increase in issuance temporarily pushed the 20-year JGB yield up to 0.450% during intraday trading on July 2. Once the 30-year JGB auction went well, market sentiment around the long end of the curve improved and the 20-year yield momentarily dropped to 0.380%. It has since been trading at around 0.40-0.43%. Based on today's market levels, this will likely be the first auction since the one held in February 2019 to be held at the yield above 0.4%.

The period of time that the 20-year yield spends above 0.4% appears to be increasing

With the start of the large issuance increases from July, the supply-and-demand rebalancing between the MOF issuance and the BOJ purchase seems to have increased the time that the 20-year JGB yield spends above 0.4%. Anxiety over the direction of the economy has become entrenched amid rising concerns over a second wave of covid-19 cases, and it remains difficult to see any exit path from the monetary easing and fiscal expansion occurring globally. Under these conditions, the key points to consider ahead of the auction can be summarized as follows:

- ✓ **We expect some demand for short covering by dealers:** Positions appear to lean short for issues near the on-the-run 20Y issue, and some demand for covering these short positions looks likely to provide support;
- ✓ **Key for the new issue (JL173, maturing June 2040) will be demand from investors who are unlikely to benefit sufficiently from the BOJ's covid-19 operations:** As already noted, the bidding yields at tomorrow's auction are likely to be above 0.4% for the first time since the February 2019 auction. Although it should not be hard to make purchases commensurate with absolute yields, the 20-year JGB yield has recently been trading in the 0.40-0.43% range and appears to have settled in there. This is not a level that is likely to evoke aggressive buying. However, this auction will be of a new issue (JL173 maturing June 2040), which is likely to increase expectations of demand from investors unable to easily benefit from the BOJ's covid-19 fudding-provision operations;
- ✓ **Not especially rich based on relative value:** The 20-year sector has not looked especially cheap or rich relative to the main sectors in the intermediate and superlong zones since the previous auction (Reference 3). The 20-year asset swap has steadily become more positive relative to yen LIBOR (cash bonds have become cheaper) since the last auction, making 20-year cash JGBs increasingly attractive relative to swaps (Reference 6);
- ✓ **The BOJ is unlikely to increase its purchases:** BOJ Governor Kuroda was asked about superlong yields at his regularly scheduled press conference following the policy meeting on July 15, and he gave the same answer that he did following the June policy meeting. This reaffirms that the BOJ has not changed its stance of leaving superlong JGBs up to market forces. Given the current level of superlong JGB yields and shape of the yield curve, we think the BOJ is unlikely to increase its JGB purchases in the over-10-year zone.

Easily absorbable: We think about our bidding stance assuming the 20-year yield will remain in the range of 0.40-0.45%

Overall, we expect the upcoming auction to be a satisfactory one. We consider our bidding stance assuming the 20-year yield stays in the range of 0.40-0.45% over the next month. It is easy to envision buying asset swaps based on relative value. The 20-year asset swap has steadily become more positive relative to yen LIBOR (cash bonds have become cheaper) since the last auction. Even if there is a third supplementary budget, further issuance increases of superlong JGBs are unlikely. From a slightly longer-term perspective, there is a possibility that fiscal worsening from expansion of the government deficit will be seen as a negative, particularly in the swap market. These should limit any widening of positive spreads from the current level. Although it is not an optimal timing, given the expectation of positive carry, we see room to consider purchasing assets swaps at a positive spread over Yen LIBOR of 15-20bp.

