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Developed Markets
Japan

Japan Yen Rates Strategy

Don't swing for the fences

- **Duration** — We may not be able to ignore the debt mountain forever, but we think it can be ignored for at least next couple of years. It is still too early to factor in an exit from QQE, although we understand some global macro traders would like to make money via a collapse for JGBs. We continue to take a bullish view of the 10yr yield testing the break of 0.5% in April-June with volatility remaining low. In our view, the BoJ is likely to extend the QQE rather than exiting from it, we strongly recommend giving up the first 50bp in an attempt to take advantage of a 300bp sell-off.

- **Curve** — The concentration in the current sector for BoJ purchase operations is likely to continue keeping 10yr rich in the curve, and expectations for further easing could make it even richer, while 10s30s is likely to remain steep until the market digests the increase in 30yr issuance as well as the first 30yr auction on Friday with weekend risk. The richening of 10yr will make the 5-10-20 fly attractive for those who anticipate success by the BoJ in the 2% inflation target.

- **JGBi** — We believe it is still too early to use the JGBi as an inflation product. In our view the market is still driven either by "PKO" speculators who expect the GPIF to squeeze the market or by holders of old linkers who wants to buy the switching right to dump the old linkers to MoF. The prices of old linkers are extremely expensive so the switching right could be very expensive. We recommend staying away from JGBi until it is traded based on inflationary expectations.

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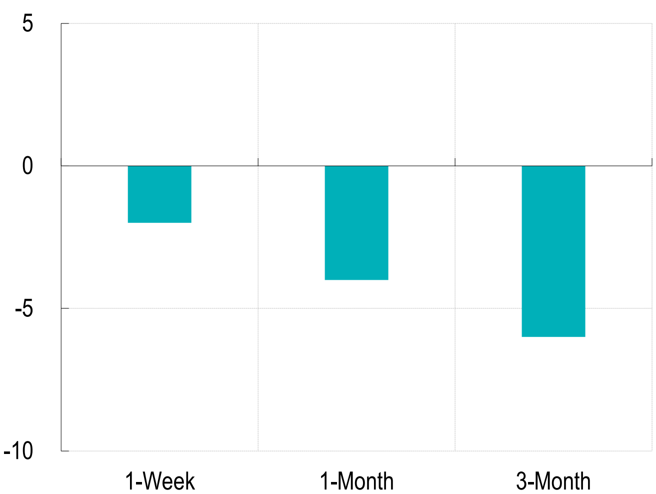
Figure 1. Strategy summary table

	View	Strategies
Duration	Range-bound for a while	Buy on dip in the 10yr, target 64.5bp
Yield curve	18y looks too rich 22y is relatively cheap	15y no longer attractive Receive 10y swap vs. short 15y JGB
Swap spreads	15y sector looks too rich Distortions likely to correct	18yr-22yr box
Volatility	Hedge needs smaller than last year Skew likely to flatten Demand for gamma in 3M	Long 10yr tail against 5yr and 20yr
USDJPY basis	Possible widening due to FY-end receiving	Wait for further widening to pay

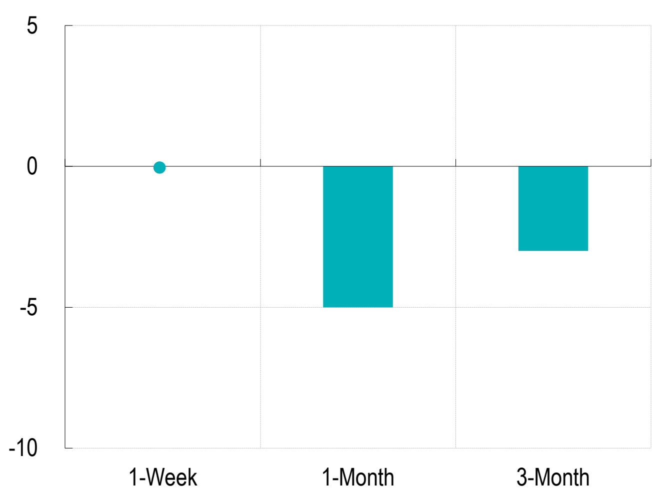
Source: Citi Research.

Figure 2. Expected changes in JGB yields (forecasts, bps)



Source: Citi Research.

Figure 3. Expected changes in volatility (forecasts, 6Mx10Y, bps)



Source: Citi Research.

