

Outlook for 10Y JGB Auction

Placing bids only to take necessary amounts

- ✓ Assuming that the 10Y JGB yield will move in a tight range around 0.05% over the next one month, we would like to place bids for JB359 tap only to take necessary amount
- ✓ In terms of the relative value, it would be worth considering switching out from 2-4Y sectors

[BOX] September BOJ JGB Purchase: BOJ should provide TDB purchase guideline with more clarity and in conformance with market trends

Strategic Memorandum DSTE398
FICC Research Dept.

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Auction Details

Auction Date:	September 1, 2020
Issue Date:	September 2, 2020
Maturity Date:	June 20, 2030
Offering Amount:	About 2.6 trillion yen

* New 10Y JGBs will likely be the second reopening of JB359 carrying a 0.1% coupon.

** On August 31, JB359 traded at 0.045 - 0.050% (-1.0 - -0.5bp v. previous day's close) and closed at 0.045% (-1.0bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Due to news on Prime Minister Abe's resignation, the 10Y JGB yield temporarily rose to 0.055%, the highest level since July 2

After the previous 10Y JGB auction went smoothly at the 0.020 - 0.025% level (unch +0.5bp vs. previous day's close), the 10Y JGB yield has been mostly on an uptrend amid softening of the JGB market. When the JGB market got bumpy on headlines about Prime Minister Shinzo Abe's resignation in afternoon trading on August 28, the 10Y JGB yield temporarily rose to 0.055%, the highest level since July 2.

Even under the new administration, the focal point will be measures to cope with the Covid-19 pandemic; current fiscal and monetary policies will likely be maintained with a high probability

On August 28, Prime Minister Shinzo Abe announced that he will step down from his post due to health problem, albeit amid the Covid-19 pandemic. According to media reports, his successor—new LDP president—is expected to be chosen at the Joint Plenary Meeting of Party Members of Both Houses of the Diet to be held on September 13, 14 or 15. In addition, an extraordinary Diet session will likely be convened on September 16, and new Prime Minister is likely to be voted as early as on September 17. Focal points in the JGB market are on fiscal and monetary policies under new administration. Considering the current situation with Covid-19, in which the government continues to think about measures to curb an economic downturn, we expect current fiscal/monetary policies to be maintained with a high probability. In terms of the fiscal policy, we are paying attention to the size of a third supplementary budget, which would be compiled in October and beyond. However, it is difficult to factor it into tomorrow's auction. With respect to monetary policy, the current monetary easing is unlikely to change unless BOJ governor Haruhiko Kuroda faces a health issue, for example, because his term of office is set until April 2023. The BOJ is likely to

persistently conduct the current yield curve control (YCC) policy also under the new administration. In such a situation, we summarize key points to think about the bidding stance at tomorrow's auction as follows:

- ✓ **Primary dealers appear to have relatively big short positions:** Short-covering will support sale of JB359 tap.
- ✓ **Decent demand is expected from investors:** Investor demand for 10Y JGBs in positive yield territory appears strong. Under the BOJ's YCC policy, decent demand is expected from investors especially at the 0.05-0.10% level.
- ✓ **Undervalued vs. the 2-4Y sectors, but overvalued vs. the 7-8Y sectors:** Our analysis based on data since the previous 10Y JGB auction shows that the 10Y sector is noticeably undervalued vs. the 2-4Y sectors, but overvalued vs. the 7-8Y sectors on the curve at the current level (Appendix 3). In particular, the overvaluation vs. the 7-8Y sectors is also confirmed by the data over the past three months. As the 7-10Y zone has been flattening, it is difficult to buy JB359 tap against JGB futures aggressively.
- ✓ **In September, the BOJ is expected to continue to offer five purchase operations totaling around 2.1tn yen in the 5-10Y zone:** In the BOJ's Monthly Schedule of Outright Purchases of Japanese Government Bonds (Competitive Auction Method) for September 2020 released last Friday, Aug. 28, the offer range and the number of offers in the 5-10Y zone were unchanged from those for August (see BOX). The BOJ's purchases totaling (at least) around 2.1tn yen (420bn yen x five times) are expected to continue also in September. While Prime Minister Abe will resign amid the pandemic, the BOJ is likely to unwaveringly implement the ongoing monetary easing via "aggressive JGB purchases and other measures," and to persistently conduct the current YCC policy. Support for 10Y JGBs from the BOJ appears to remain rock-solid.