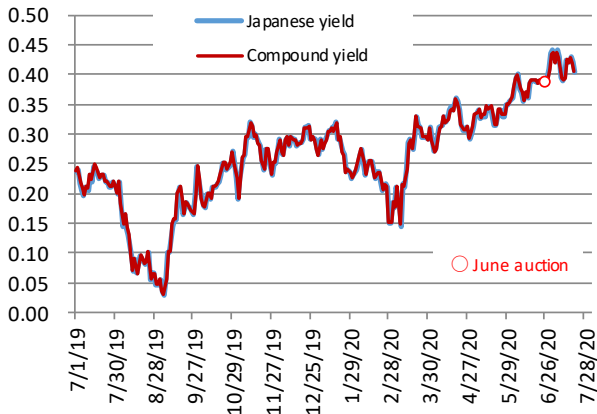
It is hard to justify aggressively purchasing the 10Y/20Y/30Y butterfly (buying the 20Y and selling the 10Y and 30Y) at the current spread level. Because of the prospects for positive carry, even without a change in the shape of the curve, which are expected from the butterfly position, however, a move in the spread to 23-24bp may make it worth considering.

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
7/21/20	173	0.4*	6/20/40	1,200**									
6/26/20	172R	0.4	3/20/40	977.7	3.87	100.24	100.20	0.04	0.386	0.389	0.003	59.9036	Good
5/20/20	172R	0.4	3/20/40	957.3	4.25	101.26	101.20	0.06	0.332	0.335	0.003	36.3983	Good
4/21/20	172	0.4	3/20/40	899.4	3.58	101.21	101.10	0.11	0.335	0.340	0.005	16.5349	Avg
3/12/20	171R	0.3	12/20/39	963.5	3.69	100.98	100.90	0.08	0.248	0.252	0.004	97.2897	Good
2/20/20	171R	0.3	12/20/39	969.8	3.99	101.27	101.25	0.02	0.232	0.234	0.002	81.9560	Good
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

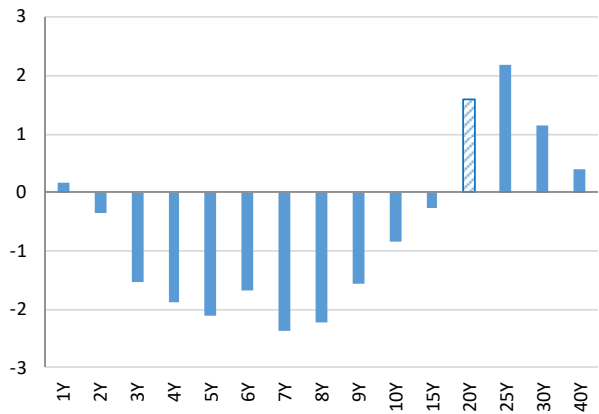
*Daiwa forecast (as of July 20) **Amount the Ministry of Finance plans to issue
 Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 20Y JGB Yield (%)



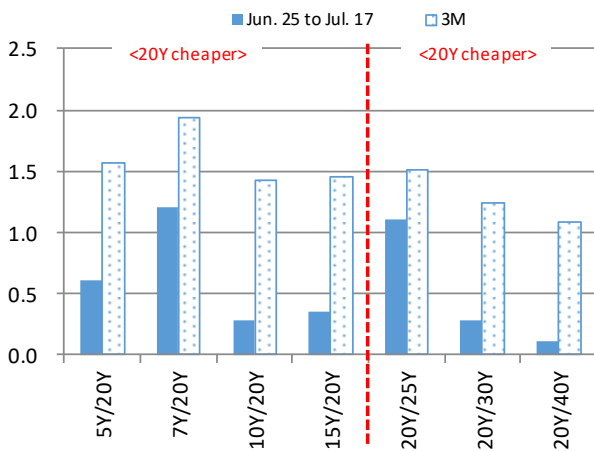
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Jun. 25 v. Jul. 17



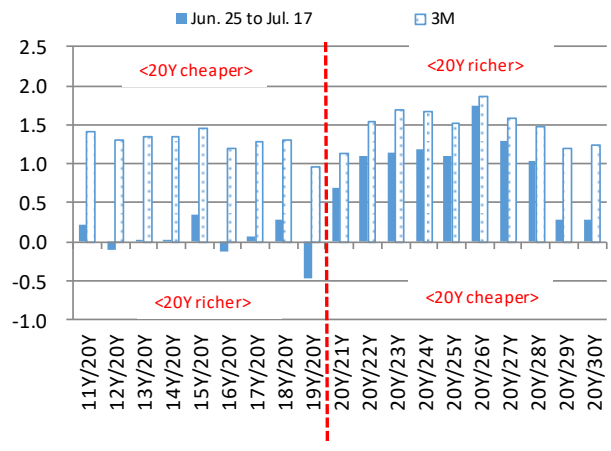
Source: Daiwa Securities.

