Daiwa Securities

Daiwa's View

Market implications of BOJ policy meeting

- Superlong yields could be pushed higher due to Kuroda's remarks and possible extension of corporate financing support

Gov. Kuroda bracing for protracted battle

- BOJ should continue to maintain stability of financial system amid severe economic conditions

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Market implications of BOJ policy meeting (Tani)

Superlong yields could be pushed higher due to Kuroda's remarks and possible extension of corporate financing support

The BOJ held a policy meeting yesterday, followed by the Governor's press conference. In this section we focus on the three points that appear to be of greatest interest to the market, as we will fully flesh out our reasoning from page 3.

First, the BOJ reaffirmed that it has completely shifted its main focus to the support of corporate financing. Speaking about the loans in its large support package worth Y110 trillion plus alpha, the centerpiece of its efforts, BOJ Governor Kuroda said that their due dates could be extended as conditions require and confirmed that support would not be cut off even if there was a second wave of covid-19. This should ease somewhat any concerns over the tail risks from a second wave.

Second were Mr. Kuroda's remarks about the yield curve. While adhering in principle to the importance of keeping the overall yield curve low and stable, he said that while superlong yields are rising in the US and Europe, they have not risen much in Japan, and that the BOJ is not specifying how much of an increase would be welcome. This reaffirms that the BOJ sees absolutely no problem with the 20yr yield having temporarily risen above 0.4% this month and that as long as the yield curve is forming naturally the BOJ will entrust superlong yields to the market. This makes it harder to envision the BOJ aggressively increasing the amount of its operations to suppress superlong yields, even amid the increase in JGB issuance from July.

Third and last were Mr. Kuroda's comments on the relationship between ratings actions (S&P's change from positive to stable) and rising yields. He said that he personally does not at all think the rating agencies' JGB ratings are objectively correct and warned of the need to discuss default risk separately from interest rates. We discuss these points here a bit further because they provoked many questions from investors.

The convertibility to gold has been suspended since the Nixon shock of 1971, and with currencies today completely fiat in nature, it is conceptually inconceivable that government debt denominated in a country's home currency could be defaulted on in the narrow sense of the word. If there were to be a debt default, it would have to be in relation to the world's reserve currency (the dollar), one reason for this being that in the CDS market, all sovereign protection (not just that for US Treasurys) is traded in USD denominations.

The premiums on USD 5-year CDS for foreign currency-denominated sovereigns are 19bp for Germany, 28bp for Australia, 28bp for Korea, and 32bp for the UK, compared with 22bp for Japan. Despite having a sovereign rating of A from both Moody's (*) and S&P (*)[1], Japan has the second lowest premium among the major advanced economies, behind only Germany. It has almost consistently been the case that the market rates Japan highly and the rating agencies give Japan low marks. This suggests the possibility that it is not the market but rather the rating agencies that are in error.

Given that Japan is a net creditor nation by a large margin, benefits from the Fed and BOJ having established an unlimited standing swap line, and has a wide range of exporting industries that are highly capable of earning foreign currency, it is probably not much of a stretch to argue that the probability of Japan defaulting on its USD-denominated debt (although Japan's debt itself is not denominated in dollars) is extremely low.

As our chief credit analyst Toshiyasu Ohashi has repeatedly pointed out, since credit ratings are not always correct, they must be used skillfully. It is of course necessary to maintain a healthy degree of caution, but it is equally important to guard against being excessively concerned about and in fear of a downgrade. We appreciate that BOJ Governor Kuroda spoke boldly enough to remind us of this important point.

[1] (*) indicates unregistered domestic rating; please see disclaimer at end of document.

Gov. Kuroda bracing for protracted battle (Iwashita)

Jun BOJ MPM returned to normal schedule

The BOJ's June Monetary Policy Meeting (MPM) was held for two days on the 15-16th in line with the initial schedule. The schedule has returned to a normal one for the first time since the January meeting. The status quo was maintained for the policy because (1) only three weeks have passed since the emergency meeting on 22 May, and (2) the market has been stable due to the effects of various measures (see chart below). The total size of "the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19)" was increased from Y75n to "Y110tn +α" in step with the government expanding its interest-free unsecured loan program as part of the second supplementary budget that was passed on 12 June. As this is automatic accumulation in line with the government's budgetary provision, it is not considered as an additional measure that requires a vote. This was shown by the amount clearly stated in the chart of additional materials.

Size of special program to cope with COVID-19 automatically upped in step with second extra budget

Mr. Kuroda's press conference: Weaker tone than in previous conference, with cautious wording

The post-meeting press conference by BOJ governor Haruhiko Kuroda was held at the podium in a large meeting room similar to April. His tone was weak compared to that in the previous conference. As a whole, there were many cautious phrases, given that the overall economy was assessed as being "in an extremely severe situation" in the June statement. Moreover, risks to the outlook were expressed as "there have been extremely high uncertainties." As this phrase is commonly used among central banks, we can feel that they are bracing for a protracted battle regarding responses to the COVID-19 pandemic.

