

Outlook for 20Y JGB Auction

Placing bids with expectation on support around 0.45%

- ✓ As market sentiment of 20Y JGBs appears to be worsening, it would be difficult to take an aggressive bidding stance. However, there are some facts to hearten buyers, such as, new 20Y JGBs auctioned tomorrow will be fresh 20Y JGBs, JL175, to be redeemed in December 2040, the 20Y sector has relative-value advantages etc. as well. We intend to take a stance of buying in a small lot, expecting support around 0.45%.

Strategic Memorandum DSTE424
FICC Research Dept.

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Auction Details

Auction Date: January 19, 2021
Issue Date: January 20, 2021
Maturity Date: December 20, 2040
Offering Amount: About 1.2 trillion yen

* New 20Y JGBs, JL175, will likely carry a 0.4% or 0.5% coupon.

** On January 18, WI barely traded, and closed at 0.450% (+2.5bp v. previous day's close). JL174 traded at 0.435-0.445% (+2.0 - +3.0bp) and closed at 0.440% (+2.5bp).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

20Y JGB yield at the highest level since July 2020; a certain degree of expectations for support at around 0.45%

The 20Y JGB yield traded at 0.370% during intraday trading on the following day of the previous 20Y JGB auction, which went smoothly at the 0.365-0.370% level (-1.0 - -0.5bp vs. previous day's close). After that, the yield edged higher amid the softness of the JGB market. Today (Jan. 18), the yield temporarily rose to 0.445%, the highest level since July 2020. Given the current shape of the 20Y JGB yield curve, we think that tomorrow's auction will likely be held at the highest bidding yield level since the auction in January 2019. As market sentiment for 20Y JGBs is worsening, it is difficult to buy aggressively. However, we should have a certain degree of expectations on support at around 0.45%.

MOF may not need to issue more JGBs in the market for the economic packaged, but market participants have been requesting further issuance of 20Y and 40Y JGBs persistently

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 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 speculations on JGB purchase operations easily emerge under the central bank's "monetary policy assessment." In addition, worries about the economic outlook are likely to strengthen partly because the Japanese

government declared another state of emergency (until Feb. 7). In such a situation, we summarize key points to think about the bidding stance at tomorrow's auction as follows:

- ✓ **Primary dealers do not appear to be short in the 20Y sector:** It is difficult to expect strong support from short-covering. The key for the auction would be the level of demand from investors;
- ✓ **A certain degree of investor demand is expected for new 20Y JGBs in a new maturity basket (JL175) at the 0.4% level:** There are no strong worries about demand from investors for new 20Y JGBs in a new maturity basket (JL175), for which bids are expected to be placed at the 0.4% level. This is all the more so, if the issue carries a 0.4% coupon and is sold under par at the auction;
- ✓ **Cheap on the curve, while becoming more overvalued against swaps:** Our analysis based on data since the previous 20Y JGB auction and that over the past three months show that the 20Y sector is markedly undervalued vs. the 5-7Y and 10-19Y sectors on the intermediate to superlong zone of the curve at the current levels (Appendix 3). The 20Y asset swap spread has been widening, albeit quite moderately, after hitting a peak at around the Yen LIBOR+20bp in August (Appendix 6). As the current level points to a slight widening compared to the level as of the previous auction, 20Y cash is becoming more overvalued against swaps;
- ✓ **Supply to continue until the Liquidity Enhancement Auction scheduled for February 10:** Starting from tomorrow's 20Y JGB auction, superlong JGBs are slated to be auctioned every week (totaling around 3.1tn yen) until the Liquidity Enhancement Auction for JGBs with over 15.5 years and less than 39 years left to maturity scheduled for February 10. By then, the BOJ may offer two purchase operations (once this month and we expect once in Feb) each in the 10-25Y zone and the over 25Y zone. However, the total purchase amount is not so large—only at around 300bn yen, which may easily prolong anxiety about the downside of superlong JGBs, rather than expectations for the upside.

Placing bids to buy in a small lot with expectations on support around 0.45%

All in all, we would like to take a stance of buying in a small lot at tomorrow's auction, expecting 20Y JGBs to find good support around 0.45%. In terms of the relative value, it would be worth considering switching out from the 5Y and 10Y sectors (Appendix 6). The switching appears attractive because (1) the 20Y sector is noticeably undervalued vs. those sectors at the current levels and (2) the BOJ is scheduled to conduct three purchase operations each in the 3-5Y zone and 5-10Y zone during the period after tomorrow's auction toward the end of month.