Appendix 3a: Z-score I



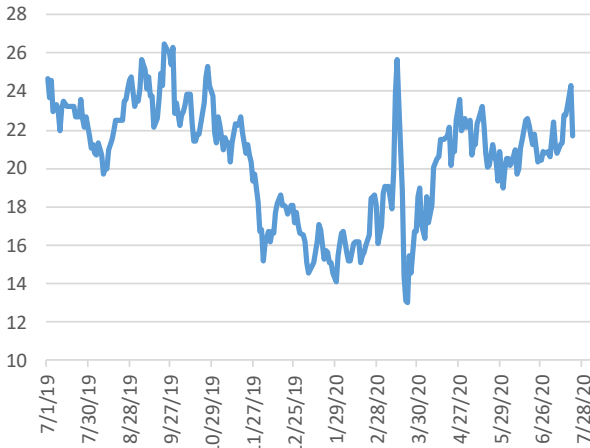
Source: Daiwa Securities.

Appendix 3b: Z-score II



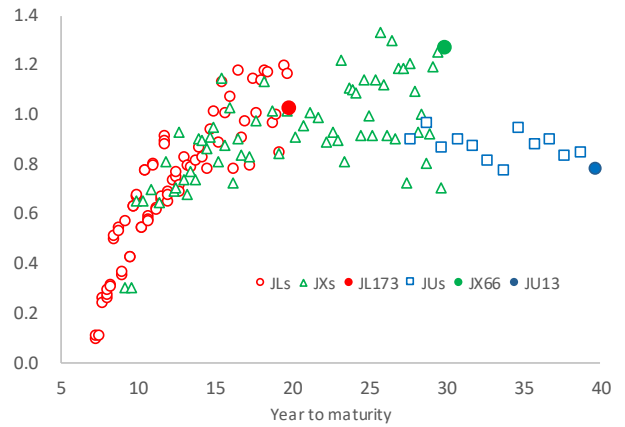
Source: Daiwa Securities.

Appendix 4: JGB 20Y/30Y and 20Y/40Y Spreads (bp)



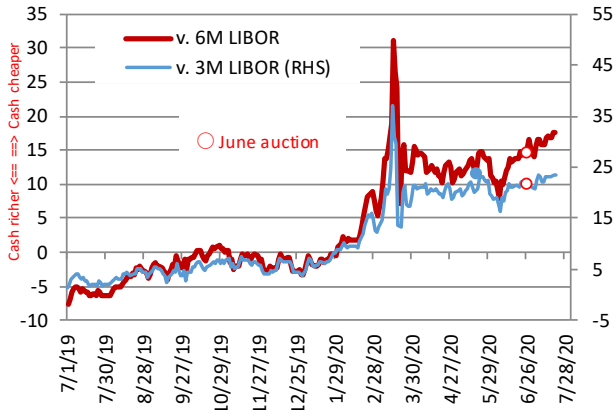
Note: On-the-run issue basis
Source: Daiwa Securities.

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



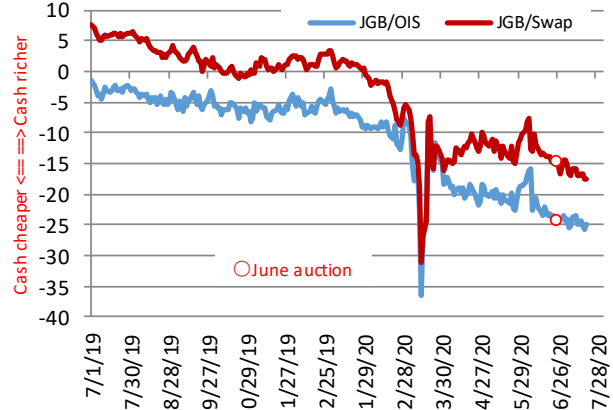
Note: Based on the July-17 JGB yield curve; factoring in roll-down effect etc.; JL173 is supposed to carry a 0.4% coupon and yield at 0.410%.
Source: Daiwa Securities.

