

Daiwa's View

Points of focus for climate change operations at BOJ's Jul MPM

- Applied interest rates, more flexible term of operations, and guidelines for investment/loans

Fixed Income Research Section
FICC Research Dept.

Chief Market Economist
Mari Iwashita
(81) 3 5555-8852
mari.iwashita@daiwa.co.jp



Daiwa Securities Co. Ltd.

At BOJ's Jul MPM, projections in Outlook Report to be revised, but without impact on policy decisions

While US is discussing monetary policy normalization, Japan is likely to take wait-and-see stance

Points of focus for climate change operations at BOJ's Jul MPM

With the level of uncertainty still high, the BOJ is holding its July Monetary Policy Meeting (MPM) on the 15th and 16th. In the *Outlook for Economic Activity and Prices* report (*Outlook Report*) to be announced at the meeting, slight revisions are expected for growth rate and price projections, but this is unlikely to have an influence on policy decisions (Chart 1). The other day, a client of mine made the following critical comment: "Both economists and strategists have recently been talking about only the US market. It is a pity that they do not talk much about Japan." In the Apr-Jun quarter, the US economy recovered to pre-pandemic levels, and policymakers are now discussing monetary policy normalization amid transitory inflation. In contrast, Japan's economy remains sluggish amid concerns about the rise in COVID-19 cases, and inflation is not spreading from upstream sectors to downstream sectors. In addition, the y/y change in core CPI remains low at around the 0-0.5% level due to lower mobile phone communication fees (contribution to nationwide CPI: -0.6 ppt). Therefore, there is no question about whether the BOJ will take a wait-and-see stance after the March assessment meeting.

Chart 1: Projections by BOJ Policy Board Members (median) and Our Forecasts (y/y)

	Real GDP			Core CPI		
	Apr 2021*	Jul 2021**	Our forecast	Apr 2021*	Jul 2021**	Our forecast
FY21	+4.0 %	+3.6 %	+3.4 %	+0.1 %	+0.3 %	+0.3 %
FY22	+2.4 %	+2.6 %	+2.7 %	+0.8 %	+0.8 %	+0.6 %
FY23	+1.3 %	+1.5 %	+1.5 %	+1.0 %	+1.0 %	+0.8 %

Source: BOJ, various materials; compiled by Daiwa Securities.

*BOJ projections.

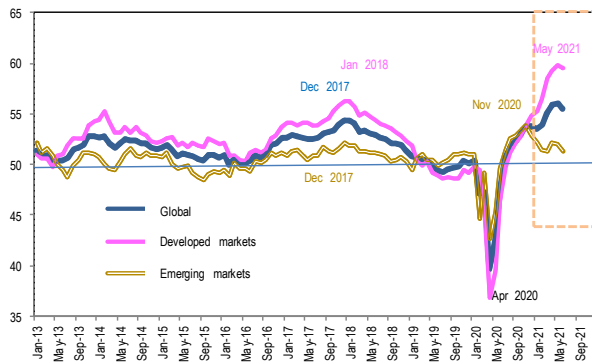
**Our estimates for policy board member projections.

Vector of US economic recovery may have peaked in 1H

We may see decline in corporate earnings and real purchasing power in US, as well as further delay in recovery in emerging nations

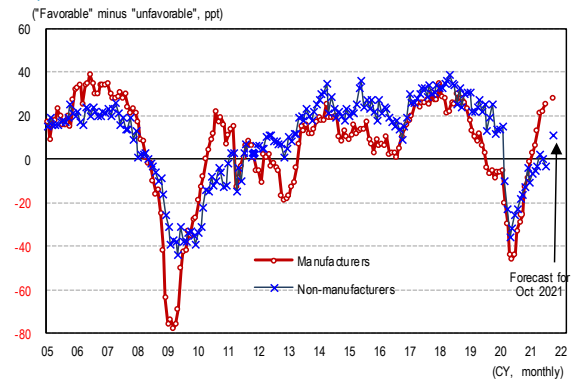
Although I spend most of my analysis work forecasting Japan's economy, Japan is unlikely to provide major market catalysts for now as decisive moves toward normalization are not anticipated. The US is likely to remain the main player in the latter half of 2021. Currently, we have started to see signs that the US economic momentum is letting up. Firstly, the pace of US growth in Apr-Jun was unsustainable. That said, we should keep in mind the possibility that higher-than-expected inflation will cause a decline in corporate earnings and price pass-through will dampen real purchasing power. Looking at the manufacturing sentiment indices, the impact of the US, the driver of the global economy, is spreading worldwide (Chart 2). With the situation regarding vaccinations and fiscal policy differing from nation to nation, the pace of economic recovery is already mixed. The possibility of a further delay in recovery in emerging nations warrants attention.

Chart 2: Global Manufacturing PMI



Source: Markit; compiled by Daiwa Securities.

