Daiwa Securities

Daiwa's View

Trial calculations in the case of YCC revisions in July

- 10yr JGB yield expected to become constricted to around 0.45-0.55% after temporarily rising to 0.7% level

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Trial calculations in the case of YCC revisions in July

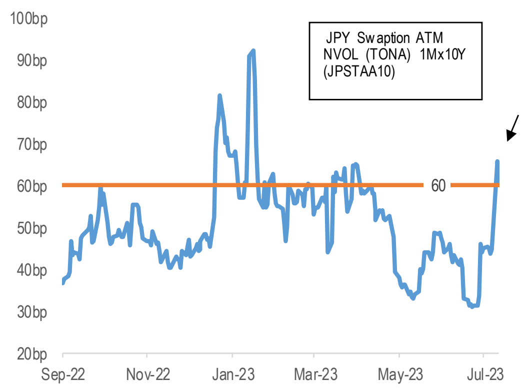
The market is becoming increasingly cautious regarding revisions to the yield curve control (YCC) policy at the July Monetary Policy Meeting (MPM) in the wake of the interview with BOJ Deputy Governor Shinichi Uchida published in the 7 July morning edition of the *Nikkei*. With the 10-year JGB yield rising from around 0.4% to around 0.45%, the USD/JPY rate declined rapidly from the Y144 level to the Y140 level (with the dollar alone tending to fall).

On 7 July, our Chief Market Economist Mari Iwashita commented on the interview, stating "This interview has been perceived as an attempt to counteract speculation that the BOJ will remove its YCC policy at the July MPM, which had been smoldering among some market participants." Also on 11 July, she maintained the view that "the time is not yet ripe" (our house view). However, it would be meaningful to examine the impact on the 10-year JGB yield in the case of YCC revisions separately from the issue of whether the YCC will be revised in July. In this report, we estimate what the levels would likely be were the BOJ to make revisions to the YCC at the July MPM.

◆ Estimates from the standpoint of the swap market

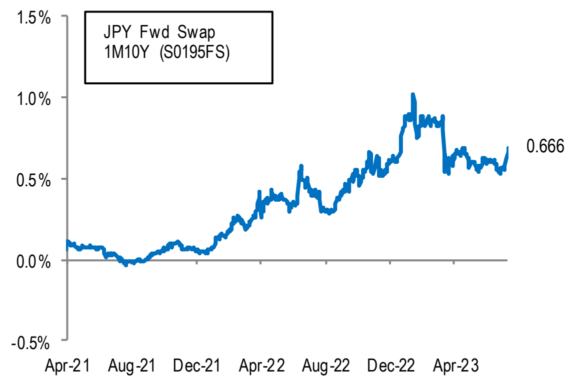
After the release of the interview with Deputy Governor Uchida, the 1M-forward 10Y (1M10Y) swaption surged to the 60bp level, almost the same as where it was during the period from the January MPM until the April MPM. Looking at the 1M10Y swap rate level (forward rate), we found that this also rose from 0.58% to 0.66% in the wake of the interview with Deputy Governor Uchida. As such, a certain degree of caution regarding YCC revisions appears to have already been priced in in the JPY swap rate market.

JPY Swaption (1M10Y)



Source: Bloomberg; compiled by Daiwa Securities.

1M10Y Swap Rate

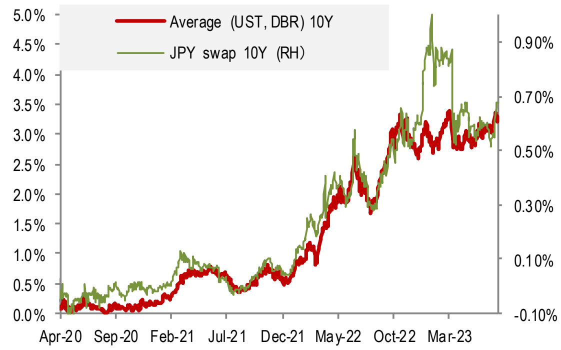


Source: Bloomberg; compiled by Daiwa Securities.

