

Outlook for 5Y JGB Auction

Expecting fresh 5Y JGBs, JS146, to find proper primary demand

- ✓ We think about our bidding stance, expecting 5Y JGB yield to move in core range of -0.120 - -0.100% over the next one month
- ✓ In terms of relative value, it would be worth considering the 5Y/7Y/10Y butterfly trade (selling 7Y/buying 5Y and 10Y), albeit in a passive manner.

Strategic Memorandum DSTE423
FICC Research Dept.

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Auction Details

Auction Date: January 13, 2021
Issue Date: January 14, 2021
Maturity Date: December 20, 2025
Offering Amount: About 2.5 trillion yen

* New 5Y JGBs, JS146, will likely carry a 0.1% coupon.

** On January 12, WI traded at -0.110 - -0.105% (-1.0 - -0.5bp v. previous day's close) and closed at -0.110% (-1.0bp). JS145 traded at -0.115% (-0.5bp) and closed at -0.115% (-0.5bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Lowering chance of taking fresh 5Y JGBs at yield level above -0.1%

After the previous 5Y JGB auction had an average result at the -0.120 - -0.115% level (-1.0bp - -0.5bp vs. previous day's close), the 5Y JGB yield (JS145 on conventional yield basis) temporarily declined to -0.130% (during intraday trading) amid the firmness of the JGB market. Since then, the yield had risen to -0.105%, while the JGB market had softened. As of 15:00 today (Jan 12), WI and JS145 trade at -0.110 - -0.105% (-1.0 - -0.5bp vs. previous day's close) and -0.115% (-0.5bp), respectively. Given the fact that market sentiment is good in the 5Y sector, we think it difficult to take new 5Y JGBs at the yield level above -0.1%.

Although upward pressure on US yields is increasing, BOJ has strong commitment to YCC policy

We check the environment surrounding the JGB market. In the US, the Democratic Party will take control of both the Senate and House of Representatives under. Under President-elect Joe Biden, both of "good yield increase" (rise in potential growth rate and economic growth, which outpaces the potential growth rate) and "pernicious yield increase" (fiscal deterioration, rise in inflation rate without economic expansion) appear possible. Upward pressure on US yields is thus increasing. In Japan, upward pressure on yields is unlikely to strengthen compared to that in the US, as the BOJ is unlikely to change the framework of the yield curve control (YCC) policy although it is currently assessing monetary policy. Amid the rapid spread of Covid-19, the Japanese government declared another state of emergency for Tokyo and three neighboring prefectures on January 7 (until Feb. 7). Soon after this, the state of emergency is expected to be expanded to three

western prefectures. Worries about the economic outlook are likely to strengthen. In such a situation, we summarize key points to think about the bidding stance at tomorrow's auction as follows:

- ✓ **Short-covering is expected to serve as a support:** In the 5Y sector, market participants seem to be short enough. Short-covering is thus likely to serve as a support;
- ✓ **We can expect a certain degree of demand from investors:** As mentioned above, it appears difficult to take new 5Y JGBs at the level above -0.1% as market sentiment is good in the 5Y sector. However, we can expect a certain degree of demand from investors partly because tomorrow's auction will likely be held still around the upper limit of the range since the previous auction and new 5Y JGBs will be "fresh" in a new maturity basket or not a tap issue;
- ✓ **Not strikingly cheap on the curve, while becoming more undervalued against swaps:** Our analysis based on data since the previous 5Y JGB auction shows that the 5Y sector is not strikingly cheap on the curve at the current level. Rather, it is noticeably overvalued vs. the 7Y and 20Y sectors (Appendix 4). As the 5Y swap spread has been in a tightening trend since the previous auction, 5Y cash has been becoming more undervalued against swaps (Appendix 7);
- ✓ **The BOJ could offer six purchase operations in the 3-5Y zone:** The next 5Y JGB auction is scheduled for February 18. In the period from tomorrow's auction to the next auction, it is highly likely that the BOJ will offer six purchase operations in the 3-5Y zone (three times this month and we expect three times in Feb). If we assume that the current offer amount will be unchanged, the total purchase amount is estimated at around 2.52tn yen (= 420bn yen x 6 times) vs. tomorrow's issuance amount of 2.5tn yen. Although we are worried about the fact that the bid-to-cover ratio was below 2.0X in recent two operations, the chance appears to be small that the BOJ will reduce the offer amount in the very near future.