Chart 3: Business Sentiment DI in Reuters Tankan (400-company basis)



Source: Reuters; compiled by Daiwa Securities.

Note: Jul 2021 survey conducted during 30 Jun-9 Jul.

Jul Reuters Tankan gave impression of K-shaped recovery

Moderate recovery expected for manufacturers, despite remaining supply constraints and gradual impact from higher material prices

Strong expectations for improvement in three months as situation is likely to approach level for achieving herd immunity

Since spring, BOJ's moves to address climate change issues have been aggressive

BOJ to release outline of climate change operations at Jul MPM, and overall picture for addressing climate change in the near future

In Japan, the July Reuters Tankan released on 14 July (based on 400 firms) gave us the impression of a K-shaped recovery, in which the level differs by sector, with the latest readings among manufacturers improving substantially, but those among non-manufacturers worsening (Chart 3). The survey was conducted from 30 June to 9 July (sent to 400 firms, of which 257 responded). During that period, some signs of the US and Chinese economies peaking were observed, and the Japanese government decided to declare a fourth state of emergency for Tokyo due to continued growth in COVID-19 cases. Despite remaining constraints to the supply of items (such as semiconductors) and the gradual impact from higher material prices, manufacturers' business sentiment is likely to continue to improve. Although we have not seen a full-scale recovery yet, we can maintain a moderate recovery scenario. Meanwhile, non-manufacturers saw mixed results due to the impact of repeated declarations of a state of emergency. While hotel and restaurant sectors are being hurt by the state of emergency, retailers have started to see bright developments thanks to a pick-up in vaccinations. In any case, it is strongly expected that the situation will approach the level for achieving herd immunity three months from now in October, and vaccinations among the elderly will be mostly completed. In the Jul-Sep quarter, Japan's economy is expected to lack strength. In the Oct-Dec quarter, however, with catch-up production and pent-up demand anticipated, a rebound is likely to gain momentum. In the July *Outlook Report*, it is very likely that the growth rate projection for FY21 will be revised downwards and that for FY22 will be revised upwards.

Since the establishment of a committee related to climate change issues in spring, the BOJ's moves to address this issue appear to be more aggressive than I expected. At the June MPM, the BOJ announced that it would launch a new fund provision measure to finance investment/loans coping with climate change issues (hereafter, climate change operations). At the July meeting, an outline of this measure is to be unveiled. Furthermore, the overall picture of the BOJ's response to climate change is slated to be announced at an appropriate time following the July MPM. In another project, the BOJ announced on 12 July that it has reached an agreement to promote investment in green bonds through the Asian Bond Fund (ABF) jointly with ten other member nations in the EMEAP (the Executives' Meeting of East Asia-Pacific Central Banks). This project is not a monetary policy to utilize the BOJ's foreign reserves but deals with overseas sovereign green bonds. Although the BOJ is keeping its distance from purchases of private-sector green bonds, it can emphasize its stance towards climate change via this agreement.

Points of focus for climate change operations are applied interest rates, more flexible term of operations, and guidelines for investment/loans

Climate change operations take over from support measures for strengthening foundations for economic growth; we wonder whether it will be as Category II or III

According to the BOJ, climate change operations are positioned as a successor to the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth, which expires at the end of June 2022. It will be interesting to see what sort of investment guidelines the BOJ comes up with, and whether, to maintain market neutrality, it provides incentives but rather just makes the term of operations more flexible and raises the macro add-on balance. In the Interest Scheme to Promote Lending that was introduced in March (Chart 4), the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth is pigeonholed as Category III and the applied interest rate is 0%. It is possible that climate change operations will be initially taken over as Category III, with responses being made flexibly thereafter. Regarding the Special Operations in Response to COVID-19, to which positive interest rates are applied, the balance is expected to decrease at some point once a clear end to the spread of the new coronavirus comes into view. Meanwhile, it is hard to see negative interest rates being done away with in the near future. Therefore, if the BOJ judges that it is better to preemptively take measures to cope with side effects at financial institutions, it will opt for Category II for climate change operations from the start.

Chart 4: Interest Scheme to Promote Lending (introduced in Mar 2021)

	Applied interest rate	Eligible fund-provisioning measures	Balance*
Category I	0.20% Higher than the rate for Category II	Special Operations in Response to COVID-19, when funds are provided against loans made by financial institutions on their own	Y4.4tn
Category II	0.10% Absolute value of the short-term policy interest rate	Special Operations in Response to COVID-19, when funds are provided against loans other than those for Category I and against private debt pledged as collateral	Y61.9tn
Category III	0% Lower than the rate for Category II	• Loan Support Program • Operation to Support financial institutions in disaster areas	Y59.5tn

Source: BOJ; compiled by Daiwa Securities.

*Based on average balance in Apr reserve maintenance period;

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings

Issues are rated 1, 2, 3, 4, or 5 as follows:

- 1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
- 2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
- 4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices

Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities

Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings

This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:

<https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf>

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association