Daiwa Securities

Daiwa's View

Things to watch for in 2021: Part 2

- Will "assessment meeting = steepening" happen again this time?

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Things to watch for in 2021: Part 2

Will "assessment meeting = steepening" happen again this time?

The BOJ intends to announce the result of the "assessment" at the Monetary Policy Meeting (MPM) in March (assessment meeting). Based on two rounds of assessment experiences in 2018 and 2019, we tend to be cautious about "assessment meeting = steepening." However, will this meeting have a similar result? In the following section, we will examine this by focusing on the 20-year JGB yield[1].

In the first place, does this assessment meeting stem from consciousness about the shape of the yield curve? We can look back at past developments. In 2018, the BOJ intended to promote a natural rise in yields by revising market recognition about the 10-year JGB yield band target of 0%, which was formed at around ±0.1% (partly because BOJ conducted fixed-rate purchase operations at 0.11%), while European and US yields turned around. In 2019, amid the extraordinary situation due to excessive declines in superlong yields, BOJ governor Haruhiko Kuroda several times complained about the situation in which sentiment could worsen via pension funds and life insurers.

Compared to the situation surrounding past assessment meetings, we do not feel that the BOJ has urgent awareness about the shape of the yield curve. This is obvious because the minutes of the MPM held on 28-29 October 2020 (disclosed 23 Dec 2020) state that "the shape of the JGB yield curve has been consistent with the guideline for market operations."

The Summary of Opinions at the MPM on 17-18 December 2020 also virtually include both opinions, rather than opinions that hope for substantial steepening of the yield curve shape. As such, board members do not appear to have discussed opinions that the yield curve should steepen.

◆ **Summary of Opinions at Monetary Policy Meeting on 17-18 Dec 2020** (disclosed 28 Dec 2020)

- It is necessary for the Bank to enhance sustainability of yield curve control and purchases of assets, such as ETFs, through the flexible conduct and be prepared so that it can respond effectively to possible changes in economic activity and prices as well as financial conditions.
- With regard to the conduct of yield curve control, it is necessary to take into account the possibility that, along with the increase in issuance of Japanese government bonds (JGBs), the amount of interest-rate risk will accumulate and supply-demand conditions will be eased in the bond market. Meanwhile, with a view to simultaneously achieving prolonged monetary easing and financial system stability, it is desirable, in a sense, for the yield curve to become steeper at a moderate pace. In this situation, it will become necessary to control the yield curve more carefully and finely.

[1] Statement and Governor's press conference clearly said that YCC's framework and negative interest rates would be maintained (excluded from assessment targets).

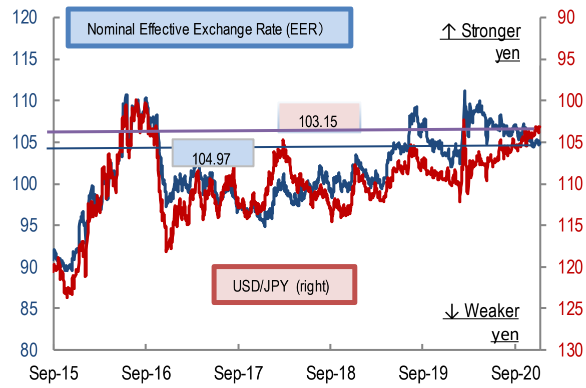
◆ International financial market

This month, the Biden administration is to take over in the US. While Fed chair Jerome Powell maintains a very strong monetary easing stance, we can say that the impact of the start of the new administration on the international financial market is unpredictable.

Confirming the recent situation surrounding the international financial market, the yen has been consistently moving toward appreciation against the dollar, although the nominal effective exchange rate has been mostly stable. Yesterday, the USD/JPY rate touched the 102 level at one point. Although the correlation between interest rates and exchange rates is not necessarily strong, it appears that the correlation between the USD/JPY rate and the domestic/overseas interest rate spread is increasing recently (right-hand chart below). If the USD/JPY rate declines to the level far below the projected rate in the BOJ's Tankan, it may have negative impact on corporate earnings from next fiscal year.

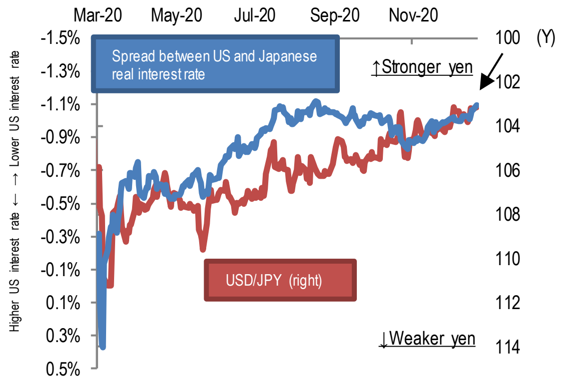
Although this is just presumption, we think that the level of interest in this change in the environment surrounding the international financial market is much higher than that in the JGB yield curve shape, which has been "consistent with the guideline for market operations." From this viewpoint, the possibility does not appear strong that the BOJ hastily intends to raise the (real) interest rate, which entails a risk of further yen appreciation.

