Daiwa's View

BOJ's cautious stance unchanged even at Jun meeting

➢ YCC revisions not expected unless high probability of side effects?

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The Monetary Policy Board meeting held late last week reconfirmed the BOJ's cautious stance. As our Chief Market Economist Mari Iwashita provides a comprehensive overview of the BOJ, in this report our focus is on potential YCC revisions and US economy downside risks, which can significantly impact market prices.

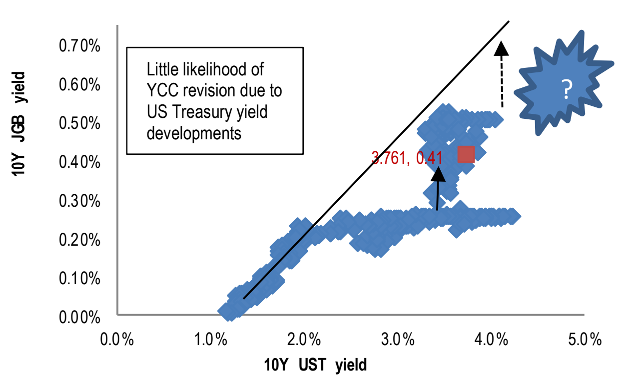
◆ YCC revisions

During last week's post-meeting press conference, BOJ Governor Kazuo Ueda was asked whether the Bank would again expand its 10-year JGB yield permissible trading range. Noting that various market functioning indicators have improved as a result of measures taken since last December, he said, "We cannot deny the possibility that side effects will become more evident if inflation expectations in Japan increase or overseas bond yields rise. We would need to decide what to do then." We have the impression that YCC revisions made to prevent side effects are now less likely going forward. The BOJ's apparent stance is to only think in terms of the balance between policy benefits and side effects, while addressing side effects if they became apparent.

Of course, if there is a high probability that a major distortion will occur in the future, the BOJ could take some preventative measures. However, at this juncture, it seems somewhat unlikely that a rise in overseas bond yields would prompt a BOJ policy revision. If we assume a beta of around 0.2 between the 10-year JGB yield and the 10-year US Treasury yield, the room for the 10-year JGB yield (currently 0.4%) to rise to the 0.5% upper bound of its permissible trading range would be equivalent to the 50bp leeway for the 10-year US Treasury yield (around 4.25%). In order to produce a noticeable distortion in the JGB yield curve, the 10-year US Treasury yield would probably need to move much higher, likely into the 4.5%-5.0% range. Considering that the Fed's current rate-hiking cycle is approaching its final stage, as well as the flattening trend discussed later, it is hard to imagine the need for YCC revisions based solely on US Treasury yield developments.

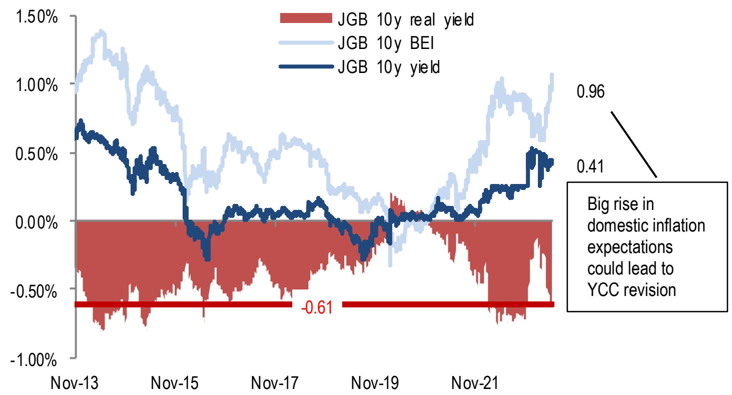
Indeed, YCC revisions are likely to come about due to a combination of factors including higher overseas bond yields. That said, "rising inflation expectations" in Japan, one of the two factors mentioned by Ueda during his press conference, more likely holds the key to the next YCC revision. If the 10-year JGB yield sticks to the 0.5% upper bound of the BOJ's permissible trading range under YCC, while domestic inflation expectations rise toward 2%, the real interest rate would decline by an amount equivalent to the increase in inflation expectations. The market functioning side effects caused by JGB yield curve distortions are also important, but the risk of excessive easing due to a decline in real interest rates cannot be ignored. In that case, the BOJ would probably need to adjust parameters to keep the degree of monetary easing within the appropriate range. We also probably need to keep an eye on Japan's breakeven inflation (BEI) rate, which has been trending slightly higher recently (see chart on next page). Ueda's press conference also reconfirmed the likelihood a certain degree of surprise when the BOJ actually moves to revise its YCC policy (albeit, the occurrence of a surprise is itself not a surprise). Monetary Policy Board meetings during those months when the BOJ also releases its *Outlook Report*'s inflation forecast revisions are particularly unpredictable.

