Daiwa's View

10-year US yield reached 2%; BOJ gave advanced notice it will conduct fixed-rate purchase operations

- Finally reached 2%, but curve has flattened surprisingly
- BOJ gave advanced notice it will conduct fixed-rate purchase operations when actual yield was at a level of just below 0.25%, dismissing the idea of 'bad depreciation of the yen'

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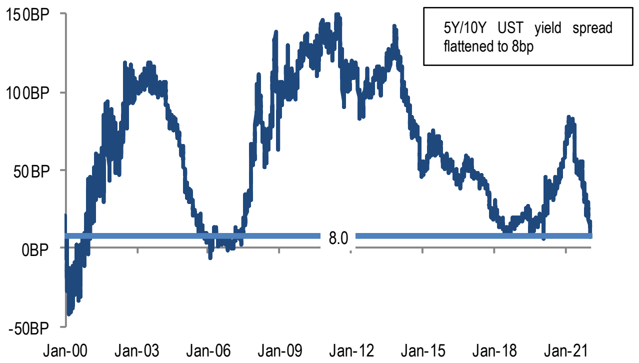
After 10 February, when the US was hit by CPI shock, the 10-year US yield rose to 2.05% at one point, exceeding 2% for the first time since July 2019. (It closed at 1.94% on the 11th.) This has led to the end of the discussions about a 10-year US yield of 2% that have continued for about one year since the beginning of 2021.

That said, at the beginning of 2021 people would not have imagined a flattening of the yield curve to this degree when the 10-year yield reached 2%. For example, the 5-year/10-year spread as of 10 February was only 8bp (5-year yield of 1.95% and 10-year yield of 2.03%).

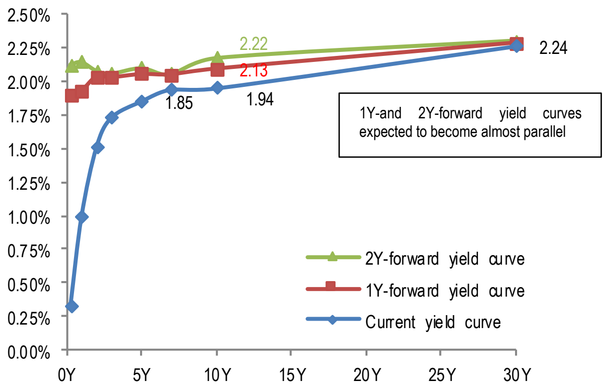
Of course, this flattening is mainly caused by further pricing of the rate-hike outlook due to rising inflation and sluggish long-term forward yields. While the 1-year forward 1-year yield rose to 1.93% on the 11th, the 5-year forward 5-year yield, which reflects long-term forward yields, was only at 2.03%. As such, the forward yield has converged to around 2%. As a result, the shapes of the 1-year forward and 2-year forward yield curves, which are components of forward yields, are becoming almost parallel at slightly above 2% (right-hand chart below).

5Y/10Y UST Yield Spread



Source: Bloomberg; compiled by Daiwa Securities.

UST Yield Curve



Source: Bloomberg; compiled by Daiwa Securities.

This shows that the US long-term yield lacks the power to substantially exceed 2% unless a rise in the terminal rate occurs. Although yields themselves appear to be in an uptrend, an expected ceiling is beginning to appear. Meanwhile, given that the Fed may slow (or suspend) the pace of rate hikes in a flexible manner if there is a sharp slowdown in the ISM Index to 50-52, it is worthwhile considering dip-buying of the 10-year US yield at slightly above 2% while keeping a close eye on discussion about QT.

BOJ gave advanced notice it will conduct fixed-rate purchase operations when actual yield was at a level of just below 0.25%, dismissing the idea of 'bad depreciation of the yen'

◆ BOJ gave advanced notice it will conduct fixed-rate purchase operations

On 10 February, the BOJ gave advanced notice that it would conduct fixed-rate purchase operations (with 0.25% as the level at which purchases would begin).

At 14:00 on the same day, an exclusive interview with BOJ Governor Haruhiko Kuroda was announced by a news outlet. We can consider this series of messages as playing the role of explaining the intentions behind the BOJ's policies to the outside world. According to the Summary of Opinions at the January Monetary Policy Meeting (MPM), several participants were of the opinion that, since it would take time to achieve the price stability target, and, therefore, the BOJ would continue with monetary easing until the price stability target was achieved in a stable and sustainable manner, the BOJ should clearly communicate the intentions behind its policy to the public.

Summary of Opinions at BOJ's Monetary Policy Meeting on 17-18 Jan 2022 (disclosed on 26 Jan 2022)

- Since it will still take time to achieve the price stability target of 2 percent in a stable manner, there has been no change in the Bank's basic thinking that it should continue with the current powerful monetary easing. It is important for the Bank to firmly maintain its policy stance and clearly communicate it to the public.
- The Bank will continue with monetary easing until the price stability target is achieved in a stable and sustainable manner. It should communicate this policy intention to the public well to avoid misunderstanding.
- The Bank will continue with monetary easing until CPI inflation meets the 2 percent price stability target in a stable and sustainable manner. The Bank needs to clearly explain this stance to the public, together with its thinking on desirable inflation vis-à-vis developments in Japan's economy.