Too early to factor in an exit by the BoJ; instead better to position for prolonged QQE

Don't swing for the fences

We may not be able to ignore the debt mountain forever, but we think it can be ignored for at least next couple of years. It is still too early to factor in an exit from QQE although we understand some global macro traders would like to make money via a collapse for JGBs. Our base case is unchanged. While the JGB market may be swayed by the change of sentiment in external markets, including equities, currency, and US Treasuries, we keep our bullish view of 10yr yield testing the break of 0.5% in April-June. Geopolitical risk and global low inflation prints tend to be favorable for JGBs. We believe yields will not start increasing to track the upward trend for the global bond market before this summer, assuming that yen is likely to weaken further in tandem with accelerating growth as well as inflationary expectations. It will take a year for the 10yr yield to cross 1%, in our view.

Figure 4. Interest rate forecasts (as of March 26, quarterly average, %)

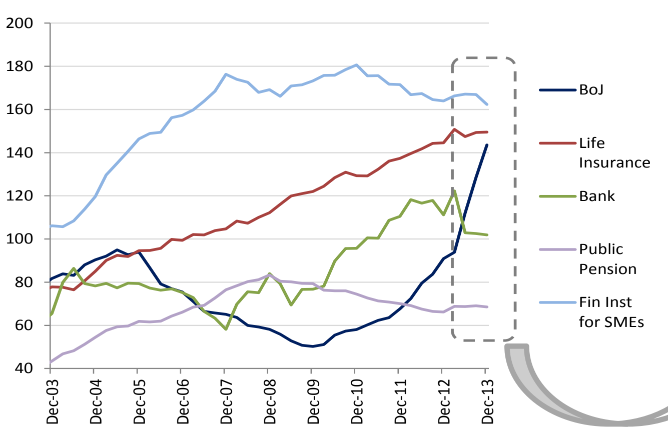
		→ Forecast			
	Current	2014 Q2	2014 Q3	2014 Q4	2015 Q1
O/N Call Rate	0〜0.10	0〜0.10	0〜0.10	0〜0.10	0〜0.10
JGB 2y	0.08	0.05	0.10	0.15	0.20
JGB 5y	0.20	0.15	0.20	0.30	0.35
JGB 10y	0.62	0.55	0.70	0.85	0.95
JGB 30y	1.70	1.65	1.75	1.85	1.90

Source: Citi Research.

Still room for further JGB purchases by the BoJ, no portfolio rebalancing so far

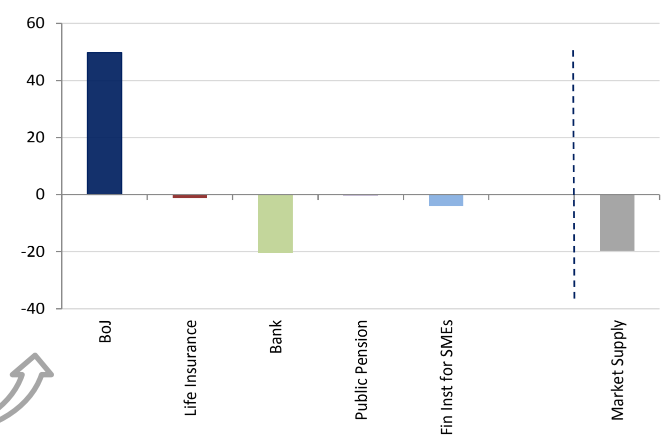
The latest BoJ's flow of funds data released on March 25 support our analysis that megabanks mainly provided their inventory to the BoJ (please see our March 20 report "Yes, the BoJ can increase buybacks"). The largest holder of JGBs is financial institutions for SMEs, including Japan Post Bank, followed by lifers, BoJ, domestic banks, and public pension funds including GPIF. Given the size shown below, the possible change in JGB holdings by these investors would be more important than the "PKO" story by GPIF.

Figure 5. JGBs outstanding by holder (¥trn)



Source: BoJ, Citi Research.