We think about placing bids only to cover positions, assuming that the 10Y JGB yield will move in a narrow range centered at 0.05% over the next month

All in all, we would like to think about placing bids only to cover positions, assuming that the 10Y JGB yield will move in a narrow range centered at 0.05% over the next month. In terms of the relative value, it would be worth considering switching out from the 2-4Y sectors. As mentioned above, the 10Y sector is currently undervalued vs. the 2-4Y sectors. On the following day (Sep 2), the BOJ is scheduled to conduct purchase operations in the 1-5Y zone. For example, switching out from 5Y JGBs with remaining maturity of less than four years will improve carry.

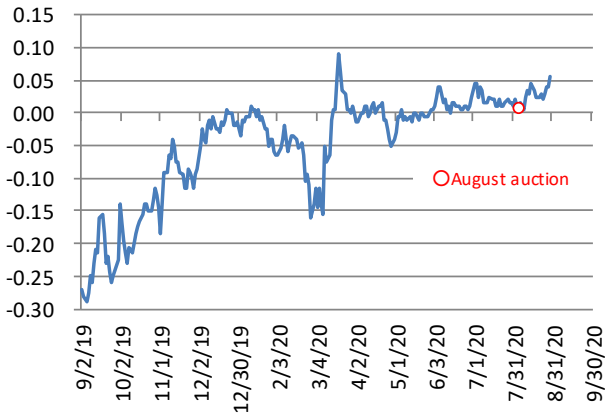
10Y JGB Auction Results

Auction Date	Issue#	Coupon %	Maturity Date	Issue Size (billion yen)	Bid/Cover	Average Accepted Price	Lowest Accepted Price	Tail (yen)	Average Accepted Yield	Highest Accepted Yield	Tail (%)	Allotment %	
9/1/20	359R	0.1	6/20/30	2,600*									
8/4/20	359R	0.1	6/20/30	2,809	3.64	100.80	100.77	0.03	0.018	0.021	0.003	61.8502	Avg
7/2/20	359	0.1	6/20/30	2,844	3.66	100.41	100.39	0.02	0.058	0.060	0.002	48.3429	Good
6/2/20	358R	0.1	3/20/30	2,099	3.36	100.98	100.96	0.02	0.000	0.001	0.001	86.4694	Avg
5/12/20	358R	0.1	3/20/30	2,308	4.09	101.00	100.99	0.01	-0.001	0.000	0.001	72.6710	Good
4/2/20	358	0.1	3/20/30	2,306	4.19	100.76	100.75	0.01	0.023	0.024	0.001	83.0105	Good
3/3/20	357R	0.1	12/20/29	2,309	3.20	101.98	101.84	0.14	-0.100	-0.086	0.014	28.9846	Poor
2/4/20	357R	0.1	12/20/29	2,271	3.63	101.50	101.48	0.02	-0.051	-0.049	0.002	77.1508	Avg
1/7/20	357	0.1	12/20/29	2,171	3.70	101.05	101.03	0.02	-0.005	-0.003	0.002	78.8770	Good
12/3/19	356R	0.1	9/20/29	2,100	3.28	101.40	101.24	0.16	-0.042	-0.026	0.016	95.7891	Poor
11/6/19	356R	0.1	9/20/29	2,100	3.62	101.99	101.94	0.05	-0.099	-0.094	0.005	80.6774	Avg
10/1/19	356	0.1	9/20/29	2,100	3.42	102.62	102.33	0.29	-0.158	-0.130	0.028	6.1227	Poor
9/3/19	355R	0.1	6/20/29	2,412	3.60	103.68	103.66	0.02	-0.265	-0.264	0.001	99.4435	Avg
8/1/19	355R	0.1	6/20/29	2,099	3.76	102.53	102.51	0.02	-0.152	-0.150	0.002	1.7771	Avg

