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Daiwa's View

Trading band widened again

➢ New yield curve forms on increase in yield cap

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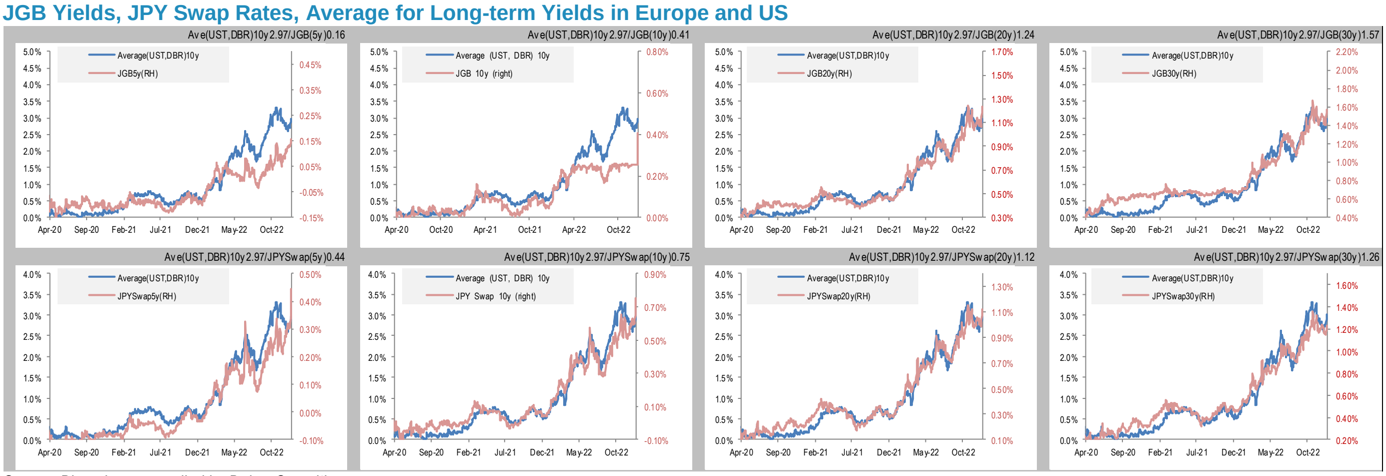
Yesterday, the BOJ stuck with its 10yr yield target of 0% but on concerns about market functionality widened the trading band from ±0.25% to ±0.5%, retaining the easing bias in its forward guidance. In a release entitled "Increase in the Amounts of Outright Purchases of Japanese Government Bonds and Other Market Operation Measures," it announced it will raise its monthly *rinban* operation purchases in Jan-Mar 2023 from Y7.3tn to Y9tn, as well as make purchases at that same pace in its operations on 26 December and make additional purchases on 22 December as necessary based on market conditions. We have already given our comprehensive assessment of the BOJ's latest policy meeting on *Daiwa's View* entitled "BOJ surprise underscores problem in terms of communication with market," so will confine ourselves here primarily to discussing the impact that the BOJ's latest policy change has on market prices.

◆ Long-term rates are largely trading in the appropriate range

Looking at the graph below showing a comparison with interest rates in Europe and the US, the rise in interest rates sparked by this policy change suggest that the adjustment in 10yr JGB yields toward levels suggested by long-term rates in Europe and the US has largely been completed. When US long-term rates were substantially above 4%, we expected there to be very strong upward pressures when the BOJ modified policy, but now that the 10yr Treasury yield has declined to the mid-3% range, the conditions may be conducive for a 10yr JGB yield cap of 0.5% to function well. It is possible that the decline in US long-term rates, which reduced somewhat the potential for yields to rise when the YCC band is widened and improved the cost/benefit balance of a policy change, encouraged the BOJ to make a move this month toward restoring market functionality.

JGB Yields, JPY Swap Rates, Average for Long-term Yields in Europe and US



Source: Bloomberg; compiled by Daiwa Securities.

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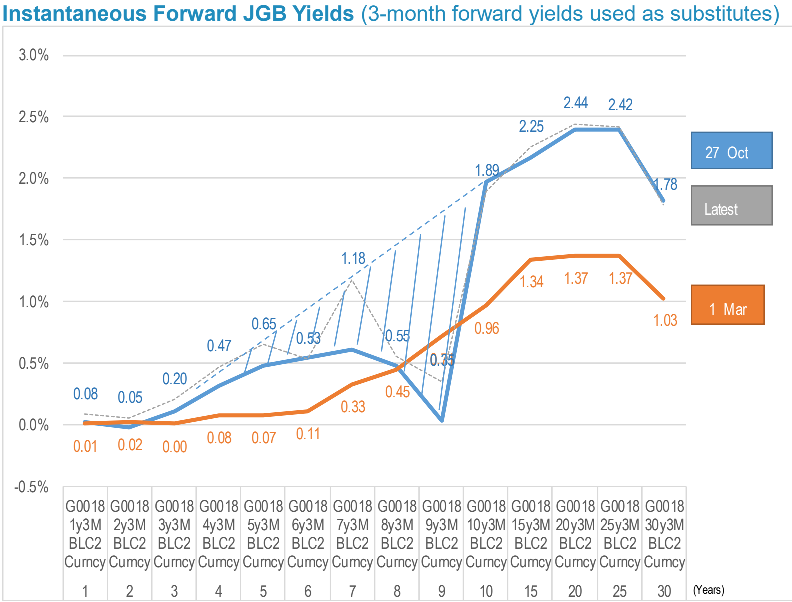
The question to ask with regards to 10yr JGB yields is whether the market will respond to the new 0.5% yield cap with a recovery of functionality or another attack on the BOJ YCC policy. If it is the latter, it would not be surprising if JGB yields fail to regain their status as the benchmark for corporate bonds and loans and the BOJ is forced to raise the yield cap further. Although difficult to predict, the fact that the 10yr JGB yield momentarily rose above 0.45% then retraced back to around 0.4% yesterday is good news for the recovery of market functionality. There are numerous possible sources of disruption, including the direction of the muddled political landscape, the selection of new BOJ leadership, and economic conditions in Europe and the US, but if these latest measures create more breathing room to examine events, it should be possible for the market to accept the new curve.