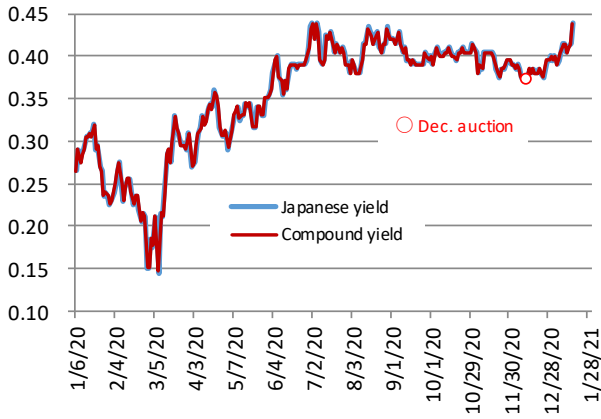
20Y JGB Auction Results

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
1/19/21	175	0.4*	12/20/40	1,200**									
12/10/20	174R	0.4	9/20/40	1,199.6	3.01	100.62	100.50	0.12	0.366	0.372	0.006	14.6471	Avg
11/18/20	174R	0.4	9/20/40	1,280.3	3.61	100.22	100.15	0.07	0.388	0.391	0.003	17.0997	Good
10/20/20	174	0.4	9/20/40	1,304.1	3.86	100.10	100.05	0.05	0.394	0.397	0.003	18.5341	Good
9/10/20	173R	0.4	6/20/40	1,243.1	3.69	99.85	99.75	0.10	0.408	0.413	0.005	75.5975	Avg
8/25/20	173R	0.4	6/20/40	1,316.2	3.92	99.94	99.90	0.04	0.403	0.405	0.002	67.8187	Good
7/21/20	173	0.4	6/20/40	1,313.4	3.80	99.70	99.65	0.05	0.416	0.419	0.003	28.5714	Good
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

* Daiwa forecast as of 15:00 JST on Jan. 18 ** Amount the Ministry of Finance plans to issue

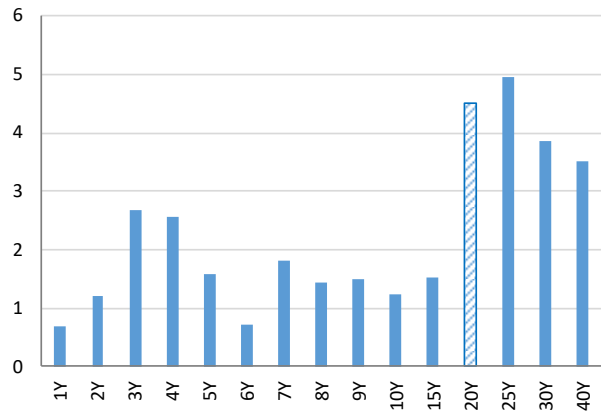
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1: 20Y JGB Yield (%)



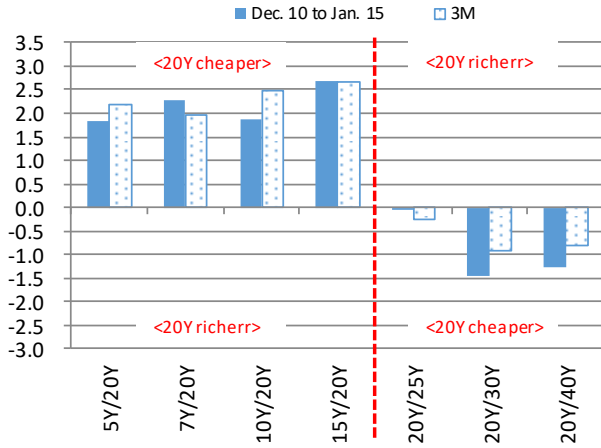
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp): Dec. 10 vs. Jan. 15



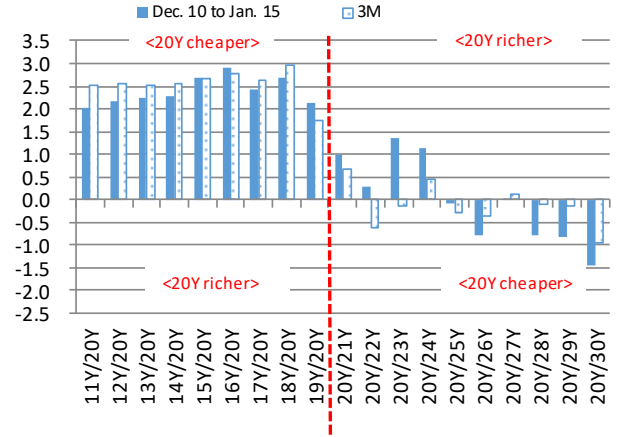
Source: Daiwa Securities.