* Amount the MOF plans to issue

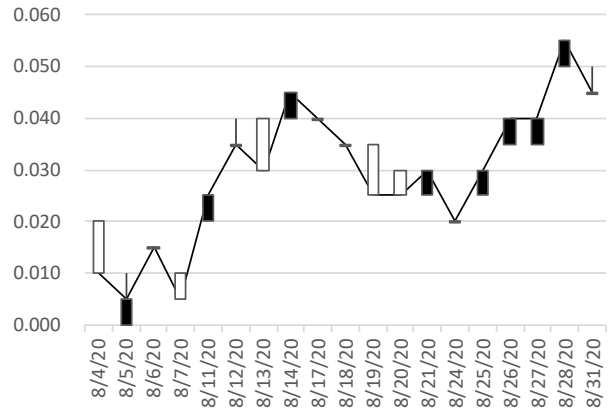
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 10Y JGB Yield (%)



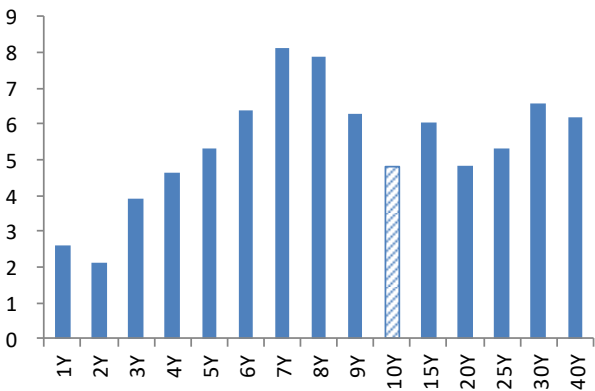
Source: Daiwa Securities.

Appendix 1a: JB359 Yield Candle Chart (%)



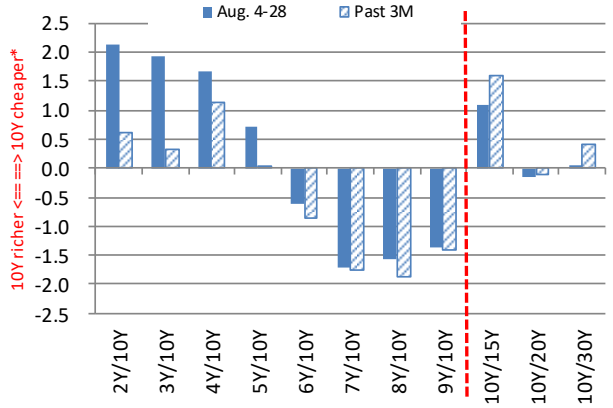
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp, Aug. 4 v. Aug. 28)



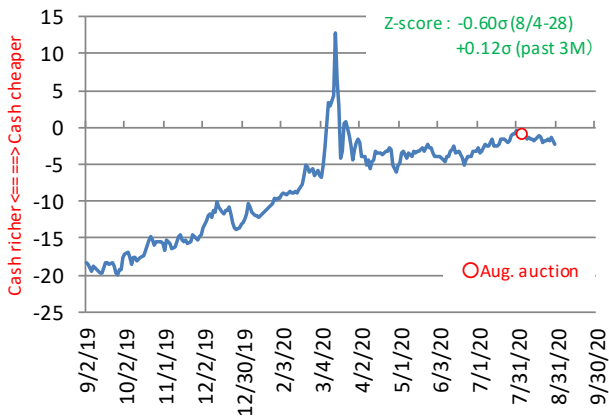
Source: Daiwa Securities.

