

Outlook for 10Y JGB Auction

Bidding with 0.06-0.10% range in mind

- ✓ Tomorrow's auction is expected to go smoothly or well on expectations for primary dealers' demand to cover short positions and investor demand. We would like to think of our bidding stance to solidly take the necessary amount, assuming that 10Y JGB yield will be range-bound between 0.06% and 0.10%.
- ✓ In terms of relative value, it would be worth considering switching out from 20Y sector, including 10Y/20Y/30Y butterfly

Strategic Memorandum DSTE439
FICC Research Dept.

Senior JGB Strategist
Keiko Onogi
+813 5555 8788
keiko.onogi@daiwa.co.jp
Daiwa Securities Co. Ltd.

Auction Details

Auction Date: May 11, 2021
Issue Date: May 12, 2021
Maturity Date: March 20, 2031
Offering Amount: About 2.6 trillion yen

* New 10Y JGBs will likely be the first reopening of JB362 carrying a 0.1% coupon.

** On May 10, JB362 traded at 0.080% (unch v. previous day's close) and closed at 0.080% (unch).

Exp. Rating on Auction Results

1	2	3	4	5
Failed	Poor	Average	Good	Outstanding

Tomorrow's auction will likely be held at the lowest bidding yield level since the auction in February 2021

After the previous 10-year JGB auction in April went well at the 0.125-0.130% level (vs. WI closing at 0.105% on previous day), the 10Y JGB yield (JB362 on conventional yield basis) temporarily declined from 0.120% to 0.060% during intraday trading on April 23 amid the firmness of the JGB market. Since then, with softening US Treasuries, the JGB market headed down, leading the 10Y JGB yield down to 0.090% at one point on an intraday basis. After the Golden Week holidays, the yield is moving at 0.080-0.085% level. It is highly possible that tomorrow's auction will be held at the lowest bidding yield level since the auction in February 2021.

10Y JGB yield may be range-bound between 0.06% and 0.10% in the near term

We look at the environment surrounding the JGB market. In the US, the 10Y Treasury yield has been lacking a clear direction since late April, as witnessed by the yield remaining in a relatively narrow range at around 1.6%. Under the Biden administration, there are strongly rooted expectations of a rise in interest rates, and both the good kind of interest rate rise (from an increase in the potential growth rate and an even faster economic expansion) and the bad kind (from a worsening of the fiscal balance and an increase in inflation without economic growth) appear to be possible. Although recent economic indicators appear mixed, distribution of Covid-19 vaccines is quite smooth, which is easing worries about the economic outlook. From the macro viewpoint, downward pressure on yields is unlikely to strengthen. In contrast, Japan, where vaccine rollout is still delayed, decided to extend the state of emergency and the "manbo" quasi-state of emergency measures by the end of May

(initially set until the 11th), alongside expansion of the targeted areas. At this point, however, the negative economic impact of the declaration of the third state of emergency (including impact of extension/expansion) is expected to be smaller than those of the first and second cases. From a slightly longer-term perspective, Japanese stock prices also appear to be stable at high levels. If we assume that US long-term yields will remain range-bound and domestic factors are unlikely to serve as a factor to clarify the direction of the JGB market, the 10Y JGB yield may move in the 0.06-0.10% range in the near term. In such a situation, we summarize key points to think about the bidding stance at tomorrow's auction as follows:

- ✓ **Solid short-covering demand expected:** the auction is unlikely to tail;
- ✓ **A certain degree of demand is expected from investors:** As 10-year JGBs are in positive yield territory and we can expect a relatively high carry, investor demand appears to remain strong;
- ✓ **Not attractive in terms of relative value:** Our analysis based on data since the previous 10-year JGB auction and that over the past three months show that the 10-year sector is neither markedly rich nor cheap on the curve at the current level (Appendix 3). Since the previous auction, the 10-year asset swap spread has remained largely flat in a narrow range, suggesting that 10Y cash is neither noticeably overvalued nor undervalued against swaps (Appendix 4);
- ✓ **The number of the BOJ's purchase operations by the June auction may be limited to three to four times (around 1.35-1.80tn yen):** It is highly possible that the BOJ will offer only three to four purchase operations in the over-5Y to 10Y zone during the period after tomorrow's auction until the auction on June 3 (three times in May and we expect zero or once in Jun). If the current offer amount in this zone is unchanged, the purchases are expected to amount to around 1.35-1.80tn yen (450bn yen x three to four times) vs. tomorrow's issuance amount of 2.6tn yen. Given the fact that the purchase amount during the period after the April auction until the May auction was at around 2.25tn yen (450bn x five times), the exit looks narrow this time.