JPY Nominal Effective Exchange Rate, USD/JPY



Source: Bloomberg; compiled by Daiwa Securities.

Spread Between US and Japanese Real Interest Rate, USD/JPY



Source: Bloomberg; compiled by Daiwa Securities.

That said, the BOJ may sow more seeds toward steepening in the future. For example, if it expands the band of the 10-year yield target of 0%, it may be able to promote natural steepening of the yield curve in the process of a rise in US interest rates from this year. However, since the assessment meeting in 2018, the 10-year yield has been allowed to fluctuate in a range of between −0.2% and +0.2%. Under this condition, the yield is currently moving at 0-0.05%. Given this, even if the band is expanded again, it would be difficult to assume a major practical change.

Recently, the tendency is increasing that the 20-year JGB yield meets upside resistance at around mid-0.4%. Although the yield was moving at the 0.5-0.6% level in around 2017-18, why is it now stable at this level? In examining this point, we think that there are two important factors: (1) the relative value and (2) a change in the investor base.

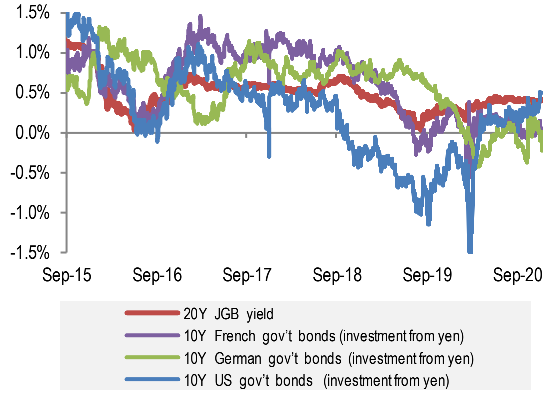
◆ Relative value

The absolute yield level of the 20-year JGB yield as of 2017-18 was certainly higher than that as of now. However, based on the comparison on a hedged basis, European and US yields were more attractive than the 20-year JGB yield. This shows that Japanese investors were able to gain returns from bond investment without sticking to JGBs.

Meanwhile, the current levels show that the 20-year JGB yield is at the same level or higher than the level of hedged foreign bonds (chart below). In the situation where the 20-year JGB yield is relatively attractive like this, investment flow from 20-year JGBs to foreign bonds is unlikely to increase even if some degree of upward pressure is put on European and US yields.

Moreover, due to the recent rise in US yields and improvement on a USD/JPY currency basis, JGB yields have been becoming less attractive than hedged US Treasury yields. Accordingly, if US yields rise from this year toward next year, we think that JPY yields could rise a little more in the form of approaching US yields (under assumption that basis will not worsen). The aforementioned re-expansion of the yield band may have the effect of amplifying this phenomenon. In terms of the relative value, meanwhile, the comparison with European government bonds cannot be ignored, but JGBs have recently become undervalued vs. European government bonds. It is premature to conclude that JGBs are becoming expensive based on the comparison with US Treasuries alone. In thinking of the steepening of the 20-year JGB yield, we need to also consider European bonds/ECB.

20Y JGB Yield, Return from Foreign Bonds (investment from yen)



Source: Bloomberg; compiled by Daiwa Securities.

◆ Change (equilibrium?) in investor base

Another factor is a somewhat intuitive discussion. We have the impression that the 20-year JGB yield is very stable at the 0.4% level, and there appears to be a kind of "equilibrium." Under the condition of the 10-year yield of 0% and the 20-year yield of 0.4%, it is possible to secure an average annual yield of around 0.8% as a carry and roll-down return. One aspect is that this level is equilibrated with operation cost at depository institutions, which have a very large amount of deposits, and their funds are being attracted, in our view.

If such an equilibrium exists, in the case that the BOJ tries to raise the absolute level of 20-year JGB yield via purchase operations alone, without moves such as (1) dissolution of the situation of excess deposits, (2) appearance of more attractive products, and (3) tighter regulations, it is highly possible that we will see the results of fund inflow from depository institutions and taking a higher interest rate risk. Judgment on whether the alleviation of the side effects via operations is really desirable would be made from the viewpoint of macro prudence.

Based on these considerations, my frank impression is that a substantial rise in the 20-year yield from the current 0.4% level after the announcement of the result at the March assessment meeting is doubtful. Of course, we do not know what will actually happen in the assessment process, and the sense of caution about this uncertainty has not disappeared. In addition, as it is the case that yields rose following the two rounds of assessment in the past, some degree of reduction in risk exposure would be a realistic response. However, the stance of buying on deep dips is recommended based on the aforementioned considerations.

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[Standard & Poor's]

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[Moody's]

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[Fitch]

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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.
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