Daiwa Securities

Daiwa's View

Supplementary examination regarding our JGB yield outlook

- If YCC were removed this week, 10-year yield would reach 1%, but it would be unlikely to be sustained

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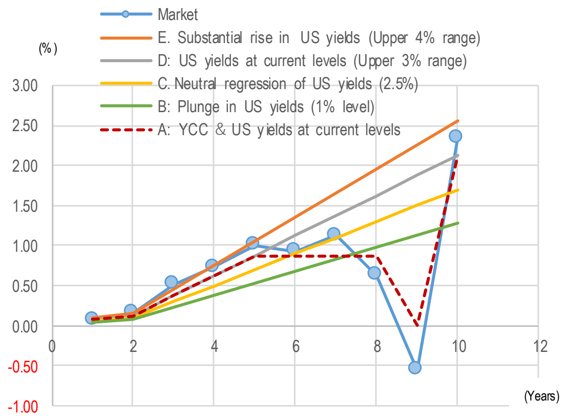
In this report, we conduct a supplementary examination of our JGB yield outlook. This is mainly because (1) on 12 January, *Yomiuri Shimbun* reported that the BOJ would re-examine the side effects from its large-scale easing and (2) our chief market economist Mari Iwashita, who is in charge of our house view, changed her main scenario regarding the outlook for the BOJ's monetary policy on 13 January from "upward revision to the trading band of the long-term interest rate" to "removal of the YCC under the new BOJ Governor by October." As of 5 December, the removal of the YCC was just a sub-scenario, but it has now been raised to the main scenario.

In our previous JGB yield outlook, the main scenario was the widening of the trading band (with the upper limit widening from 50bp to 75bp) in July after suspension of US rate hikes by the Fed. When the YCC ends and the upper limit of the trading band is raised are important issues. The assumptions to be made regarding the external environment (overseas economies and interest rates) vary greatly depending on whether we are talking about July 2023, when it is highly likely that the Fed will have suspended rate hikes, or January, when the Fed will still be in the process of raising rates. Given the current conditions, we need to consider what will happen under the sub scenario—i.e., the BOJ suddenly removing the YCC or widening the upper limit of the trading band to 1% in January when the Fed is still in the process of raising rates.

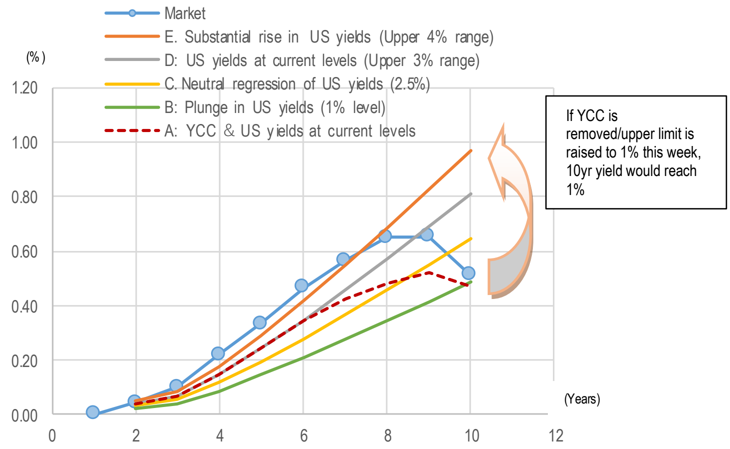
Looking at the instantaneous forward rates that were used for the previous outlook (chart below), the yield levels with residual maturities of up to five years have mostly risen to the orange line, and superlong forward yields have also risen close to 2.5%, rather than 2%. This indicates that the 10-year JGB yield is expected to reach 1%, equal to the orange line, if the BOJ suddenly removes the YCC or widens the upper limit of the trading band to 1% at the January Monetary Policy Meeting (MPM). At the end of last week, the 10-year yield hit 1% in the JPY swap market, and the same movement is also expected for JGBs.

JGB Instantaneous Forward Rates



Source: Bloomberg; compiled by Daiwa Securities.

Estimated JGB Yield Curves



Source: Bloomberg; compiled by Daiwa Securities.