Appendix 3a: Z-score I



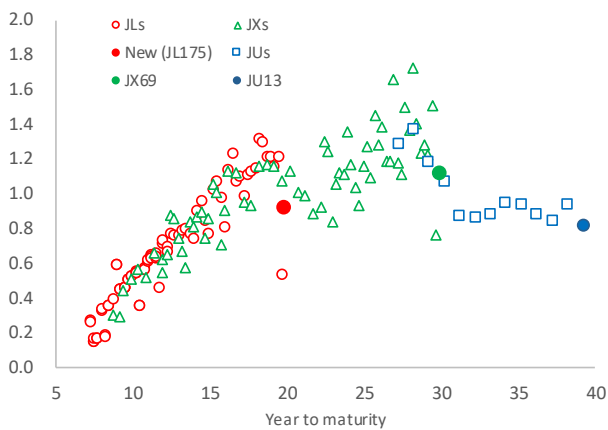
Source: Daiwa Securities.

Appendix 3b: Z-score II



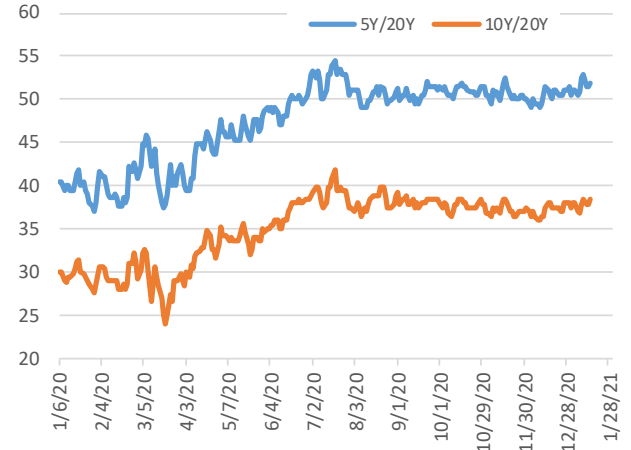
Source: Daiwa Securities.

Appendix 4: JGB Total Return Curve (3M, %)



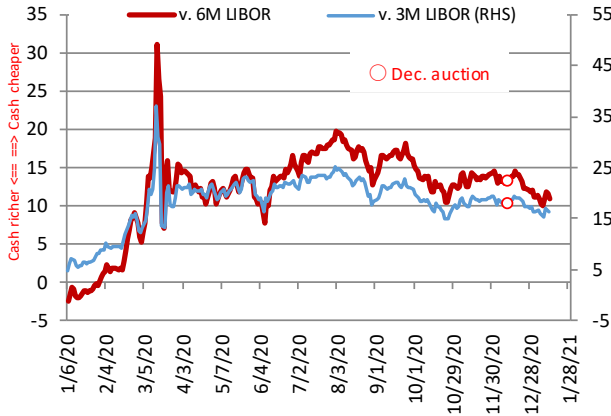
Note: Based on the Jan-15 JGB yield curve; factoring in roll-down effect etc.; New 20Y JGBs, JL175, are supposed to have a 0.4% coupon and 1bp spread (on Japanese yield) to JL174.
Source: Daiwa Securities.

Appendix 5: JGB 5Y/20Y, 10Y/20Y Spreads (bp)



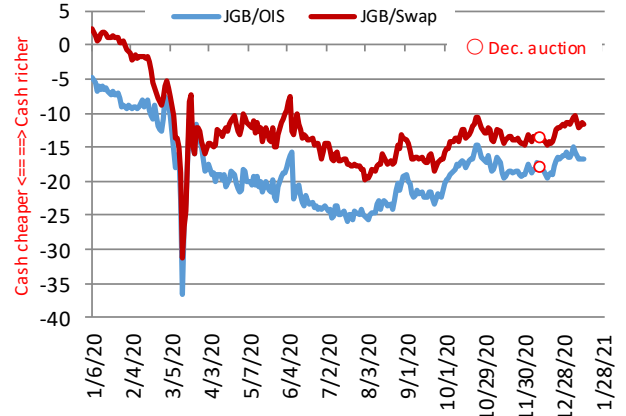
Note: On-the-run issue compound yield
Source: Daiwa Securities