It was somewhat unexpected that the BOJ would give advance notice that it would conduct fixed-rate purchase operations before the 10-year yield had actually hit 0.25%. However, with the 5-year and 10-year JGB yields having already risen to 0.03% and 0.23%, respectively, if the US CPI (announced during a three-day weekend in Japan) became a surprise, the 10-year JGB yield could have surged to a level above 0.25% at the beginning of the week. So, the advanced notice appears to have partly played the role of a pre-emptive move.

The preemptive decision may have also been made in part due to the announcement of news casting doubt on the BOJ's intention to maintain 0.25%, in which a former BOJ policy board member expressed the opinion that the BOJ was unlikely to demonstrate a staunch position in which it would prevent the long-term yield from rising above the upper limit. In Oct-Nov 2021, the Reserve Bank of Australia (RBA) discontinued the yield target that had been explicitly stated, without securing the upper limit of the target. There have been precedents in which it has been difficult to calm the situation once this kind of speculation has spread. It is expected that last week's advance notice of fixed-rate purchase operations by the BOJ will have the effect of preventing the spread of speculation that the BOJ's yield curve control will follow the same pattern as the RBA.

◆ Also serves as preemptive move to deal with idea of 'bad depreciation of the yen'

Moreover, if the BOJ were to bolster its stance of reining in higher yields via fixed-rate purchase operations, people might fixate on the idea that depreciation of the yen would be bad due to widening of the relative yield difference. Governor Kuroda made a preemptive move in this respect at an exclusive interview on the same day. In the interview, he acknowledged the possibility of widening of the relative yield difference due to continued easing by the BOJ, and then virtually dismissed the possible impact on the foreign currency exchange market, saying that it would depend on the situation.

BOJ Governor Haruhiko Kuroda (10 Feb 2022)

- It is very possible that the yield spread between Japan and the US will widen in the case of rate hikes in the US and other regions, but its impact on the foreign currency exchange market will depend on the situation.

Of course, this partially depends on the extent, but it is now clear that the BOJ has no intention of allowing a rise in yields beyond the target due to continuing weakening of the yen to a level slightly above the current level. Recently, certain market participants have often speculated that the BOJ might accept higher yields in order to ease depreciation of the yen, but Governor Kuroda warned against this in his comment.

◆ <u>It could also be taking into consideration corporate sentiment (wage hikes)</u>
The BOJ's advance notice that it would conduct fixed-rate purchase operations also appears to take into consideration corporate sentiment. Reflecting the recent surge in yields and the return of the 5-year yield to positive territory, the corporate bond market has seen the pricing method in the 5-year zone return to that used before the introduction of the negative rate policy (from absolute value pricing to spread pricing). Therefore, there have been an increasing number of questions from Japanese companies about how much fundraising costs would worsen.

Needless to say, if personal incomes rise and companies can pass higher cost onto consumers, like in the US, the impact of rising fundraising costs on corporate sentiment will be limited. However, under the current circumstances in which companies are suffering from higher resource prices with no clear idea of how much fundraising costs will be, it will be increasingly difficult to accept the 3% wage hikes requested by the Kishida administration.

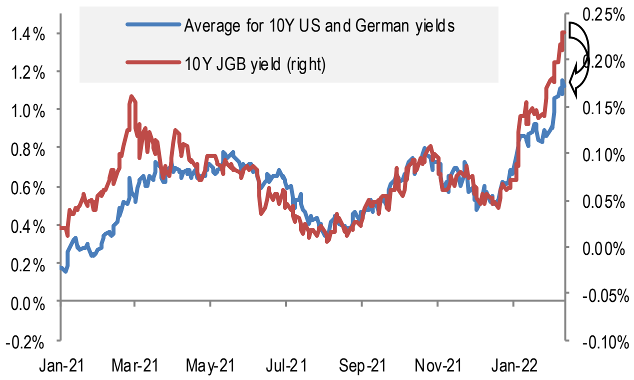
If companies were to fail to implement wage hikes, cost-push inflation would reduce real disposable income among consumers. This would worsen the output gap. In the end, as Governor Kuroda stated, wage hikes are required in order to approach the 2% target in a sustainable manner. His overall opinion appears to be that the pace of economic recovery in Japan is slower than that in Europe and the US, and inflation is about 0.5%, and, therefore, there is no need or it is not possible to shift to tapering or tightening of monetary policy.

◆ <u>Risk/reward high with carry and roll-down strategy with a 10-year yield at the lower 0.2% range</u>
In his interview, Governor Kuroda expressed the opinion of ruling out discussing the exit strategy, saying that if they were to discuss the exit strategy before the CPI reached the 2% target, it might mislead the market, and that as long as the current price projections were unchanged, there would be no chance that he would discuss the exit strategy during his term in office.

Of course, speculation regarding policy revisions after the end of his term will not disappear. However, policy will not be revised until April 2023 at the earliest, which is a bit too far off in order to serve as a short-term market factor. Combined with the aforementioned advance notice of fixed-rate purchase operations, volatility in the yen-bond market is likely to calm down, although speculative investment has recently increased.

Given the fact that downside volatility of the 10-year JGB price was eliminated due to the advance notice of fixed-rate purchase operations (i.e., absence of downside deviation), we can point out a significant improvement in the risk/reward with a carry and roll-down strategy with a 10-year yield at the lower 0.2% range. If we also consider that JGBs have underperformed 10-year yields in Europe and the US since January (left-hand chart below), the 10-year JGB yield could move below 0.2%.

10Y JGB Yield, Average for 10Y US and European Yields



Source: Bloomberg; compiled by Daiwa Securities.

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