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Daiwa Securities

Daiwa's View

High chance of implementation of fixed-rate purchase operations in the 2-year sector

- Simple linear interpolation suggests implementation in the 2-year zone is not far off

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In the European debt crisis in 2011-12, we saw the widening of spreads in Greece, which was the most fragile in the zone. Next, PIIGS became the target, and then France became the target, surprisingly. Initially, the crisis started in nations/regions in which fundamentals justified it. However, once a psychology of fear mounted, fundamentals tended to be ignored. The media gave serious attention to arguments that can be regarded as extreme (such as the collapse of the euro). While long-term investors took a more cautious stance, market developments were led by short-term money. This process continued until then ECB President Mario Draghi stated that “the ECB is ready to do whatever it takes to preserve the euro” and the trust of long-term investors was restored.

While the details may be different, of course, the recent rise in global yields gives us a slight sense of déjà vu. Specifically, panic has been spreading as people search for what will be next. First, rate-hike pricing started in the US, where fundamentals justified it, but once the more extreme arguments—about a 50bp rate hike or seven hikes/year, for example—had played out, the focus shifted to Europe, and then Japan. In this kind of situation, it is the central banks that have the power to calm this psychology of panic.

In that respect, we can’t deny that the panicked mindset is partially aggravated by expectations of policy revisions by the BOJ. However, the BOJ has already explicitly stated that the level for fixed-rate purchase operations for consecutive days was a 10-year JGB yield of 0.25%. In forward guidance for the policy interest rate, as well, it has clearly stated “at their present or lower levels.” While doubts regarding revisions to easing by the BOJ may linger, at the very least it’s probably OK to trust it in the near term regarding this 10-year JGB yield level of 0.25%. (However, this level is also likely to shift, of course, in line with hikes to the zero percent target for the 10-year yield.)

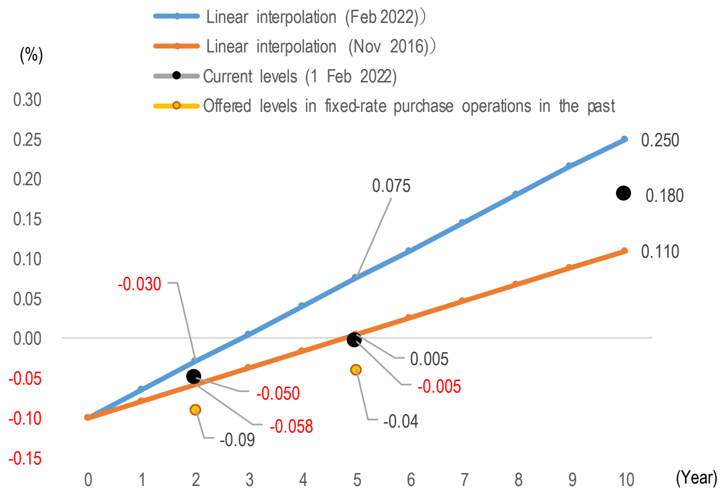
In the past, the BOJ implemented fixed-rate purchase operations with three maturities—the 2-year, 5-year, and 10-year sectors. Therefore, we can presume that the BOJ is giving considerable importance to the 2-year and 5-year sectors. In 2016, when the allowable trading range of the zero percent target for the 10-year yield was around ±0.1%, narrower than the current one, the levels chosen for the 2-year yield and a 5-year yield were -0.09% and -0.04%, respectively. However, now the 2-year and 5-year yields have exceeded these levels for fixed-rate purchase operations in the past, reaching around -0.05% and 0%, respectively, with a 10-year yield of about 0.18%. What are we to expect regarding future levels?

We would like to examine this based on the yield levels officially indicated by the BOJ and linear interpolation, which is simple (easy to understand on an intuitive level).

When fixed-rate purchase operations were implemented on 17 November 2016, the policy rate was -0.10% and the upper limit of the trading band of the 10-year yield was 0.11%. Connecting this policy rate and the upper limit of the trading band linearly, we can derive -0.058% as the point corresponding to the 2-year yield and 0.005% as the 5-year yield (y = 0.021x - 0.1). At that time, the actual fixed-rate purchase operations were offered with a 2-year yield of -0.09% and a 5-year yield of -0.04%. This means that the BOJ chose levels that were 0.032% and 0.045% lower, respectively, than the figures based on linear interpolation. Of course, given the existence of the forward guidance, we think that the yield levels derived from simple linear interpolation are excessively conservative. Therefore, it would be appropriate to choose lower figures.

Currently, with a policy rate of -0.10%, the level of fixed-rate purchase operations for consecutive days has changed to 0.25%. Therefore, the above-mentioned formula for linear interpolation has changed to 'y= 0.035x - 0.1' (upward shift). Using this formula, we can derive a 2-year yield of -0.03% and a 5-year yield of 0.075%. Given the existence of the forward guidance, we do not think there will be rate hikes in the near future. If we assume that fixed-rate purchase operations will be implemented in the current situation, the levels lower than the aforementioned levels (a 2-year yield of -0.03% and a 5-year yield of 0.075%) can be envisaged.

Linear Interpolation Based on Policy Rate and Upper Limit of Trading Band



Source: Bloomberg; compiled by Daiwa Securities.

In that respect, the currently observed 2-year yield in the market is -0.05%, just 0.02ppt below the level derived from linear interpolation in the chart above. Unlike the long-term zone, where a certain degree of market fluctuation is welcome, an excessive rise in the short-term zone can be interpreted as a decline in confidence in forward guidance. If short-term/intermediate yields continue to rise going forward, we should assume that there is a considerably high chance of implementation of fixed-rate purchase operations, especially in the 2-year sector. Although the 5-year yield is now slightly far from the assumed level, such operations in the 5-year sector may be offered simultaneously in order to make one-time action effective.

The above-mentioned examinations are just simple ones based on the policy rate levels indicated by the BOJ, the upper limit of the trading band, and the levels of fixed-rate purchase operations in the past. This may be seen as being overly simplistic. However, it is important to be able to understand these things on an intuitive level when people are dominated by a psychology of fear. In short, simple is best. (People tend to be gripped by fear in the presence of a black box.) Once we get an idea of the overall 'big picture' in general terms, a more accurate idea of the situation can be understood by taking specific factors into account as necessary. A levelheaded perspective shows that a peak is approaching.

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