Minutes of the Meeting of JGB Investors
(75th Round)

・Date: Tuesday, June 26, 2018 (10:30 a.m. to 11:30 a.m.)
・Place: Special Conference Room 3, Ministry of Finance
・Gist of the Proceedings

1. Issuance amount of Inflation-Indexed Bonds in the July–September 2018 quarter

▶The Financial Bureau gave the following explanation about the issuance amount of Inflation-Indexed Bonds in the July–September 2018 quarter:

・As regards Inflation-Indexed Bonds the JGB Issuance Plan for FY2018 says on page 3 that "the debt management office flexibly adjust issuance amounts taking into consideration opinions exchanged with JGB market participants, the market environment and investment demands" for making four issuances in the year by the per-issuance amount of ¥400 billion. Therefore, today we would like to hear your opinions about the issuance amount in the July - September 2018 quarter.

・For the April–June quarter, as shown on page 4, we conducted the auction for the issuance amount of ¥400 billion in May and Buy-back Auctions in the amount of ¥20 billion in April and June. Page 5 shows that the May auctions continued to successfully end, as seen for example by the bid-to-cover ratio of 4.01, the highest since issuance was resumed. While we saw some wavering of the bid-to-cover ratio with regard to Buy-back Auctions and the Bank of Japan (BOJ)'s Outright Purchase, the results were generally stable and conformed to market yields as shown on page 6.

・The secondary market has continued to be stable over the past months with the BEI around 0.5% as shown on page 7.

・In such circumstances, we asked for your opinions beforehand and found that many of you are concerned about the continuing limited expansion of the investor base for Inflation-Indexed Bonds, therefore being of the opinion that the debt management office should desirably maintain for the July - September quarter the current issuance amounts of Inflation-Indexed Bonds and of Buy-back Auctions.

・In view of such a situation, as shown on page 8, we are considering issuing Inflation-Indexed Bonds in the July - September quarter in the amount of ¥400 billion and carrying out Buy-back Auctions in the amount of ¥20 billion in the even-numbered month of August, in the same amount as the April - June quarter.

・The development of the market for Inflation-Indexed Bonds, is an important issue related to the Debt Management Policy. Therefore, we would like to hear your opinions, on the direction of our policy related to the issuance amounts in the July - September quarter, the auction schedule at equal intervals, etc.

▶Many attendees agreed to the proposal for the issuance amounts of Inflation-Indexed Bonds in the July - September 2018 quarter and other things, while some attendees expressed the following opinions:

・Under the BOJ's monetary policies, the unemployment rate has fallen to 2.5%; this is comparable to the time of the bubble, when unemployment hovered around 2% and suitable inflation rate realized. Based on that, we believe there is a chance that prices will rise, and we are maintaining a certain level of Inflation-Indexed Bonds. However, we request to continue with the Buy-back Auctions because liquidity in the secondary market has not improved and flexibly adjusting the outstanding amount of these bonds continues to be difficult.

・We agree to the proposal. Since Inflation-Indexed Bonds continue stable issuance, there is no need to make any changes to the issuance amount.

・We have no objection to the proposal. Due to insufficient liquidity in the Inflation-Indexed Bond market, the debt management office must maintain the current issuance amount and Buy-back Auctions.

・Some argue that the inflation rate in Japan is connected to the price of oil, but sudden spikes in oil prices tend to (1) decrease the overall buying power of Japan, (2) cause business revenue to decline, and (3) prevent businesses from rolling rising costs into product prices, which means that (4) wages don't increase. Since all of these factors drive down the inflation rate, the inflation that results from increases in the price of oil can't be expected to continue. As such, it is difficult to state that demand for Inflation-Indexed Bonds will increase.

2. Liquidity Enhancement Auctions in the July–September 2018 quarter

▶ The Financial Bureau provided the following explanation regarding the Liquidity Enhancement Auctions for the July–September 2018 quarter:

・As shown on page 10, the FY2018 JGB Issuance Plan states the following about the Liquidity Enhancement Auctions:
(1)While the operating assumption is that the total annual issuance amount will be ¥12.6 trillion (¥2.4 trillion for the 1 - 5 - remaining - year zone, ¥7.2 trillion for the 5 - 15.5 - remaining -year zone, and ¥3.0 trillion for the 15.5 - 39 - remaining - year zone),
(2)ultimately, "based on discussions with market participants, the issuance amount for each zone would be adjusted flexibly manner in response to the market environment and investment demands".
Accordingly, we request you to discuss the issuance amount for each zone in the July–September quarter.