If we provisionally assume that the 10-year swap rate in about one month (after the Jul MPM) will be 0.66%, what the 1M10Y swap rate in the swap market was on 11 July, deducting the swap spread allows us to get an estimation for the 10-year JGB yield in one month. There is a risk that swap rates will rise further if revisions are actually made to the YCC. However, given the balance with overseas yields, even if the 10-year swap rate surges temporarily, we do not expect it to remain high (left-hand chart below).

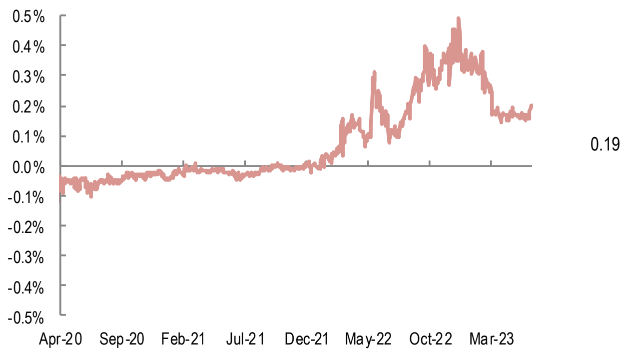
While the 10-year swap spread stood at 19bp as of 11 July, it was around 15-17bp before the release of the *Nikkei* interview with Deputy Governor Uchida (right-hand chart below)[1]. Deducting the current swap spread from the 1M10Y swap rate gives us a 10-year JGB yield of 0.47%. Deducting the swap spread before the release of the interview gives us an estimated yield of 0.49-0.51%.

10Y JPY Swap Rate, Average for 10Y Yield in US and Germany



Source: Bloomberg; compiled by Daiwa Securities.

10Y Swap Spread (Swap rate – JGB yield)



Source: Bloomberg; compiled by Daiwa Securities.

Moreover, when YCC revisions are made, the swap spread may widen beyond current levels. In January 2023, when caution about additional revisions to the YCC mounted to an excessive degree, former BOJ Executive Director Eiji Maeda stated that, in the process of removing YCC, possible measures for avoiding a surge in long-term interest rates included temporary expansion via an increase in JGB purchases and utilization of the Funds-Supplying Operations against Pooled Collateral. I have a similar view in this regard. If there were a risk of substantial impairment to monetary easing effects due to a surge in yields when YCC revisions were made, the BOJ would be expected to implement measures to ease drastic changes, such as increasing JGB purchases in *Rinban* operations (+ Funds-Supplying Operations against Pooled Collateral). That would likely strengthen the flow effects and stock effects on JGBs.

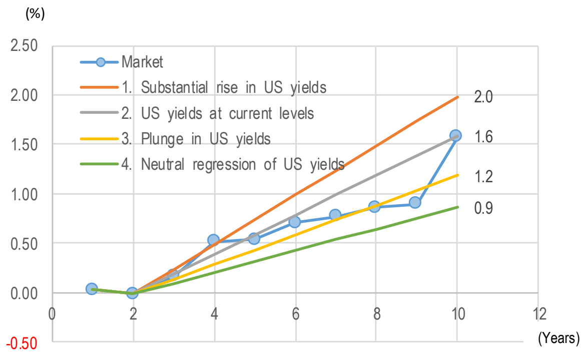
◆ Estimated yield curve: 0.55% in the case of removal of YCC

Next, we would like to estimate what yields would be in the case of YCC revisions by using an estimated JGB yield curve in the case of removal of YCC. If we restructure an instantaneous forward rate based on the assumption that the rate will approach a line shape towards the current level of the 10Y3M yield (1.6% as of 11 Jul) after remaining low and stable for the time being (essentially meaning that negative rates are maintained), we expect that the 10-year JGB yield would rise to around 0.55% (gray line in right-hand chart on next page).