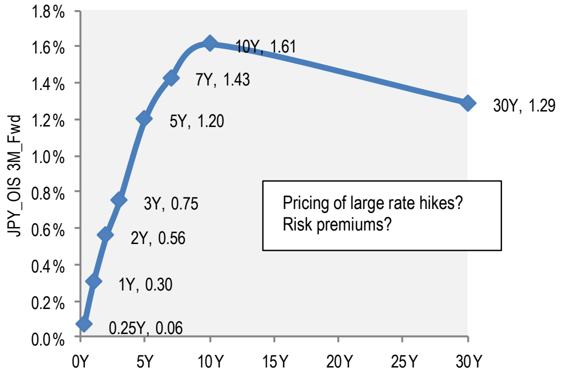
That said, as Ms. Iwashita reported last week, we do not consider widening of the trading band at the January MPM to be the main scenario. (According to media reports on 13 January, former BOJ executive director Hideo Hayakawa appears to have come to the same conclusion.) On 12 January, *Yomiuri Shimbun* reported comments by those in the know that (1) there would be a re-examination of the side effects from large-scale easing, (2) yields with short redemption periods have tended to rise since January, in addition to the long-term yield staying at its upper limit, which is not what the BOJ is aiming for, and (3) the BOJ would carefully watch whether it can correct distortions in the market through adjustments to the amount of JGBs purchased and other means, and, if necessary, it would make additional modifications to policy. The wording "if necessary" reminds me of a media report (dated 12 Mar 2021) about the previous assessment based on remarks by those in the know that the BOJ would announce its analysis of the impact of deeper negative interest rates, and that the Bank would implement them, if necessary. At the previous assessment meeting (Mar 2021), the BOJ did not deepen negative interest rates despite media reporting before the event that the BOJ would implement them, if necessary.

Based on the 12 January *Yomiuri Shimbun* article, it would seem unlikely that the January MPM will end the YCC. This MPM is to conduct a re-examination of side effects, not an assessment. Moreover, related articles have reported that (1) the level of the FY24 core CPI projection (incl. the impact of the economic measures) in the January *Outlook Report* is expected to exceed 2% and (2) the level of the core-core CPI projection is to be revised upwards, but that it is unlikely to reach 2%. With respect to these outlook revisions, the above-mentioned *Yomiuri Shimbun* article reported that, regarding the decision on monetary policy at the meeting, the BOJ is likely to share the stance of emphasizing the price trends excluding the impact of economic measures. This appears to be signaling the possibility that the BOJ will not judge that the requirement for removing the YCC—until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2% and stays above the target in a stable manner (forward guidance for YCC)—have been satisfied.

Of course, we cannot deny that there could be a surprise at the January meeting (there is likely an incentive to rob the YCC policy of its effectiveness in one fell swoop) because the policy was modified at the previous meeting by breaking with previously established communications. However, with the series of media reports regarding price projections since the beginning of 2023 being largely controlled, the possibility of continuing to see a surprise appears to be decreasing.

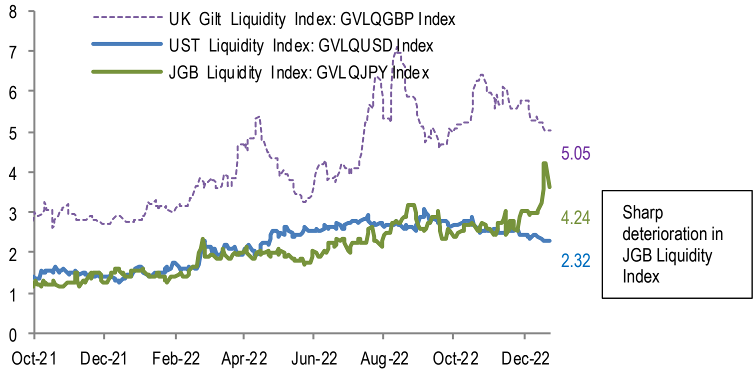
Currently, the OIS yields one year from now, two years from now, and three years from now are 0.3%, slightly above 0.5%, and 0.75%, respectively. As such, the OIS market is currently factoring in hikes to the short-term policy rate at a fast pace, in addition to the removal of negative interest rates (Chart below). We wonder about this path, and suspect that this is reflecting hedging in preparation for turmoil in the case of the removal of the YCC, alternative hedging due to the lack of market functions for bond futures, and distortion of supply/demand mainly due to loss-cut of assets held. Current JGB yields probably largely comprise of risk premiums due to the confusion since the December 2022 MPM, and interpreting the risk premiums as rate-hike pricing appears to be creating unjustified feelings. (The Bloomberg Government Securities Liquidity Index has worsened to the extreme level of 4.24, which also proves the risk premium narrative.)