・Page 11 shows that issuance for the April–June quarter went according to the JGB Issuance Plan; ¥400 billion was issued in May for the 1 -5 - remaining - year zone, ¥600 billion was issued each month for the 5 - 15.5 - remaining - year zone, and ¥500 billion was issued in April and June for the 15.5 - 39 - remaining - year zone.
・Page 12 and afte shows the results of the Liquidity Enhancement Auctions. Each zone exhibited stable results.

・When we heard opinions under these conditions about the Liquidity Enhancement Auctions for the July - September quarter in advance, there were many opinions that maintaining the current issuance amount is appropriate.

・In view of such a situation, we have prepared our proposal for each zone's issuance amount during the July–September quarter (see page 15). We are considering issuing ¥400 billion in July and September for the 1 - 5 - remaining - year zone, ¥600 billion each month for the 5 - 15.5 - remaining - year zone, and ¥500 billion in August for the 15.5 - 39 - remaining - year zone.

・Based on today's discussion, we will decide the issuance amount for each zone of the Liquidity Enhancement Auctions in the July – September quarter, and so we would like to ask for opinions.

▶Many attendees agreed to the proposal for the Liquidity Enhancement Auctions for the July-September 2018 quarter, while some attendees expressed the following opinions:

・We agree to the proposal. Since we continue to see stable issuance in the Liquidity Enhancement Auctions, there is no need to make any changes to the issuance amount.

・We agree to the proposal. Since Liquidity Enhancement Auctions provide investment opportunities outside of auctions for current issues, we request to maintain the increased amount in the issuance plan for this fiscal year.

・We request an increase to ¥600 billion per auction for the 15.5 - 39 - year zone because we need to purchase super long-term bonds in order to close the gap between our asset and debt duration.

・As the percentage of bonds owned by the BOJ increases, the demand-supply condition gets tighter. Since we are witnessing demand for off-the-run bonds with positive interest rates from different business sectors' investors, we request to increase the issuance amount for the 15.5 - 39 - year zone.

3. Latest JGB market situation and outlook for future investments

▶Summarized below are the views and opinions presented by the attendees：

・We feel that there is declining expectation for revision of the yield-curve control. Although we would like to invest in bonds with shorter than remaining 10 years to maturity, doing so continues to be impossible under the current interest rates, and we are growing more concerned that there is no end in sight to this situation.

In addition, we are concerned that investors who did not originally focus their investments on the super long-term zone are now investing super long-term bonds and have the interest rates risk.

・Since we are no longer able to employ the strategy of ensuring the carry with JGBs, we are transitioning to methods that seek capital gains and diversifying our investments to stocks, exchange, and bonds. If we cannot expect interest rates to rise significantly (1–2%) in the future, which would generate suitable revenue through the carry alone, then it will be difficult for a significant amount of departed capital to return to the JGB market.

The current information we are receiving from the BOJ has also changed somewhat, and we feel that an increasing number of references are being made to the side effects of monetary easing. When normalizing monetary policies, it is imperative that a well-timed exit strategy which is sufficiently incorporated into the market is developed and followed.

・Originally, investments took the form of continuously held bonds, but that has now shifted to an investment strategy that resembles hedge funds and includes not only bonds but also stocks and exchange investments.

・We are diversifying our investments internationally since we cannot invest in JGBs with negative interest rates.

In terms of future monetary policies, we would prefer to gradually adjust yield-curve control and target interest rate while fully communicating to the market that the policies are intended to mitigate the side effects on the earnings of financial institutions as inflation is not expected to increase. At that time, it is imperative that we don’t send the wrong message to foreign investors that monetary easing will be tapering.

