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Daiwa Securities

Daiwa's View

JGB yield outlook for 2H FY21

- I. Expected range for 10yr yield is -0.05% to 0.15% and core range is 0.00% to 0.10%

  II. Risk factors are (1) supplementary budget, (2) monetary policy stance, and (3) energy prices

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JGB yield outlook for 2H FY21

We expect a range for the 10yr JGB yield in 2H of -0.05% to 0.15% and core range of 0% to 0.10%.

◆ 5yr JGB yield

Our forecast for the 5yr JGB yield is around -0.1%, with a range of -0.15% to 0.05%. The *Outlook for Economic Activity and Prices* report released by the BOJ in July forecast a CPI of 0.9% to 1.1% in FY23. Monetary policy still maintains a price stability target of 2% and the continuation of quantitative and qualitative monetary easing with yield curve control until inflation remains stable at that level. The policy is to continue expanding the monetary base until the actual y/y change in the CPI (excl. fresh food) stabilizes at over 2%. The BOJ is currently focused on impacts from the pandemic and will not hesitate to provide additional monetary easing measures if necessary. It's has stated clearly that it will maintain its policy rates level with or below the current level of short-term and long-term yields.

Based on the above-noted economic outlook and monetary policy stance, we expect the policy rate to stay around -0.1% until end-FY23. Uncertainty surrounding its economic and price outlook from FY24, which the BOJ has yet to announce, is increasing, and the biggest question regarding the policy rate is whether the negative interest rate policy (NIRP) will be lifted. The 5yr yield forecast that we expect would prompt the BOJ to eliminate its NIRP from FY24 is around -0.05% and that for keeping NIRP in place is around -0.10%. There is of course more than a zero chance of the policy rate being lowered even further (from its current level), depending on the state of the economy. To summarize the above, our forecast for the 5yr JGB yield in 2H is around -0.1%, with a range of -0.15% to 0.05%.

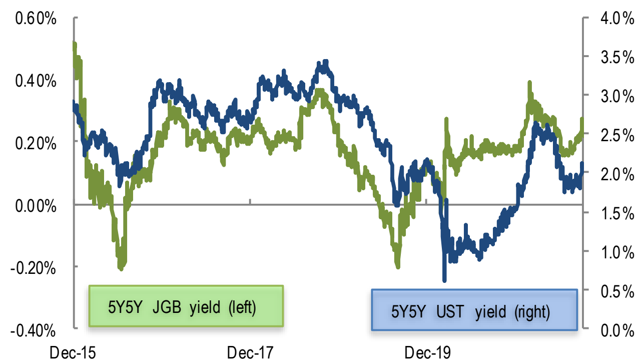
◆ 5yr forward 5yr JGB yield

We expect the 5yr forward 5yr JGB yield to trade at 0.20% to 0.25% and think it is likely to stay within a range of 0.15% to 0.3%. As the latter portion of the 10yr yield, the 5yr forward 5yr yield is currently at 0.23%. Since the BOJ implemented its policy of yield curve control (YCC), the highest that the 5yr forward 5yr yield has been is 0.40% and the lowest it has been is around -0.20%.

Two characteristics of previous periods of increases in the 5yr forward 5yr yield are (1) sharply rising Treasury yields and (2) a widening of the BOJ's YCC band (or a reduction in the credibility of YCC). As that relates to the current environment, we do not expect Treasury yields to rise sharply (see our US yield forecasts). Given the start of the Kishida administration, which is influenced to some degree by former prime minister Shinzo Abe, the eponymous proponent of Abenomics, as well as the BOJ's current priority on dealing with the pandemic, we do not think the conditions are in place for a sharp rise in the 5yr forward 5yr yield during 2H.