We think about our bidding stance, expecting the 5Y JGB yield to move in a core range of -0.120 - -0.100% over the next one month

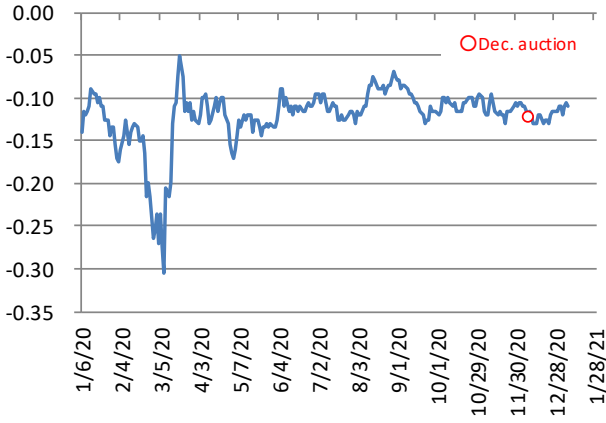
All in all, we would like to think about our bidding stance, expecting the 5Y JGB yield to move in a core range of -0.120 - -0.100% over the next one month. In terms of relative value, it would be worth considering the 5Y/7Y/10Y butterfly trade (selling 7Y/buying 5Y and 10Y), albeit in a passive manner. This is because (1) positive carry can be expected even if the shape of the yield curve is unchanged and (2) the 5Y/7Y/10Y's curvature is unlikely to decline substantially unless the market advances sharply (Appendix 6).

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 (%)	
1/13/21	146	12/20/25	0.1*	2.5**									
12/8/20	145R	9/20/25	0.1	2.5	3.96	101.05	101.03	0.02	-0.118	-0.114	0.004	91.2414	Avg.
11/12/20	145R	9/20/25	0.1	2.7	3.52	101.00	101.00	0.00	-0.105	-0.105	0.000	87.5921	Good
10/18/20	145	9/20/25	0.1	2.7	4.90	100.95	100.94	0.01	-0.091	-0.089	0.002	40.8768	Good
9/8/20	144R	6/20/25	0.1	2.5	3.56	100.92	100.90	0.02	-0.091	-0.087	0.004	96.8040	Poor
8/20/20	144R	6/20/25	0.1	2.5	3.55	100.94	100.93	0.01	-0.093	-0.091	0.002	99.4049	Avg.
7/9/20	144	6/20/25	0.1	2.7	4.25	101.01	101.00	0.01	-0.103	-0.101	0.002	82.5283	Good
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

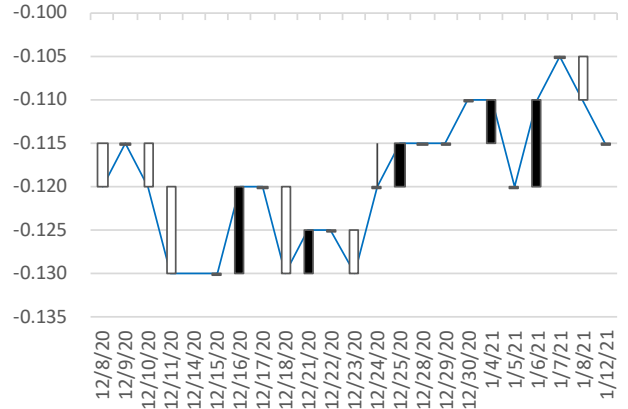
* Daiwa forecast as of Jan. 12 ** Amount the MOF plans to issue
Source: Ministry of Finance, Daiwa Securities.

Appendix 1a: 5Y JGB Yield (%)



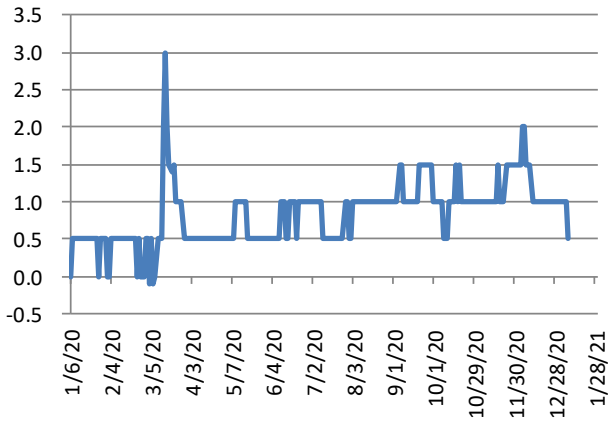
Note: On-the-run issue
Source: Daiwa Securities.