Tomorrow's auction expected to go smoothly or well depending on demand from investors / Relatively easy to think of switching out from the 20Y sector

Given the above, we see that tomorrow's auction will go smoothly or well depending on demand from investors. We would like to think of our bidding stance to solidly take the necessary amount. Despite the lack of attractiveness in terms of the relative value, it would be relatively easy to think of switching out from the 20Y sector. This is because (1) JB362 is superior to, for example, JL174-176 in terms of carry (reflecting high rolldown effect, etc., Appendix 8), (2) the 20Y sector became more expensive in the 10-30Y zone of the curve under the favorable supply/demand environment of superlong JGBs after the start of the new fiscal year (Appendix 7), and (3) since the beginning of the new fiscal year, the 10Y/20Y spread has stopped tightening at around 36bp (Appendix 6). Given the fact that the 30Y JGB auction and 20Y JGB auction are scheduled for the 13th and 21st, respectively, we think that switching out from the 20Y sector based on a delta-neutral strategy and/or the 10Y/20Y/30Y butterfly spread are worthwhile.

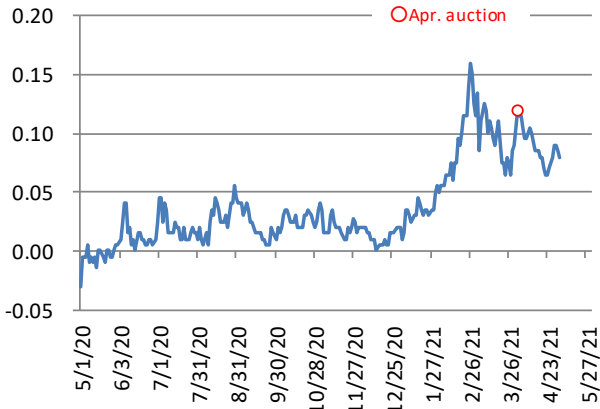
10Y JGB Auction Results

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 %	
5/11/21	362R	0.1	3/20/31	2,600*									
4/1/21	362	0.1	3/20/31	2,848	3.54	99.77	99.76	0.01	0.123	0.124	0.001	82.7380	Good
3/2/21	361R	0.1	12/20/30	2,844	3.14	99.70	99.67	0.03	0.131	0.134	0.003	30.8194	Avg
2/2/21	361R	0.1	12/20/30	2,841	3.42	100.46	100.45	0.01	0.053	0.054	0.001	62.9236	Good
1/6/21	361	0.1	12/20/30	2,599	3.40	100.80	100.77	0.03	0.019	0.022	0.003	32.9842	Avg
12/1/20	360R	0.1	9/20/30	2,812	3.42	100.79	100.77	0.02	0.019	0.021	0.002	69.6232	Avg
11/4/20	360R	0.1	9/20/30	2,824	4.13	100.53	100.52	0.01	0.046	0.047	0.001	73.1880	Good
10/1/20	360	0.1	9/20/30	2,814	4.06	100.75	100.74	0.01	0.024	0.025	0.001	51.3823	Good
9/1/20	359R	0.1	6/20/30	2,600	3.15	100.64	100.53	0.11	0.034	0.045	0.011	21.1681	Poor
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

* Amount the MOF plans to issue

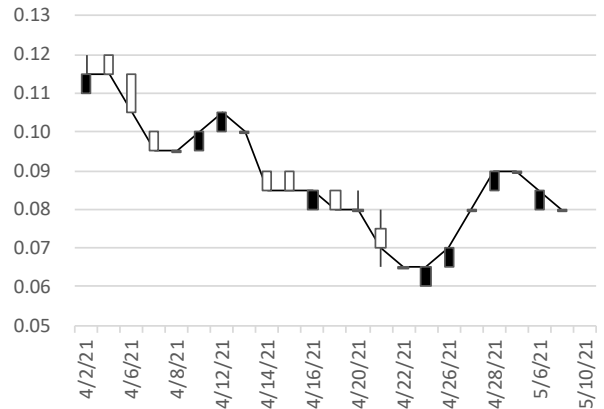
Source: Ministry of Finance (MOF), Daiwa Securities.

Appendix 1a: 10Y JGB Yield (%)



Source: Daiwa Securities.

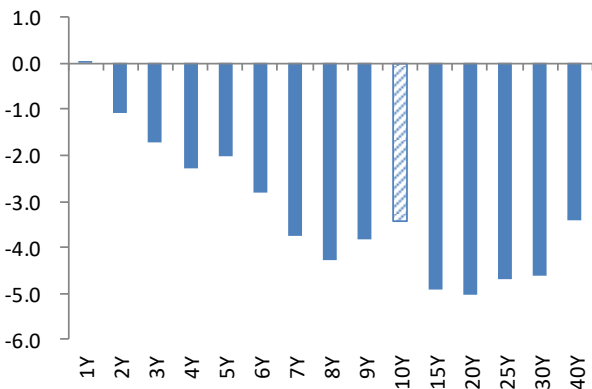
Appendix 1b: JB362 Yield Candle Chart (%)



Note: As of 15:00 JST on Mar. 31

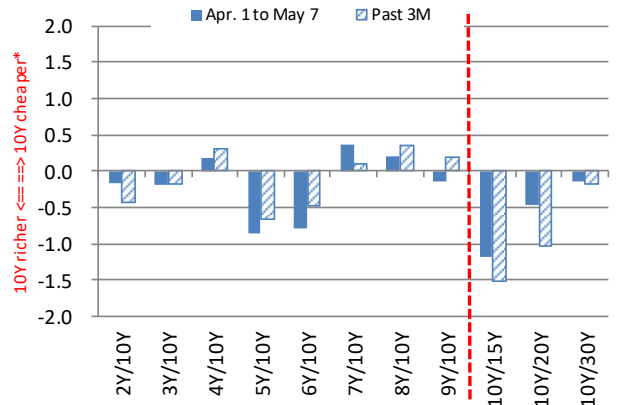
Source: Daiwa Securities.