◆ Yield curve: Stronger management of the front end

When the BOJ announced it was expanding its fixed-rate purchase operations beyond the 10yr sector into the 1yr-5yr and 10yr-25yr zones, it signaled an intent to strengthen its control of the entire curve. This message was especially striking for the intermediate zone, where it reported it would purchase 5yr JGBs at a yield of 0.17%, much lower than the over 0.25% that the bonds were trading at prior to the announcement. In previous reports, our chief market economist Mari Iwashita pointed to the possibility that strengthening management of the front end of the yield curve when modifying the 10yr yield cap would likely put downward pressure on yields in the short-term to intermediate zones that are most affected by monetary easing, and the fixed-rate purchase operations announced yesterday were probably meant to do just that.

Furthermore, although the targeted yields for the fixed-rate purchase operations announced yesterday—0.02% for the 2yr, 0.17% for the 5yr, 0.50% for the 10yr, and 1.245% for the 20yr— should not be seen as hard caps, they may for the time being serve as benchmarks for the yield curve. A 2yr yield cap of 0.02% implies that short-term rates are unlikely to be raised into positive territory within the forward guidance window of two years. Given that, a 5yr yield cap of 0.17% would roughly equate to a 2yr forward 3yr yield of about 0.25-0.3%. This would equate to generally maintaining the instantaneous forward yield shape that formed on 27 October and close to a slight increase from the absolute yield level. Furthermore, a 20yr yield of 1.245% equates roughly to superlong forward yields of over 2%. These operations provide a reminder that the BOJ has a brake lever on the superlong zone that controls the terminal portion of the curve, and probably also send the message that the 20yr sector is not going to collapse in response to worsening supply-demand, given the BOJ's influence over the 10yr yield.

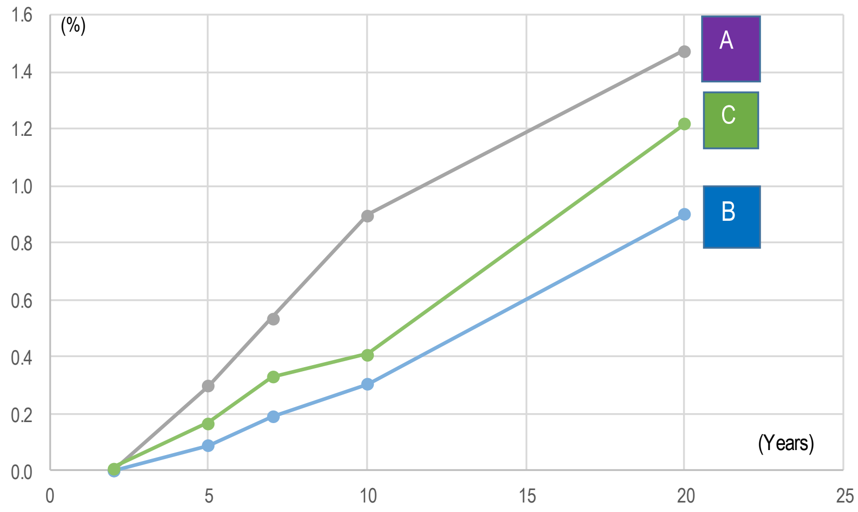
Instantaneous Forward JGB Yields (3-month forward yields used as substitutes)



Source: Bloomberg; compiled by Daiwa Securities.

Although the existence of the YCC policy provides some constraint on yield levels, forward yields are somewhat less distorted than they were on 27 October. Assuming the current level of instantaneous forward yields and the 10yr yield cap of 0.5%, we would expect the yield curve for now to be at around 0% for the 2yr, 0.15% for the 5yr, 0.3% for the 7yr, and 0.4% for the 10yr (the range around these figures is of course wider than it was prior to the BOJ widening the trading band). These numbers will of course depend strongly on the level of superlong forward rates and timing of policy rate hikes. If forward rates were to decline in step with overseas interest rates, it would pull the overall curve downward (the fixed-rate operations in the 20yr sector would probably provide some support in the upward direction), and if the timing of policy rate hikes is moved forward, the consequent increase in the yield curve would be led from the front end.

JGB Yield Curves by Scenario



	JGB yields (%)				
	2y	5y	7y	10y	20 y
A: End of YCC (& Strengthening of forward guidance)	*0.0*	*0.3*	*0.5*	*0.9*	*1.5*
B: Theoretical value (Fwd 1.5%)	*0.0*	*0.1*	*0.2*	*0.3*	*0.9*
C: As of 20 Dec 2022	*0.0*	*0.2*	*0.3*	*0.4*	*1.2*

Source: Compiled by Daiwa Securities.

◆ Rise in banking stocks and insurance stocks (indicating few concerns over the financial system)

Lastly, we offer some brief remarks regarding concerns over the financial system. Abandonment of YCC would result in a sharp jump in long-term yields, and this could harm the capital bases of banks and insurance companies and threaten the stability of the financial system. Therefore it is worth paying particular attention to the performance of bank and insurance stocks when a policy modification is announced. In the Tokyo stock market yesterday, although TOPIX reacted to the policy change by declining 1.54%, the bank stock index rose 5.12% and the insurance stock index rose 4.49%. These share price trends suggest at the very least that concerns over financial stability, one of the perceived challenges of the BOJ exiting YCC, are not very strongly felt.

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