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



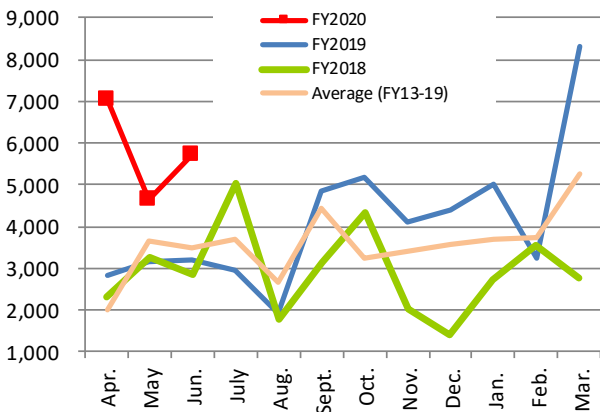
Source: Daiwa Securities.

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



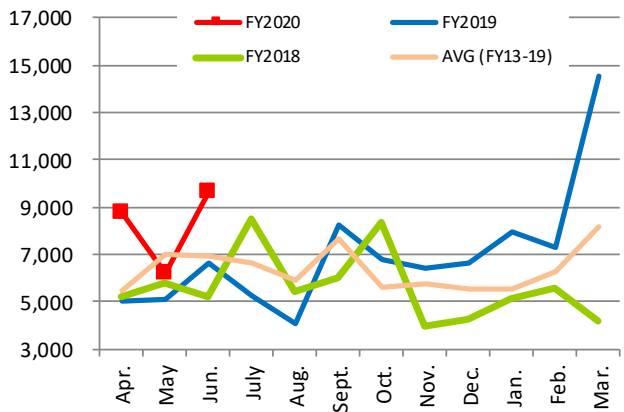
Source: Daiwa Securities.

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



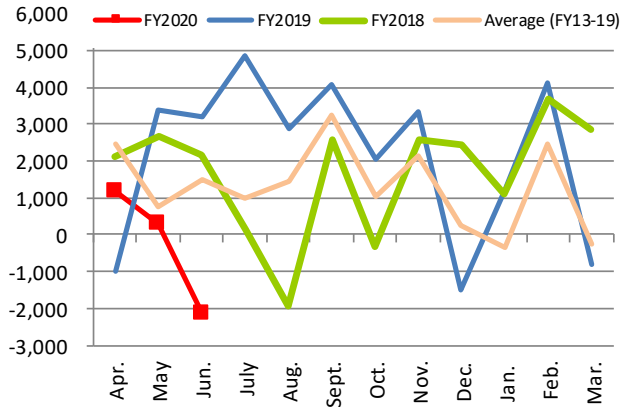
Source: JSDA

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



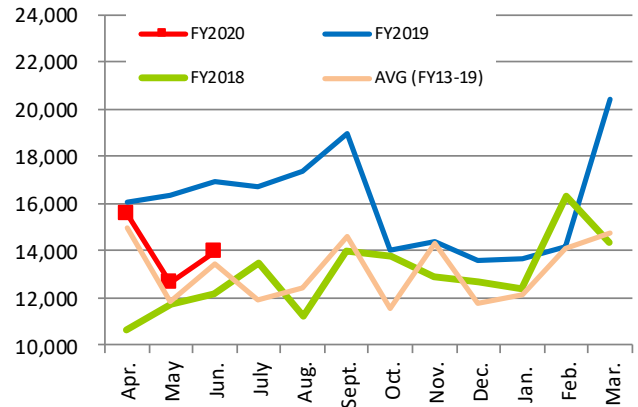
Source: JSDA

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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February 2020

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