Daiwa Securities

Daiwa's View

True YCC revision reflecting higher inflation expectations

➢ Implication at this juncture is 0.75% 10yr JGB yield cap, but change to 1.0% cap possible depending on future inflation expectations

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True YCC revision reflecting higher inflation expectations

◆ BOJ decides to make YCC more flexible

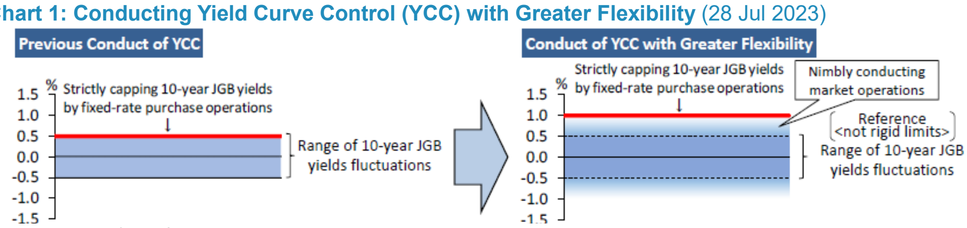
Late last week the BOJ decided to add more flexibility to its yield curve control (YCC) policy. Specifically, while the Bank said it will continue to allow the 10-year JGB yield to fluctuate in the range of around ±0.5% from the target level, it will conduct YCC with greater flexibility by regarding the upper and lower bounds of the range as "references" and not as rigid limits. At the same time, the BOJ will offer to purchase 10-year JGBs at 1.0% through fixed-rate purchase operations[1]. For a comprehensive consideration of the BOJ's decision and an assessment of the surprise YCC revision, please refer to the separate report from our Chief Market Economist Mari Iwashita, who is responsible for Daiwa's overall view. In this report, we will consider the YCC revisions from a market-based perspective, taking into consideration the expected yield levels.

◆ Essentially raised 10yr JGB yield cap to 0.75%

While the BOJ left its permissible 10-year JGB yield trading range unchanged (but added more flexibility to its interpretation of that range), it revised upward the line for triggering its fixed-rate purchase operations from 0.5% to 1.0%. If interpreted in the context of traditional YCC operations, there is probably the tendency to view the 10-year JGB yield target as 0.5% with its ceiling raised to 1.0%. However, our interpretation of this decision is somewhat more dovish. Indeed, we believe the **implication at this juncture** is that the 10-year JGB yield cap has essentially been raised to near 0.75%.

Here we use the wording "essentially" because we believe that a level above 0.75% is difficult to sustain under the current conditions as the BOJ will flexibly execute/increase its *Rinban* (regular purchase) operations and funds-supplying operations (see below for further details). After last week's meeting, the BOJ released a document entitled "Conducting Yield Curve Control (YCC) with Greater Flexibility." Here, it provided a chart in which the shading fades from beyond 0.5% to almost no shading (all white) at 1.0% (= level at which BOJ will nimbly conduct market operations). This chart can serve as a good reference for the BOJ's future conduct of market operations.

Chart 1: Conducting Yield Curve Control (YCC) with Greater Flexibility (28 Jul 2023)



Source: Excerpted from BOJ materials.

[1] One dissenting vote from Toyoaki Nakamura (only member on board representing industry).

Here, we stress the wording "at this juncture" because a cap level above 0.75% would become justified if the BOJ were to raise its 10-year JGB yield cap due to a further increase in inflation expectations (same trend as this time, where exceeding 0.5% was justified). This is an extremely important point in terms of anticipating future BOJ actions, so we will expand on this view in the following section.

◆ True YCC revision reflecting higher inflation expectations

Readers of this report may be tired of hearing this same point over and over again, but we should reiterate that the catalyst for true policy revisions is not "side-effect countermeasures" but "operational parameter adjustments to keep monetary easing within the appropriate range."