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



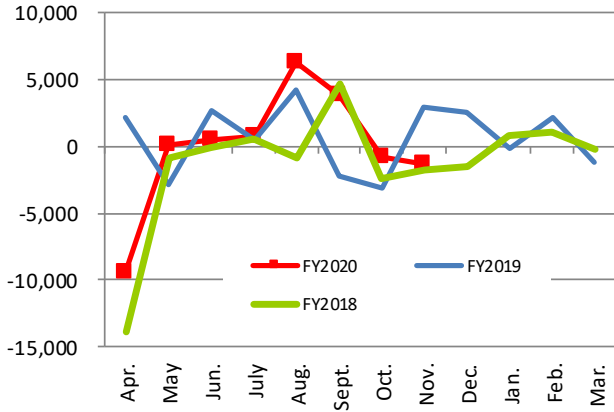
Source: Daiwa Securities.

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



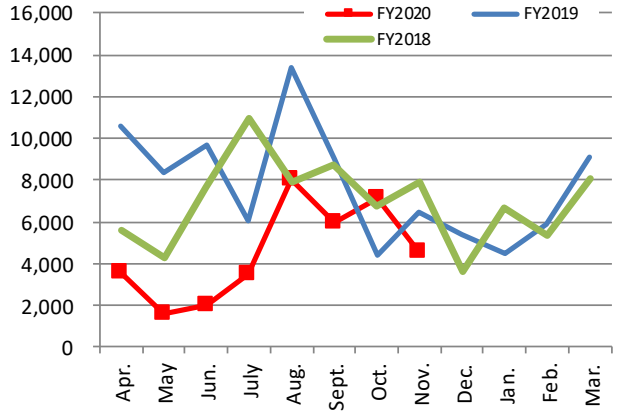
Source: Daiwa Securities.

Appendix 7a: Trend of Major Banks' Net Purchase of Superlong JGBs (Yen 100M)



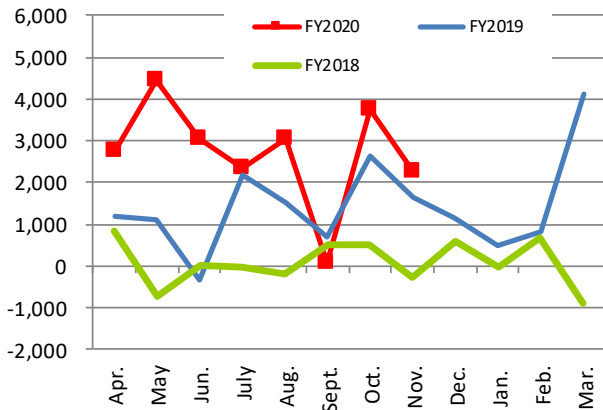
Source: JSDA

Appendix 7b: Trend of Major Banks' Gross Purchase of Superlong JGBs (Yen 100M)



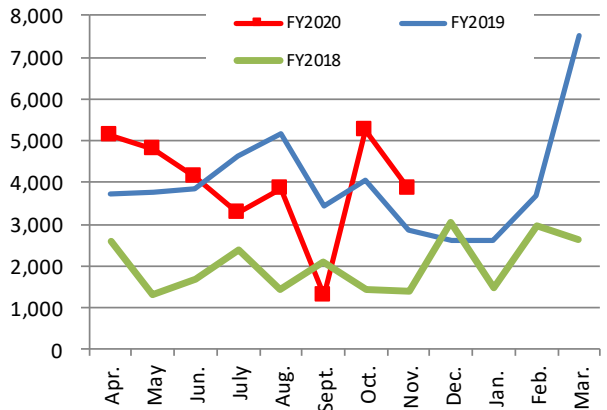
Source: JSDA

Appendix 8a: Trend of Regional Banks' Net Purchase of Superlong JGBs (Yen 100M)



Source: JSDA

Appendix 8b: Trend of Regional Banks' Gross Purchase of Superlong JGBs (Yen 100M)



Source: JSDA

Explanatory Document of Unregistered Credit Ratings

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- 2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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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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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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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.
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- 3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.
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- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
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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.

** 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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