Appendix 3: Z-scores of JGB Yield Spreads (σ)



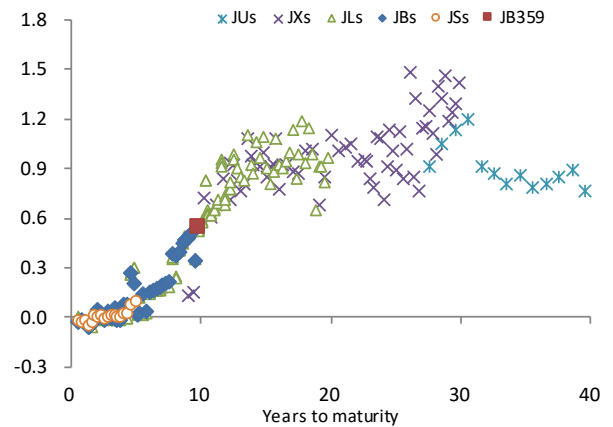
Note: + (-) 10Y richer (cheaper) for 10Y/15Y, 10Y/20Y and 10Y/30Y
Source: Daiwa Securities.

Appendix 4: 10Y JGB Asset Swap Spread (bp)



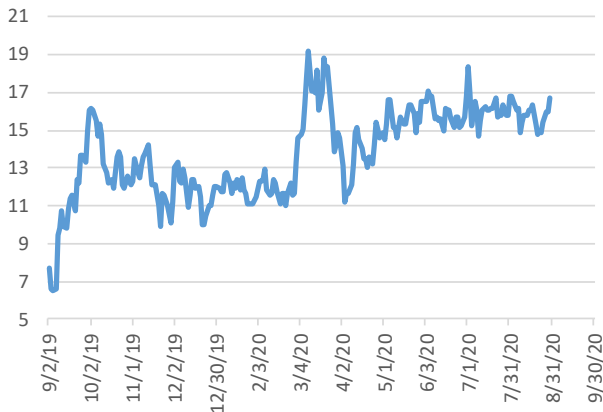
* Yen LIBOR basis
Source: Daiwa Securities.

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



Note: Based on JGB yield curve on Aug. 28; assuming that those yield curve shapes do not change and factoring roll-down effect etc.
Source: Daiwa Securities

Appendix 6: JGB 4Y/10Y Spread (bp)



Note: Generic compound yield
Source: Daiwa Securities.

【BOX】 September BOJ JGB Purchase: BOJ should provide TDB purchase guideline with more clarity and in conformance with market trends

On August 28, the BOJ announced the Monthly Schedule of Outright Purchases of Japanese Government Bonds (Competitive Auction Method) for September 2020, in which the offer range and the number of offers in all the purchase target zones were unchanged from those for August. The number of monthly offer days has declined to nine from ten days in August (Table 1 and 2).

Reflecting this release, it is highly likely that each target zone's offer amount in the first operation in September will be unchanged from that in the last operation in August. Currently, price volatility is high because of Prime Minister Shizo Abe's sudden resignation. However, Witnessed by the fact that auctions of coupon-bearing JGBs in August generally ranged from satisfactory to successful, the MOF supply has not reached the point of amplifying upward pressure on JGB yields. Although intermediate-term JGBs in the over 1-5Y zone remain unstable, the distortions in and softening of supply-demand do not appear to have gotten to the point of pushing the 10Y JGB yield higher. Given current yield levels and curve shape, we think the BOJ is unlikely to be in a hurry to increase purchases in the superlong zone, for which the central bank has decided to "leave up to market forces."

This time, the announcement of Outline of Outright Purchases of Japanese Government Securities was skipped again, meaning that the guideline as of April 27 will remain effective. The BOJ is therefore likely to continue to buy TDBs, maintaining the guideline for the offer amount of "about Y500bn to Y3.0tn" per operation. The August market for TDBs was heavily impacted by the significant increase in issuance (although it has calmed down recently), and TDB yields edged higher with each auction. We think major reason for this is that amid thinning demand from overseas investors and demand for collateral from domestic investors not keeping up with the pace of issuance increases, uncertainty has been rising over the BOJ's stance on TDB purchase operations since it surprised the market by reducing purchases at its TDB purchasing operation on August 4, and this has made it harder for dealers to build and/or maintain TDB positions. The BOJ has provided no guidance other than what it wrote in its Outline of Outright Purchases of Japanese Government Securities released on April 27, which was "the Bank will decide the purchase size per auction considering the effects on financial markets. The Bank will purchase about Y500bn to Y3.0tn of T-bills per auction for the time being." It is reassuring that the GC repo market has settled down, but instability in the T-bill market is likely to spread further out the JGB curve, into the over 1-3Y and eventually the over 3-5Y zones. The BOJ should provide a TDB purchase guideline with more clarity and in conformance with market trends.