Figure 6. Changes in JGB holdings and market supply during QQE (¥trn)

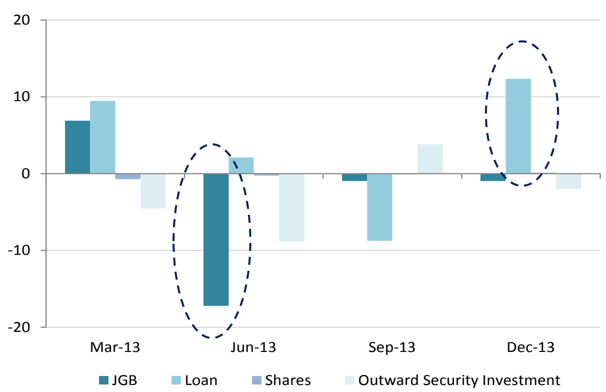


Note: Changes in investors' JGB holdings (asset) are shown in +'ve for increase/-'ve for decrease while increased new supply (liability for the government) is shown in -'ve.
Source: BoJ, Citi Research.

Portfolio rebalancing is not enough

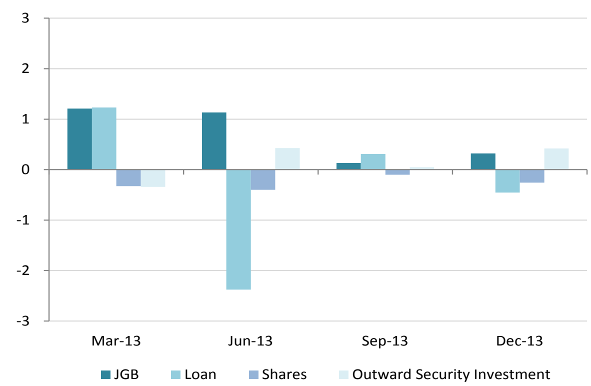
Those institutions with an account at the BoJ, such as domestic banks and financial institution for SMEs, reduced their JGB holdings by ¥24.4trn. Megabanks and regional banks seem to have accumulated excess cash by selling JGBs at the BoJ's current account. As for lifers, although their JGB holdings did not change, their share dropped by 0.6% because the pace of JGB purchases clearly slowed after QQE, partly due to their small ALM gap being enough to wait for a higher yield. It is hardly proven that banks and lifers made progress in terms of portfolio rebalancing. For banks, notable changes were the large net increases in loans in October-December (Figure 7), which seems to be mostly in overseas. Lifers were even quieter, especially in equity purchases (Figure 8).

Figure 7. Financial transactions by domestic banks (¥trn)



Source: BoJ, Citi Research.

Figure 8. Financial transactions by lifers (¥trn)

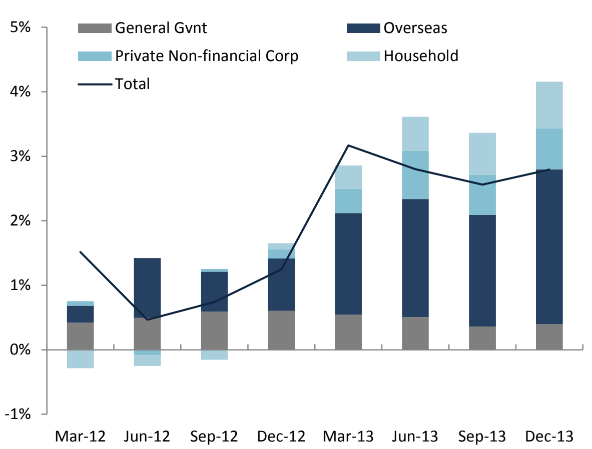


Source: BoJ, Citi Research.

Domestic loan demand is still weak

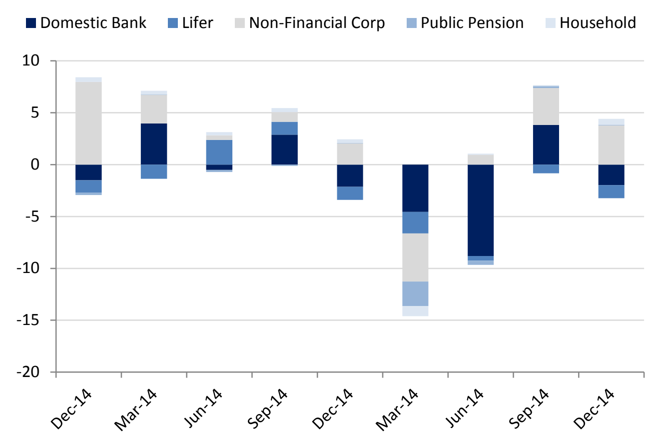
Of the loan component, as shown in Figure 9, the contribution from overseas is notable, with its actual size up more than 50% compared to the peak of the previous recovery before the financial crisis in 2008, while the size of others are still below peak. Meanwhile, trends in outward investment seem to be mainly swayed by changing expectations for the Fed's monetary policy. The portfolio rebalance so far indicates that on an xccy basis the market would be affected most rather than yen swap spreads as domestic demand is still weak. In our view, it will be OK to wait until domestic demand for capital picks up before "swinging for the fences".