Appendix 1b: Candle of JS145 Yield (%)



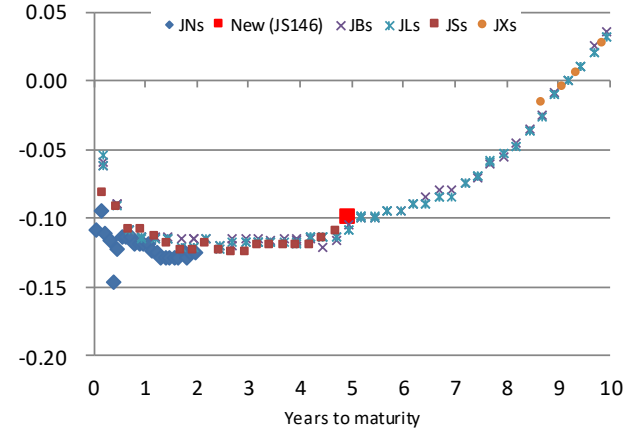
As of 15.00 JST on Jan. 12
Source: Daiwa Securities.

Appendix 1c: On- and Off-the-Run Issues Spread (bp)



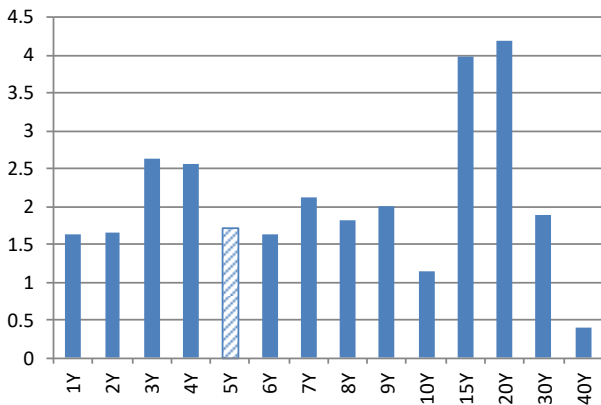
Note: On-the-run issue and off-the-run issue 3 months early to mature
Source: Daiwa Securities.

Appendix 2: JGB Yield Curve (% as of Jan. 8)



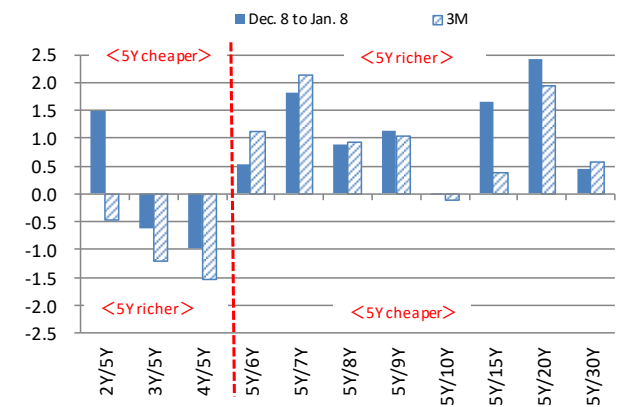
Source: Daiwa Securities.

Appendix 3: JGB Yield Change (bp): Dec. 8 vs. Jan. 8



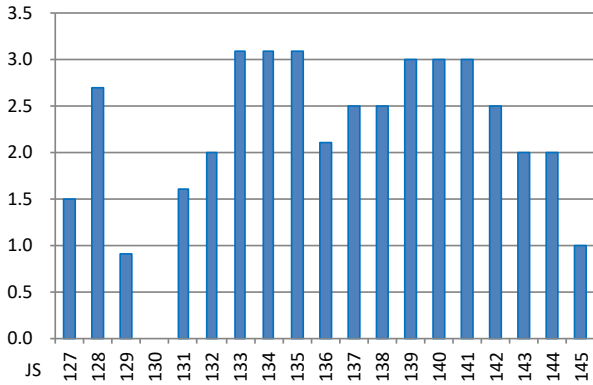
Note: Generic compound yield
Source: Daiwa Securities.

Appendix 4: Z-scores of JGB Yield Spreads



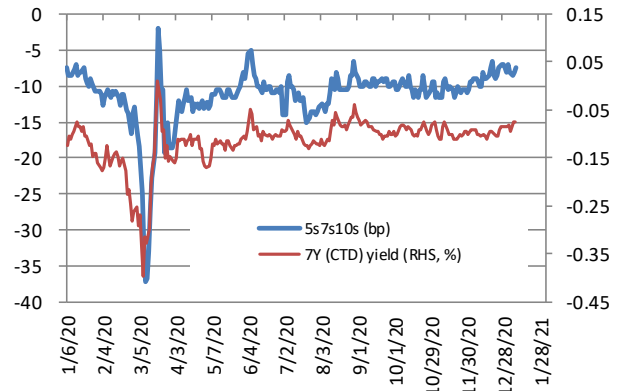
Note: Generic compound yield
Source: Daiwa Securities.