Appendix 2: JGB Yield Change (bp, Apr. 1 vs. May 7)



Source: Daiwa Securities.

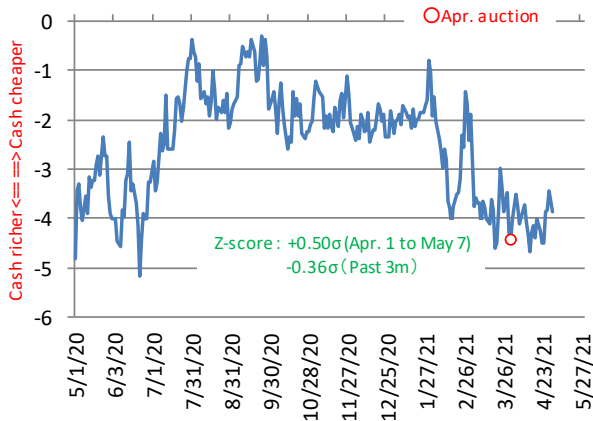
Appendix 3: Z-scores of JGB Yield Spreads (σ)



+ (-) 10Y richer (cheaper) for 10Y/15Y, 10Y/20Y and 10Y/30Y

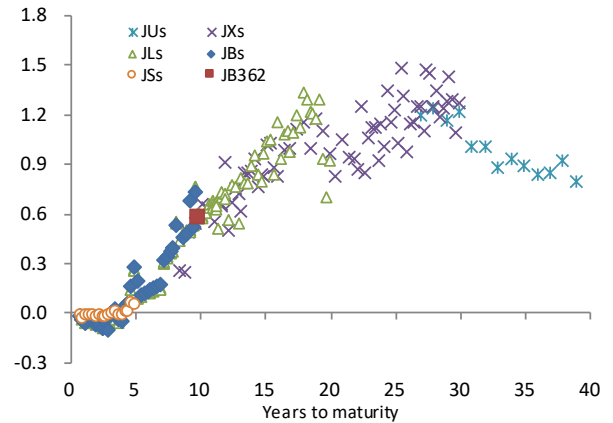
Source: Daiwa Securities.

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



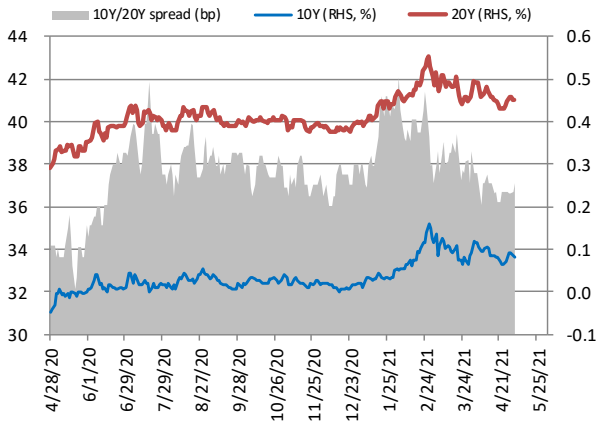
* Yen LIBOR basis
Source: Daiwa Securities.

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



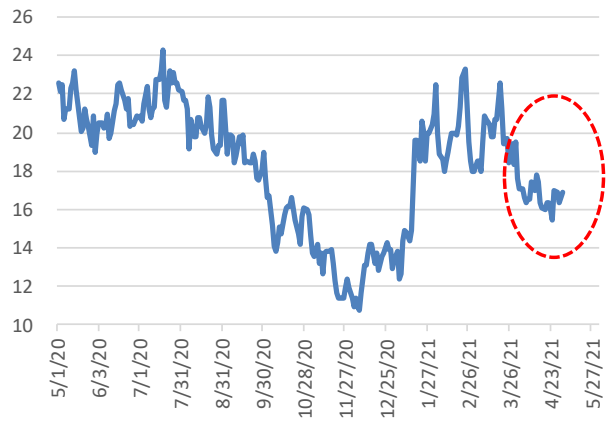
Note: Based on JGB yield curve on May 7; assuming that those yield curve shapes do not change and factoring roll-down effect etc.
Source: Daiwa Securities

Appendix 6: JGB 10Y/20Y Spread (bp)



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

Appendix 7: JGB 10Y/20Y/30Y Butterfly Spread (bp)



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

Appendix 8: Comparison of Cushion and Roll-down (bp)

	Cushion ①	Roll-down ②	①+②
JB362	0.4	1.0	1.4
JL174	0.7	0.5	1.2
JL175	0.7	0.2	0.9
JL176	0.8	0.4	1.2

Note: Based on the May-7 yield curve; 3M
Source: Daiwa Securities.

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[Standard & Poor's]

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[Moody's]

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February 2020

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