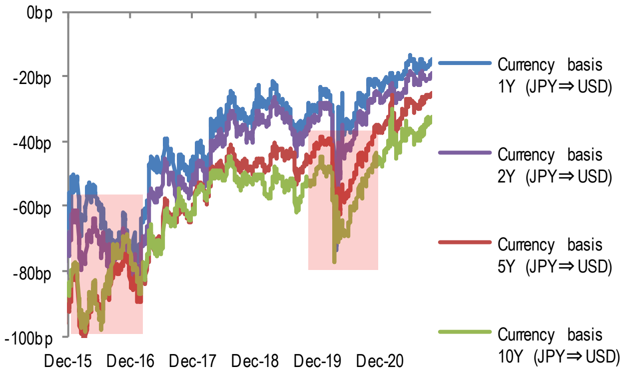
Periods of previous declines in the 5yr forward 5yr were characterized by expectations of further easing by the BOJ including reductions in the policy rate, notable declines in overseas yields, and a widening of negative spreads on currency basis swaps (caused by overseas investors using those swaps to aggressively invest in JPY bonds). We do not expect a sharp decline in Treasury yields during 2H and expect currency basis swaps to remain around where they are now, which is less negative than usual. With the outlook expected to improve, it is unrealistic to expect the BOJ to cut its policy rates. Under these conditions, we expect the 5yr forward 5yr yield to trade around the middle of its historical range at 0.20-0.25% and think it likely to stay within the range of 0.15% to 0.3%.

5Y-forward 5Y Yields in Japan and US



Source: Bloomberg; compiled by Daiwa Securities.

USD/JPY Currency Basis Swap



Source: Bloomberg; compiled by Daiwa Securities.

◆ 10yr JGB yield

Combining our outlooks for the 5yr JGB yield and 5yr forward 5yr yield, we expect the 10yr JGB yield to range between -0.05% and 0.15%, with a core range of 0.00% to 0.10%.

The question is whether that is a suitable range width. One of the models used by the BOJ to estimate the 10yr JGB yield in its March policy review uses three policy variables, the 10yr Treasury yields, Japan's CPI (excl. fresh food), and Japan's job-offers-to-applicants ratio. The 10yr Treasury yield captures global factors while the CPI and job-offers-to-applicants ratio capture local factors. Although the JGB yield is not determined solely by Treasury yields, Treasury yields have to be considered when forecasting JGB yields.

As we explained in this report last week, we forecast a range for the 10yr Treasury yield of 1.25% to 1.75% (a range 50bp wide). The BOJ's forecast model noted above uses 0.25% as the coefficient for the 10yr Treasury yield, which roughly agrees with the Japan/US rate linkage assumed in this report. Based on two data points, the width of the forecast range for the Treasury yields in this report and the regression coefficient from the BOJ, we get 50bp x 0.25 = 12.5bp as a reference value for the 10yr JGB yield's forecast range. We think this corroborates the suitability of the above-noted forecast range width for the 10yr JGB yield.

We expect the 20yr yield to trade in a range of 0.20% to 0.50%

◆ 20yr yield

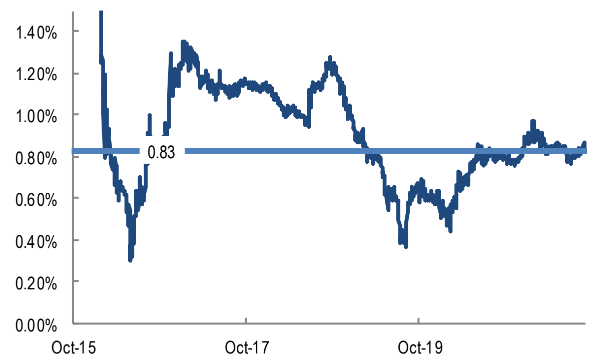
Our forecast range for the 20yr yield is 0.27% to 0.55% (0.43% at end-FY21), with a core range of 0.37% to 0.45%. Compared with shorter maturities, fluctuations in over-10yr superlong yields outside of the BOJ's YCC parameters will probably be more strongly influenced by global factors. Based on past moves in, and the forecast range of, the 10yr forward 20-year Treasury yield, which is included in the 30yr Treasury yield[1], we estimate the range of the 10yr forward 10yr yield, which is included in the 20yr JGB yield, to be 0.60% to 1.00% (it is currently at 0.83%). Combining this 10yr forward 10yr yield range with the 10yr JGB forecast range, we get a range for the 20yr JGB yield of 0.25% to 0.55%.