・When the bonds we own are redeemed, we cannot reinvest those funds into the short-to-medium-term zones because they have negative interest rates, therefore we have no choice but to purchase bonds with longer maturities. That has caused our duration to lengthen and our interest rate risk to increase.

Since drastic increases in interest rates might shock the market if monetary policies are normalized in the future, we would prefer that interest rates are gradually increased in response to the situation .

・Amidst the shifting environment surrounding monetary policies, the severe situation regarding current interest rates has led us to engage in other initiatives such as extending our lending to areas where we see the potential for growth. We hope that interest rates will rise and that earnings will improve.

・If JGB interest rates rise as the process of normalizing monetary policies, some investments that have held off until now may gradually return, but the behavior of investors may change. When interest rates were raised in the past, we saw that investors preferred bonds with shorter maturities. We think that the challenge is to make decisions regarding future issuance while considering past examples such as these.

・Because domestic financial institutions have yen-denominated debt and also focus their investments on yen-denominated instruments, we expect that there will be suitable demand for JGBs in the future as well. However, if concerns arise about the government finance during the process of normalizing monetary policies, it will be difficult to continue purchasing JGBs; this means that maintaining investor confidence in JGBs through their ratings and other factors is a prerequisite for these bonds being purchased.

・Since we have yen-denominated debt, we would really like to invest in yen-denominated bonds, but under the current interest rates we have no choice but to invest in other areas such as currency-hedged foreign bonds. Many investors are probably of the opinion that they would like to return some of their investments to yen-denominated bonds if interest rates become positive again.

When low volatility continues for a long period of time due to the yield curve control, the JGB investment teams of financial institutions are diminished and we may find that there are no longer any people who have experience working in a volatile market. There are fears that such a situation will cause the market to fluctuate far more drastically than is necessary when monetary policies are normalized.

・Many investors are diversifying their investments in assets other than JGBs, such as currency-hedged foreign bonds, credit, and alternatives. We expect that there will be some return to JGBs if interest rates rise; but in order to do so, investors will have to raise JGB purchasing funds by selling other held assets—and there is sufficient reason to believe that this movement of capital will exert pressure on markets other than JGBs.

・Under these negative interest rates, we are unable to invest in JGBs from the short-to-medium-term zones; but if interest rates become positive again, we think that we will be able to redirect enough of our investments to those zones from a financing point of view.

・Over the long term, revenue has to exceed the assumed interest rate on the debt side, which means that even if interest rates become slightly positive it will be difficult to immediately allocate more funds to JGBs.

・In the last fiscal year, the interest rate for 10-Year Bonds went from 0% to 0.1%. So far, it has only moved from 0.02% to 0.08% during this fiscal year, which we feel is an even narrower range. Foreign interest rates are on the move, as evidenced by the drastic increases in US interest rates since the first of the year as well as the shifting views regarding ECB policies in Europe. Compared to that, we cannot help but admit that the JGB market has lost some of its functionality.

The low interest rates and low volatility of our market make earning income and seeking capital impossible, and as a result JGBs are not at all an enticing investment target. Even if the BOJ revises its monetary policies at a later date, it will only allow interest rates to rise at an extremely gradual rate, which means that this investment-stifling environment will continue for the foreseeable future.

・Most short-term bonds are held by foreign investors through foreign exchange swaps. If the negative interest rates become positive, we can imagine that the ownership of short-term bonds will shift from foreign investors to domestic investors. We must closely observe the behavior of foreign investors and the hedge yield of JGBs as seen from overseas.

Compared to volatility, the bid-ask spread is not very tight at present, and there is not sufficient depth. It is important that we continue to monitor the market's functions and liquidity while keeping in mind that future market shifts may cause a sudden loss of liquidity.

・If the BOJ does not raise its target interest rates in accordance with economic cycles during this year or by the start of next year, we think that revising its policies will become even more difficult. Realistically, we expect that there will be a small change made to target interest rates in consideration of the revenue of financial institutions.

･In addition to our declining expectation that the yield curve control policies will be revised, we are worried that market liquidity has decreased substantially. We are also concerned about the slackness of financial discipline, and we think that maintaining the credibility of JGBs will be difficult if we assume that expanding government finance will cause no problems due to the low interest rates.