Table 1: BOJ's JGB Purchase Plan for September 2020

(Yen billions)

	Offer size per operation		Number of Offers (per month)	First offer size exp. in Sept.		Monthly Total exp. in Sept. (a)	MOF issuance in Sept.* (b)	(a)/(b) (%)	
	Mid				Last offer in Aug.			YCC Avg.***	
JGBs ex Linkers and Floaters									
1 year and less	50	- 150	100	3	100	100	300	-	-
Over 1 to 3 years	250	- 600	425	6	420	420	2,520	3,000	84.0 76.2
Over 3 to 5 years	200	- 500	350	6	350	350	2,100	2,500	84.0 88.2
Over 5 to 10 years	250	- 600	425	5	420	420	2,100	2,600	80.8 104.8
Over 10 to 25 years	50	- 200	125	2	120	120	240	1,200	20.0 78.4
Over 25 years	0	- 50	25	2	30	30	60	1,400	4.3 30.8
Linkers	30	-	-	2	30	30	60	-	-
Floaters (in even months)	100	-	-	1	-	100	-	-	-
TOTAL**:							7,320	10,700	68.4

(Note) "Last offer in Aug." is as of Aug. 25 * Excluding auction II and AEL ** Excluding JGB floaters and JGB linkers *** Based on the sum of 30Y JGB issuance amount and one-half of 40Y JGB issuance amount

Source: Bank of Japan, Ministry of Finance (MOF), Daiwa Securities.

Table 2: BOJ's JGB Purchase Schedule in September 2020

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	
9/1/20 T	9/2/20	10Y JGB Auction									
9/2/20 W	9/3/20		◎	◎		◎			○		
9/3/20 TH	9/4/20	30Y JGB Auction									
9/4/20 F	9/7/20	○			◎			○	3M		
9/7/20 M	9/8/20		◎	◎			◎				
9/8/20 T	9/9/20	5Y JGB Auction								○	
9/9/20 W	9/10/20								6M	○	
9/10/20 TH	9/11/20	20Y JGB Auction									
9/11/20 F	9/14/20		◎	◎	◎				3M		
9/14/20 M	9/15/20	○				◎					
9/15/20 T	9/16/20	AEL for 10Y and 20Y JGBs with over 5 to 15.5 years left to maturity								○	
9/16/20 W	9/17/20		◎	◎	◎				1Y		
9/17/20 TH	-	BOJ MPM (Day 2)									
9/18/20 F	9/21/20	AEL for 2Y, 5Y, 10Y and 20Y JGBs with over 1 to 5 years left to maturity								3M	
9/21/20 M	-	Public Holiday (Respect-for-the-aged Day)								-	
9/22/20 T	-	Public Holiday (Autumnal Equinox Day)								-	
9/23/20 W	9/24/20		◎	◎	◎						
9/24/20 TH	9/25/20	40Y JGB Auction								6M	
9/25/20 F	9/28/20								3M		
9/28/20 M	9/29/20		◎				◎	○			
9/29/20 T	9/30/20	2Y JGB Auction								○	
9/30/20 W	10/1/20	○		◎	◎						

Note: ◎ Announced by BOJ on Aug. 28, ○ Daiwa forecast as of Aug. 31

Source: Bank of Japan, Ministry of Finance (MOF), Daiwa Securities.

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[Standard & Poor's]

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February 2020

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- 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.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association