Figure 9. Contributions to loan increase by borrower (YoY)



Source: BoJ, Citi Research.

Figure 10. Outward securities investment flow (¥trn)



Source: BoJ, Citi Research.

Curve: summary of factors to affect curve shapes

Duration adjustment by the BoJ

Just like the inconsistency between the BoJ's annual stock target of ¥50trn and its monthly flow target of ¥7trn confused the market, another inconsistency between the bank's average maturity target of 6yr to 8yr and average maturity of newly-issued JGBs of 10yr confused the market. If market participants had sold their inventory of JGBs with the size proportional to outstanding amount, then average maturity should be between 6yr and 8yr. However, market participants tend to sell current issues, especially when their inventory is underwater, so that the average maturity of BoJ purchase becomes close to that of issuance, which is much longer than that of outstanding. The concentration in 10yr current issues in the 5yr-10yr segment contributed most to the extension of average maturity, in our calculation, while the BoJ adjusted the average maturity by reducing the size of 10yr+ segment to encourage 10yr-30yr steeper along with the increase in issuance in 30yr (please see our March 7 report "A signal for further easing?"). We believe the concentration in the current sector could ease in April if we see seasonal profit-taking activities to make more off-the-run issues go into the BoJ buybacks.

Liquidity Auction: richness at 15yr sector is likely to correct

Liquidity auctions are the key factor to counteract BoJ purchases. An increase in liquidity auctions for the 5y-15y segment along with a decrease in BoJ purchases for 10yr+ segment should contribute to the correction of richness at 15yr sector. The supply of the 15yr sector has been squeezed out by strong demand for the 6yr sector, but we believe the trend will not continue next month (please see our march 14 report "Liquidity Auction in focus"). Once the richness of 15yr is corrected, demand for 20yr from trading accounts will likely decrease as a roll down of 20yr will no longer be attractive and the sector will be more affected by the target level of duration buyers.

Restart of 20yr bond futures: 18yr sector is likely to cheapen

Another factor important for the super-long sector is the restart of 20yr bond futures on April 7. The importance is not for supply/demand of the contracts or very small conversion factor around 0.5 to make delta adjustment at delivery difficult; what we see as most important is that CTDs are likely to be exempt from BoJ purchases, as is the case with 10yr bond futures. JL142, in particular, is likely to be the CTD for both September and December contracts so this issue should be exempt from BoJ purchasing until December. We believe the sector does not price in the risk of lack of BoJ demand for a long time and should cheapen.

Lending support program: 5yr is likely to stay firm in a sell-off

As pointed out in our February 21 report "Lending support program may not increase lending but may reduce volatility in JGBs", the BoJ will provide banks a term funding at 0.1% for a maximum of four years with prepayment right up to the amount, which is twice as much as net increase in their lending. If the size grows to around ¥30trn as the BoJ expects, it is unlikely for the 5yr to underperform in a sell-off, and we would be unlikely to have the massive 2s5s steepening we saw during the market turmoil last April and May. A risk-weighted flattener (e.g., buy 10yr and sell twice of 5yr) may looks attractive in an historical chart, but we believe the net duration short will not be able to cover the possible cheapening in 10yr in a sell-off due to the massive "gamma" provided by the BoJ.

Expectation for further easing by the BoJ

As we pointed out in our March 20 report "Yes, the BoJ can increase buybacks", we believe the BoJ is technically able to increase the size of JGB purchases by as much as another ¥50trn to ¥100trn as retired Yale university professor Koichi Hamada suggested. Given that there is less room for megabanks to contribute to the BoJ operation, we think we need lower yields to encourage regional banks, who don't have as much equity as megabanks do, to sell their inventory to the BoJ. In that case, bull steepening in 10s20s and bull flattening in 5s10s is likely to make 10s extremely rich in the curve, while we believe distortion in the curve especially in

the around-15yr sector to correct before the market starts pricing in further easing in June.