Appendix 5: JS Yield Change (bp): Dec. 8 vs. Jan. 8



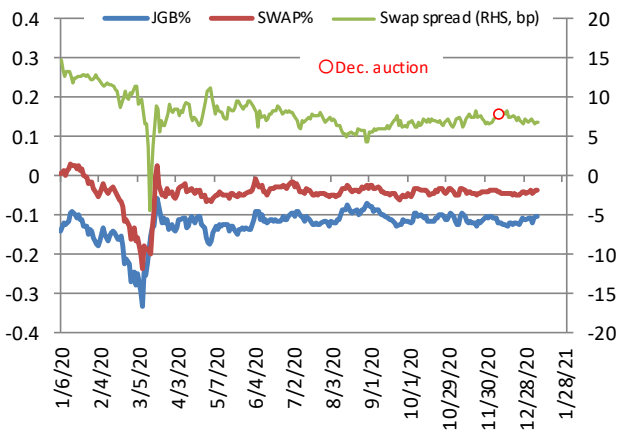
Source: Daiwa Securities.

Appendix 6: JGB 5Y/7Y/10Y Butterfly Spread (bp)



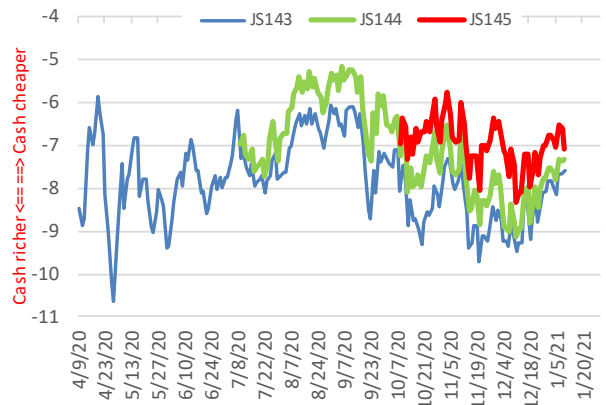
Note: On-the-run and CTD compound yield
Source: Daiwa Securities.

Appendix 7a: 5Y Swap Spread (bp)



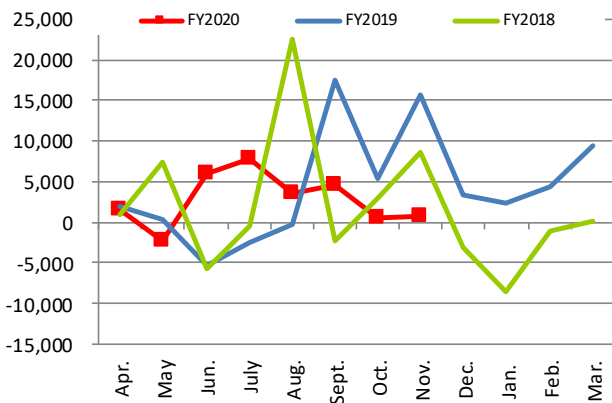
Source: Daiwa Securities.

Appendix 7b: JS Asset Swap (bp)



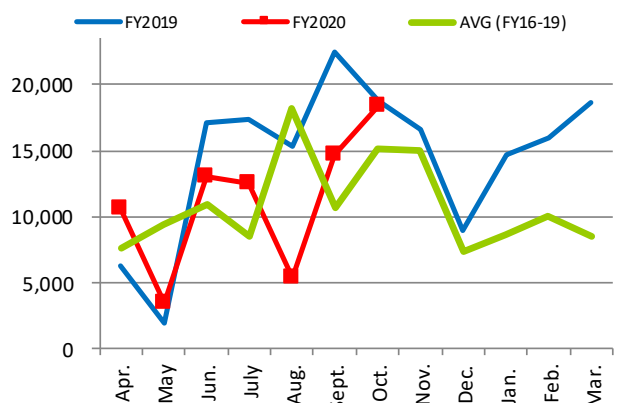
Note: Yen-Libor basis
Source: Daiwa Securities.