Data period		Sensitivity between JGB and UST yields (10Y10Y)	Intercept
3 Oct 2016	1 Oct 2021	0.288	0.093

	20Y10Y UST yield (assumption, %)	10Y10Y JGB yield (%)	10Y JGB yield (%)	20Y JGB yield (%)
Upper limit	3.00	0.96	0.15	Around 0.55
Lower limit	1.75	0.60	-0.05	Around 0.25

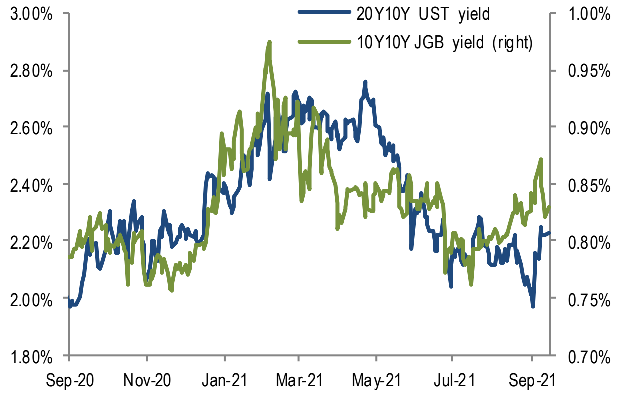
Our assumption for the 20yr forward 10yr Treasury yield is based on conservatively using 3.00%, which is above the top of its range over the past year, and the top of that range may be high. Realistically, because we would expect strong demand when the 20yr JGB yield rises above 0.50%, supposedly one benchmark for operating costs used by deposit-taking institutions, the top of the range at 0.55% may be overly conservative. Furthermore, the 20yr JGB has become a maturity held by a diverse range of investors since the BOJ implemented YCC, and we would expect significant selling pressures if yields were to drop substantially and cause valuation gains to increase. Consequently, we cut off 0.10bp from the top and bottom to get our core range of 0.37% to 0.45%.

10Y-forward 10Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

20Y-forward 10Y UST Yield, 10Y-forward 10Y JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

◆ Risk factors

(1) Supplementary budget (additional economic package) and JGB issuance increases

Regarding the amount of spending to be contained in the supplementary budget, Mr. Kishida commented in an interview after he was elected LDP president that the government would craft an economic package of at least Y20 trillion by December. Although the actual size of the economic package still unknown, based on comments by LDP secretary-general Akira Amari, it would not be surprising if actual stimulus totaled Y30 trillion. The supplementary budget should be put together well before the initial FY22 budget and may be decided by December. Market participants probably recognize this as a potential source of disruption to bond supply-demand (for details, see *Daiwa's View: Due to general election on 31 Oct, supplementary budget likely to be passed by end of year*). Looking ahead to the post-pandemic era, given the ideology and fiscal stance of the Kochikai, which is Mr. Kishida's faction, we think there is unlikely to be any continued relaxation of fiscal discipline.[2] If that is the case, although there is a near-term risk of concerns over rising rates from a ballooning

[1] Because the issuance of 20yr Treasury bonds was just restarted in 1H 2020 and there is a lack of meaningful historical data, we use the 30yr note.

[2] In his "Kishida Vision" published in October 2020, Mr. Kishida wrote the following. "If the nation fails to consistently express an intention of maintaining sound public finances, there is reason to be concerned that domestic and overseas investors will at some point give up on Japan and cause a collapse in its currency and government bonds. ... There is a responsibility to later generations to work toward maintaining fiscal sustainability once the economy gets on track."

supplementary budget, that could create an opportunity for some dip buying over the longer term.