Until FY22, BOJ is far from rate hikes; most important point is yield curve remaining low and stable

In replying to questions, he stated that possible concrete easing tools are (1) expansion of the special support program, (2) a cut in short-term and long-term interest rates, and (3) an increase in ETF purchases. He pointed out the possibility that the first tool will be needed, depending on the outbreak situation. Regarding purchases of CP and corporate bonds, he implied that the current period until the end-March 2021 can be extended, depending on the situation. Meanwhile, he regarded the biggest issue with respect to the virus as emerging nations, saying that "unless vaccines widely become available, the risk of another wave of infections remains." While the Fed's dot chart showed a stance of not raising interest rates until 2022, the BOJ's price projections in the *Outlook for Economic Activity and Prices* report *(Outlook Report)* are low. Mr. Kuroda admitted that the BOJ is far from a rate-hike situation until FY22. As expected, there is a long way to go until normalization. Regarding the yield curve, which is garnering a lot of interest in the JGB market, he replied that "the most important point is that the yield curve remains low and stable." As he also stated that "Japan's superlong yields have not risen that much," the current level appears to still be acceptable.

BOJ's measures to strengthen easing played out in Apr

The BOJ's responses to the COVID-19 crisis started with the extraordinary announcement of Gov. Kuroda's statement in the morning of 2 March. However, its measures to strengthen easing played out on 27 April. Since then, it has just increased the size of operations and extended the period. For the time being, the central bank is likely to continue with operations while checking the effects of responses thus far.

Chart: BOJ's Measures to Cope with COVID-19 Pandemic (since Mar 2020, as of 16 Jun)

Support for corporate financing	Special Program to Support Financing in Response to the COVID 19 Total size of around Y110tn + α Until end-Mar 2021 ① Purchases of CP/corporate bonds: Y20tn ② Special operations in response to COVID-19 pandemic (incl. new fund-provisioning measure): Y90tn
Provision of yen and foreign currency funds to stabilize financial markets	① JGB purchases: Unlimited ② Operations to supply USD Actual amount of increase since Feb: Y40tn (total of ① and ②)
Purchases of ETF/J-REIT	Annual pace of about Y12tn For the time being Pace of annual purchases ① ETF: Y12tn, ② J-REIT: Y180bn

Source: BOJ; compiled by Daiwa Securities.

Despite signs of bottoming out of sentiment indicators, level still low

Jun Tankan will confirm differences across sectors

Replies to the BOJ's June Tankan survey (to be released 1 Jul) have started (normally about 70% of responses received by around 11 Jun, response deadline). Due to full-scale lifting of a state of emergency, sentiment indicators overall are widely expected to have bottomed in Apr-May. Even after hitting a bottom, however, the DI level is still low, which will prevent us from envisaging a sharp earnings recovery. The June Tankan will serve as a factor to confirm differences across sectors.

Jul *Outlook Report* attracting attention, but projections for negative growth in GDP and prices to be unchanged

Already assumed that prices will not easily rise, so current situation unlikely to lead to talk on additional easing

In the July *Outlook Report* to be released on 15 July, board members will discuss whether they need to revise GDP growth rate projections following the passage of the second extra budget. It is highly likely that Apr-Jun real GDP will post substantial negative growth. Despite a phased resumption of economic activities since June, only a fair degree of pent-up demand is expected in Jul-Sep amid recommendation for cautious activities. As witnessed by growing concerns about a second wave of infections, COVID-19 entails strong uncertainty. The downside risk thus remains high. In the previous *Outlook Report* issued in April, the forecast range of majority of policy board members was −5.0 to −3.0% for FY20 and +2.8 to +3.9% for FY21. The FY20 projection is slightly stronger than the private-sector forecasts (avg. of ESP forecast survey of −5.37% for FY20 and +3.27% for FY21 in Jun). Meanwhile, the projection range of FY20 prices (core CPI incl. impact of consumption tax hike, by majority of board members) as of April was −0.7 to −0.3%, which is close to the private-sector forecast (−0.48% for FY20). As such, the BOJ already has a cautious view. As it is assumed that prices will not easily rise, the current weakness is unlikely to lead to discussion on additional easing.

Lack of confidence in economy in COVID-19 era; impact of new normal should be discerned

At the press conference, Mr. Kuroda stated that "we do not need to definitively say that the economy will not recover for a long period." However, he also showed a lack of confidence, saying that "people have not returned to sightseeing spots or restaurants. We do not know yet if this will be a short-term phenomenon or the new normal." Then, he made an in-depth remark—"if the demand structure changes in the new lifestyle, some sectors may start to face difficulty in financing." Meanwhile, he also said that "I do not necessarily think that prices will go down in the new lifestyle." Either way, time is needed for assessment as we do not yet know the degree of the impact.

Dividing line between monetary policy and fiscal policy becoming vague in US

In Japan, gov't has large role in corporate support, while BOJ should maintain stability of financial system

In the US, the Fed is buying corporate bonds via an SPV invested in by the Treasury Department, and the dividing line between monetary policy and fiscal policy is becoming vague. In Japan, the government plays a large role in support of continuous business operations, maintenance of employment, and prevention of chain-reaction bankruptcy. As long as the phase of these crisis responses continues, the top priority at the BOJ is to stabilize the financial system, rather than achievement of the price stability target. In the near term, the BOJ is likely to maintain its lateral support by buying enough JGBs (which will be issued further to fund gov't fiscal stimulus) to keep the 10-year JGB yield (around 0%) from rising. The central bank will probably think that additional easing is necessary only in the case of drastic downward revisions to economic projections or appreciation of the yen staying below the rate of 100 to the dollar.

Daiwa Securities

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[Standard & Poor's]

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