Appendix 8a: Net Purchase of Intermediate-term JGBs by Major Banks (Yen 100 millions)



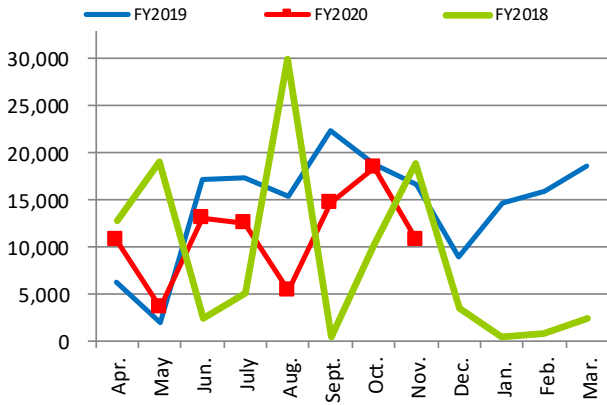
Source: JSDA

Appendix 8b: Gross Purchase of Intermediate-term JGBs by Major Banks (Yen 100 millions)



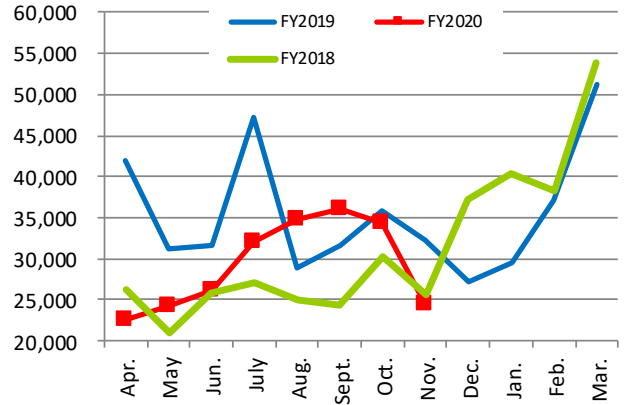
Source: JSDA

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



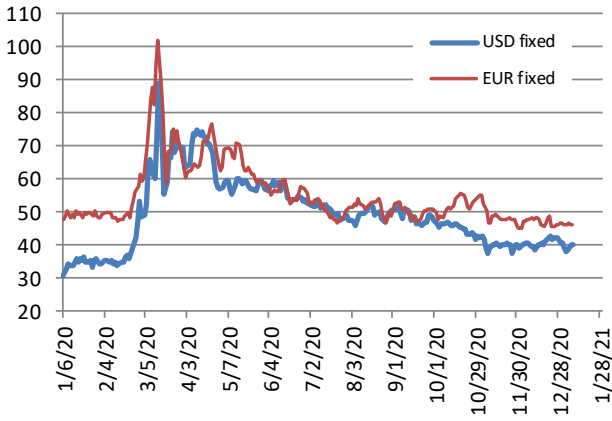
Source: JSDA

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



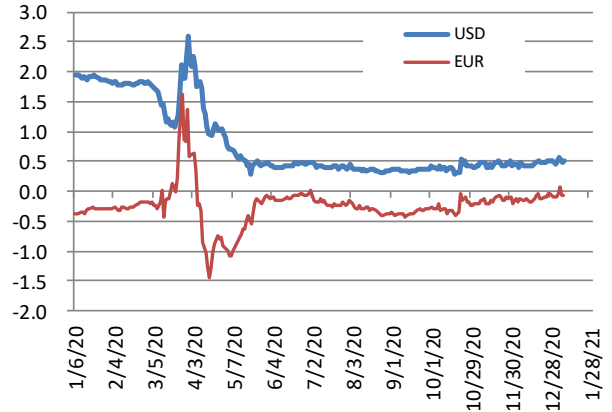
Source: JSDA

Appendix 10a: 5Y JGB Benchmark Spreads (bp)



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

Appendix 10b: 5Y Hedged JGB Return (%)



Source: Daiwa Securities

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■ Credit Rating Agencies

[Standard & Poor's]

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February 2020

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- 1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies. As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter's outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.
- 2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITs: Daiwa Office Investment Corporation (8976), Nippon Healthcare Investment Corporation (3308), Japan Rental Housing Investments (8986).
- 3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.
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- 5) Daiwa Securities Group Inc. and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group Inc. is to acquire up to 5.01% of Credit Saison's total common shares outstanding (excl. treasury shares; as of 31 Jul 2019).

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- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* 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.

** The ratio of margin requirements etc. to the amount of the transaction 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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