JPY Swap OIS 3M Forward Yield (as of 13 Jan)



Source: Bloomberg; compiled by Daiwa Securities.

Bloomberg Government Securities Liquidity Index

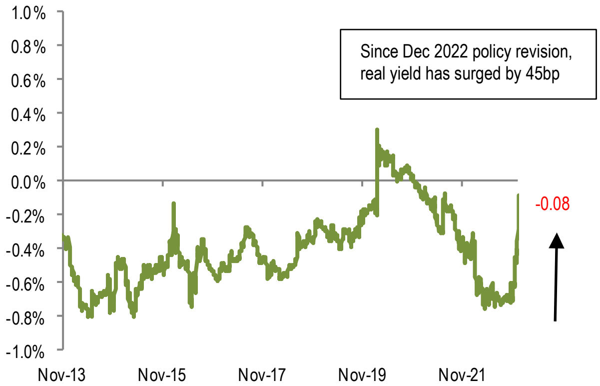


Source: Bloomberg; compiled by Daiwa Securities.

That said, reflecting the latest confusion, the 10-year real yield rose sharply by 45bp from -0.53% to -0.08%, while 10-year JGB inflation expectations declined by 22bp from 0.88% to 0.66%. This combination of higher real yields + lower inflation expectations is an undesirable reaction in Japan, where inflation expectations are far below the target. This indicates that (1) the sudden widening of the trading band in December 2022 was interpreted as the first step for tightening measures and (2) tightening action at the current stage would be premature with regard to Japanese inflation.

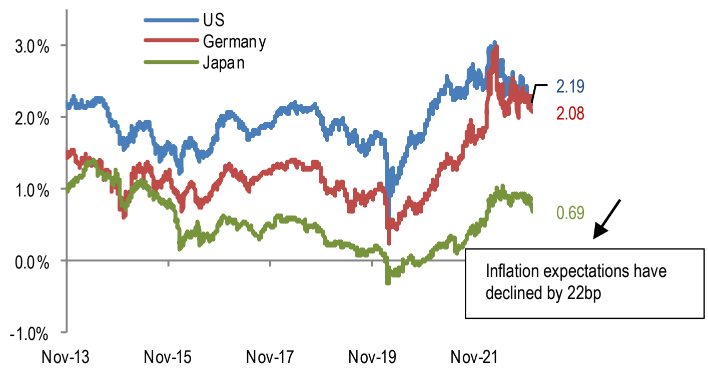
If so, and if real yields rise due to further widening of the trading band at the January MPM, Japanese companies will shift to more defensive behavior, which will create concern about the possibility of dampening the momentum for wage hikes. (Note: Decisions on wage hikes are made by corporate heads.) This is likely to result in further suppressing Japanese BEI, which is already at a markedly low level compared to Europe and the US.

10Y JGB Real Yield



Source: Bloomberg; compiled by Daiwa Securities.

10Y Inflation Expectations in Japan, US, Germany



Source: Bloomberg; compiled by Daiwa Securities.

All in all, if the BOJ were to remove the YCC and/or widen the trading band at the January MPM at once amid market turmoil, the 10-year yield would be expected to temporarily rise to 1%, which would entail risk premiums. However, it is unlikely that it would be sustained from the standpoint of inflation expectations + real yields. Convergence of risk premium turmoil may require 1%, which is a psychological threshold among investors. (This may be equivalent to the US long-term yield of 4%.) That said, our outlook is unchanged that the 10-year yield will decline towards the latter half of the year due to an economic slowdown and lower overseas yields.

Looking back on the recent market, the US long-term yield stayed at the 4% level for only 19 business days (10 Oct-9 Nov 2022, ending due to the reverse CPI shock). Only three months after that, the US long-term yield declined to 3.5%, verifying that the 10-year US yield at the 4% level provided a buying opportunity. From the standpoint of hedging costs, it appeared difficult for Japanese investors to buy the 10-year US yield at the 4% level. However, if the 10-year JGB yield, for which there are no limitations for hedging costs, were to exceed 1%, we would recommend referring to successful investment cases for US Treasuries by prominent US investors, such as Jeffrey Gundlach, PIMCO, and Citadel, as they consistently had a buy-on-dip stance for the 10-year US yield at the 4% level in the context of fundamentals. In a situation in which no one can estimate where the bottom is, having an excessive, short-sighted fear of possibly seeing further declines could result in losing a good opportunity as an investor during the arrival as a phase (even if that view is correct in terms of deciding on the span as an investor).

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