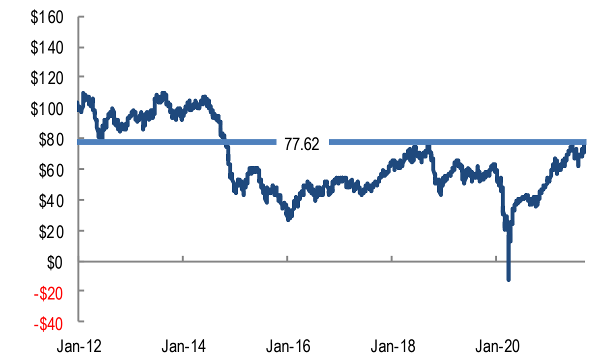
(2) Monetary policy

Unlike Mr. Kono, who distanced himself from Abenomics, we think Mr. Kishida is likely to follow roughly the same trajectory as Mr. Abe. Additionally, the BOJ has indicated that it will stick to its focus on pandemic impacts for the time being. Consequently, we do not expect the market to anticipate any policy change by the BOJ during 2H. The BOJ's operations also suggest a continuation of Abenomics, and there was no change in purchase amounts in the quarterly schedule of the BOJ's outright JGB purchases released at the end of September (the market consensus was for a reduction). With TOPIX hovering close to a nearly 31-year high since the LDP presidential election on 29 September, the BOJ made its first ETF purchases in nearly 3 months. Of course, the BOJ's decision to keep JGB buying operations at the same level may be in anticipation of JGB issuance increases soon, but it made its ETF purchases during the morning session when TOPIX had declined by more than 2%. Even still, these operations do give the impression that monetary policy has NOT CHANGED. The new administration will likely try to find its own policy mix.

(3) Sharp rise in energy prices

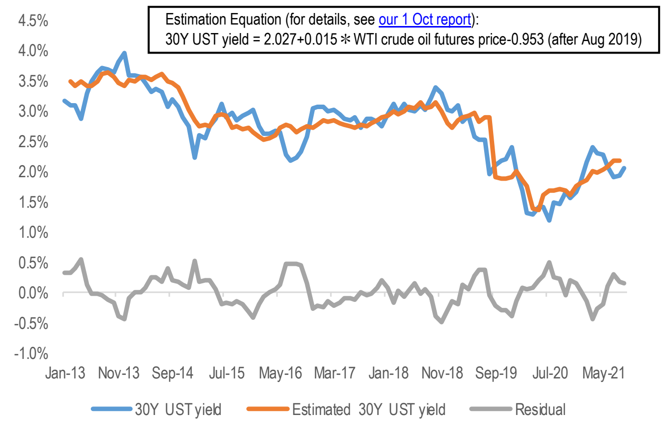
The other day, the WTI crude oil price broke above the high recorded on October 2018 up to $77.62, its highest level in seven years, going back to 2014. As shown in the lower right chart, energy prices and long-term forward rates show a relatively strong correlation, and if energy prices continue climbing it could deepen concerns over stagflation. In the US, consumer confidence and the misery index have already worsened to levels last seen in 2011 and are drawing close to where they were in the 1970s. We expect resource supply constraints and rising demand as the pandemic fades to keep energy prices in a rising trend over the near term. We expect cost-push inflation to cause the economy to deteriorate (stagflation) and ultimately pull interest rates lower, but during the interim it is possible that uncertainty over inflation and the central bank's position on rate hikes cause forward rates to rise via the term premium. During 2H, there is a risk of an "interim" rise in interest rates brought by sharply rising energy prices.

WTI Crude Oil Futures Price



Source: Bloomberg; compiled by Daiwa Securities.

Breakpoint Regression Analysis of 30Y UST Yield



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