JGBi: Stay away unless you need to dump old linkers

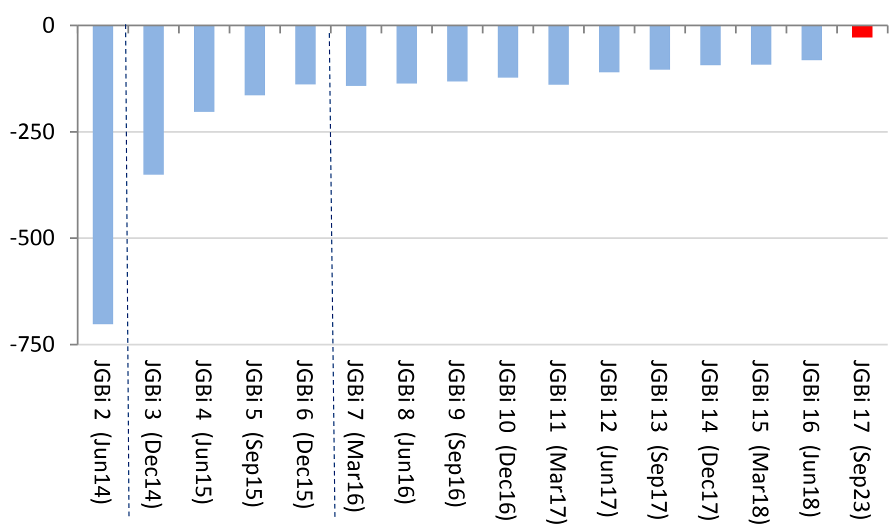
Switching needs could make the JGBi extremely expensive

We believe it is still too early to use the JGBi as an inflation product. In our view, the market is still driven either by "PKO" speculators who expect GPIF to squeeze linkers or by holders of old linkers who wants to buy the switching right to dump the old linkers to MoF. The prices of old linkers are extremely expensive so that the switching right could be very expensive. We recommend staying away from JGBi until it is traded based on inflationary expectations.

GPIF may not participate in auction if switching right is too expensive

In the past three months, old issues rallied by as much as 700bp in real yield (JBi2), or as much as 447cents in price (JBi11). JBi2 cannot benefit from the consumption tax increase in April and the tax hike was already decided three months ago. The average price change of old issues in the past three month is 295 cents, which can be seen as buffer to buy switching right to dump old issues to the MoF. Some of the BEI are already higher than 200bp even after taking into account of consumption tax hike both in this April and next October. Those who want to purely invest in an inflation product, such as GPIF, do not have to pay such expensive premium for unnecessary right to dump old linkers. In our view, it would be better to buy at secondary after the richness due to the premium is adjusted or it would be better to simply short nominal 10yr on the assumption of the achievement of the 2% inflation target.

Figure 11. Real yield 3M change (bp)



Source: Citi Research.

Figure 12. Market event calendar for March - April

Mon	Tue	Wed	Thu	Fri
Mar 31	**Apr 1**	**2**	**3**	**4**
	JGB 10y auction [JPY2.4trn]	*BoJ operation** *(5-10, 10+)*	JGBi auction [JPY0.4trn]	*BoJ operation** *(1-5, 10+)*
7	**8**	**9**	**10**	**11**
BoJ Policy Meeting	BoJ Policy Meeting	Enhanced-liquidity auction [JPY0.3trn]	*BoJ operation** *(1-5, 5-10)*	JGB 30y auction [JPY0.7trn]
14	**15**	**16**	**17**	**18**
*BoJ operation** *(5-10, 10+)*	JGB 5y auction [JPY2.7trn] FOMC	*BoJ operation** *(1-5, 5-10)*	JGB 20y auction [JPY1.2trn]	*BoJ operation** *(1-5 , 10+)*
21	**22**	**23**	**24**	**25**
*BoJ operation** *(<1 , FRN)*	Enhanced-liquidity auction [JPY0.4trn**]	*BoJ operation** *(5-10, 10+)*	JGB 2y auction [JPY2.7trn]	*BoJ operation** *(<1, 1-5)*
28	**29**	**30**		
*BoJ operation** *(1-5, 5-10)*	FOMC National Holiday	BoJ Policy Meeting FOMC		

Note*: Schedule for the BoJ's long-term JGB purchase operation is Citi's forecast. Forecasts are shown in italics while the actual operation bracket is in regular font.
Source: Citi Research.

Appendix A-1

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