10Y UST Yield, JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Breakeven Inflation Rate



Source: Bloomberg; compiled by Daiwa Securities.

◆ <u>US economy downside risks</u>

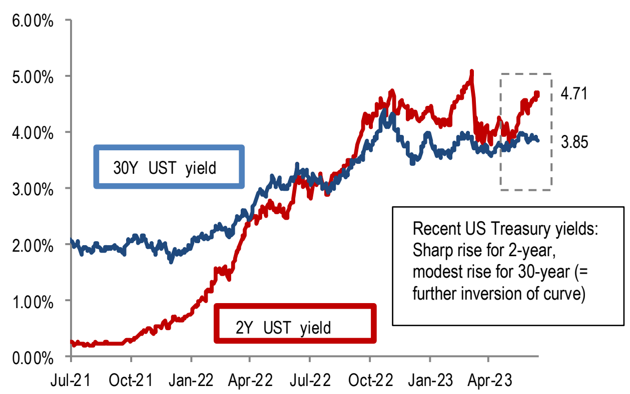
Even during his press conference last week, Ueda emphasized the extremely high level of uncertainty about the future on various fronts. We reconfirmed Ueda's emphasis on US economic trends in particular, as well as overseas economies in general. Regarding the US economy, he mentioned the near-term strength of the economy and prices and mentioned the risk that this could lead to further rate hikes and strong downward pressure on the US economy in the future.

On this point, the US Treasury yield curve is again inverting and private economists continue to lower their 2024 US growth forecasts. These are new trends that we must keep in mind. As of the end of last week, the yield on the 2-year US Treasury rose 7bp to 4.71%, while that for the 30-year US Treasury rose only 1bp to 3.85%, further deepening the curve's inversion. This inversion of the yield curve started to correct soon after the collapse of Silicon Valley Bank in March of this year, but it is again worsening as the Fed sharpens its hawkish stance.

The OIS (overnight index swap) market is currently pricing in a terminal rate of only *5.3%*. If this market were to start pricing in a higher terminal rate toward the 5.625% level indicated by the Fed's dot chart, recession fears and banking concerns, which have subsided for the time being, could resurface.

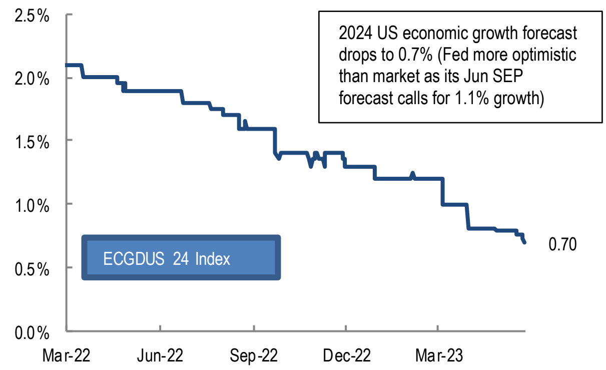
Economists' consensus on US economic growth in 2024 fell to 0.7%, below the Fed's June SEP forecast of 1.1%, and has been on a consistent downward trend since early last year (see chart below). This development supports Ueda's concern that the strong economy and prices over the near term will lead to a string of interest rate hikes, which in turn will put downward pressure on the economy in the future. Naturally, this will reinforce the cautious stance of Ueda, who is trying to carefully nurture the "buds" of inflation.

2Y US Yield, 30Y Yield



Source: Bloomberg; compiled by Daiwa Securities.

US Growth Rate Forecast for 2024 (Bloomberg consensus)



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