Meanwhile, the JGB yield level is greatly influenced by overseas yields, particularly US yields. If the 10Y3M JGB yield rises to around 2% due to a sharp rise in US yields from the current level, the 10-year JGB yield is expected to rise to a level slightly below 0.7%. In contrast, if there is a decline in the US long-term yield from the current level, the 10-year JGB yield is expected to decline to around 0.4%. Even if the market were to panic due to YCC revisions and the 10-year JGB yield temporarily exceeded 0.7%, a level higher than the orange line, which assumes a 10Y3M yield of 2%, would probably be unlikely to continue.

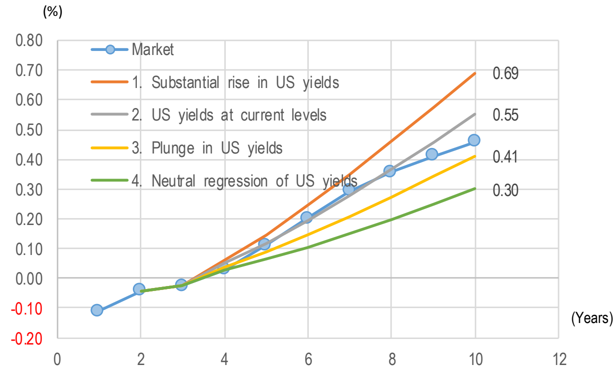
[1] As this widening of the swap spread partially reflects the rise in the BOJ's share of JGB holdings due to last year's YCC attacks, it is unlikely to return to the level it was at in 2021 right away. For details, refer to our 28 Jun 2023 report *Increasing stock effects due to rise in BOJ's share of JGB holdings*.

JGB Instantaneous Forward Rates



Source: Bloomberg; compiled by Daiwa Securities.

Estimated JGB Yield Curves

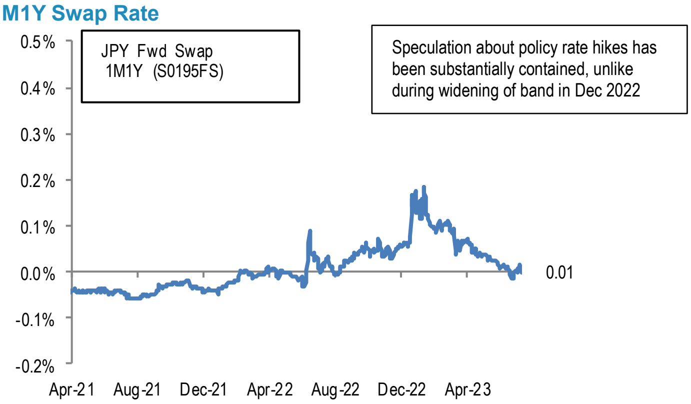


Source: Bloomberg; compiled by Daiwa Securities.

An important assumption in the trial calculation mentioned above is that speculation about hikes in short-term interest rates would not mount. When the trading band was widened in December 2022, speculation about substantial rate hikes emerged regarding not only long-term rates, but also short-term rates. Due to the substantial rise in short-term/intermediate yields, the yield curve was pushed up substantially from its base. Subsequently, the base of the yield curve was stabilized as the BOJ clarified its stance of suppressing short-term/intermediate yields via the decision to expand the Funds-Supplying Operations against Pooled Collateral at the January MPM. Owing to stabilization of the yield level and volatility in the short-term/intermediate zone, the 10-year JGB yield is not expected to rise beyond 1% in our trial calculation at this point.

Accordingly, if the BOJ were to prematurely destabilize short-term/intermediate yields, the estimated value for the 10-year yield mentioned above could change drastically. That said, in his interview, Deputy Governor Uchida discussed removal of negative rates, asserting that it was a 0.1% rate hike, and that given the current economic and price conditions, the BOJ thought there was still a long way to go before it would be able to make a decision about the issue. Therefore, compared to the previous meeting, speculation about removal of negative interest rates (destabilization of short-term/intermediate yields) at the July MPM has been contained. Because there has been a decoupling of views regarding long-term interest rates and short-term rates during the next round of policy revisions, the chance of the estimated 10-year JGB yield collapsing from the base, like in December 2022, is limited, even if revisions are made to YCC at the July MPM.

1M1Y Swap Rate



Source: Bloomberg; compiled by Daiwa Securities.

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