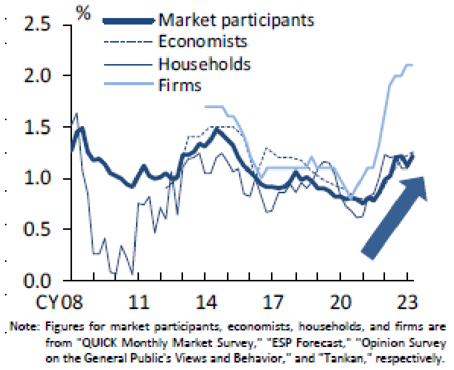
The BOJ's "Conducting Yield Curve Control (YCC) with Greater Flexibility" includes a graph of inflation expectations, which suggests that its decision to make YCC more flexible was due to higher inflation expectations. If the YCC excessively restrains the nominal interest rate upper limit in the face of higher inflation expectations, the real interest rate would be pushed lower, strengthening the effects of monetary easing. At the same time, this would impact volatility in the bond market and other financial markets, which could have the end result of reducing the effectiveness of monetary easing.

◆ **Statement on Monetary Policy at Jul BOJ MPM** (28 Jul 2023)

Signs of change have been seen in firms' wage- and price-setting behavior, and inflation expectations have shown some upward movements again. If upward movements in prices continue, the effects of monetary easing will strengthen through a decline in real interest rates, while on the other hand, strictly capping long-term interest rates could affect the functioning of bond markets and the volatility in other financial markets. Such effects are expected to be mitigated by conducting yield curve control with greater flexibility.

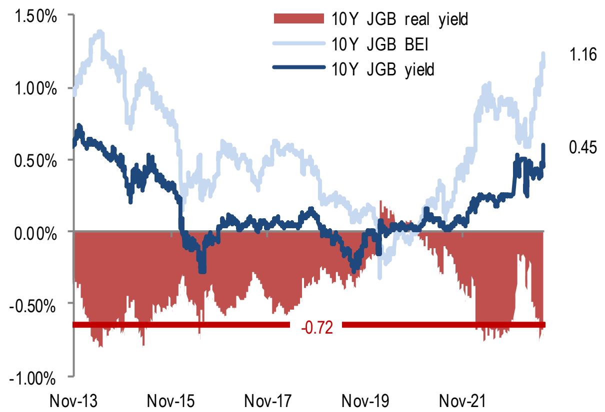
The BOJ revised its YCC policy last December and again last week. In both cases, the 10-year JGB yield cap was revised after the 10-year breakeven inflation (BEI) rate increased and the 10-year real interest rate fell to the -0.7% range. Of course, Japan's inflation-indexed bonds and BEI are not perfect sources of data to represent actual inflation expectations. Still, as shown in the BOJ's inflation expectations graph in the lower left-hand panel, the YCC revisions this time were clearly due mainly to the higher domestic inflation expectations. In that sense, the latest YCC revision was a "true revision" that was destined to become necessary within the BOJ's step-by-step process of moving closer to achieving its 2% price target.

Inflation Expectations



Source: Excerpted from BOJ materials.

10Y JGB Yield (previous night of Jul MPM)



Source: Bloomberg; compiled by Daiwa Securities.

Given the current inflation expectations, the latest YCC revision can be understood as explained above. However, if the inflation expectations continue to rise going forward, the same logic used in this case would justify a 10-year JGB yield above 0.75%. Here, it should be noted that the 1% upper limit entails the possibility of the yield moving up to its cap in the real sense. For example, if the BEI rate (symbol inflation expectations) rises to a level above 1.5% in the future, the BOJ would likely need to loosely tolerate a 10-year JGB yield above 0.75%.

Also, that likelihood is not particularly high at this juncture. Still, if the BEI rate rises above 1.75%, the real interest rate would be below -0.75% even if the 10-year JGB yield reaches its 1% ceiling. By that time, the YCC forward guidance[2] will likely have been met and the next step could be the outright elimination of YCC. Of course, if a move toward 1% is due to deteriorating supply/demand in the absence of higher domestic inflation expectations, it would be regarded as "speculative selling" that causes the real interest rate to rise. In that case, the BOJ would use its fixed-rate purchase operations and other means to prevent that rise.

Inflation Expectations and YCC

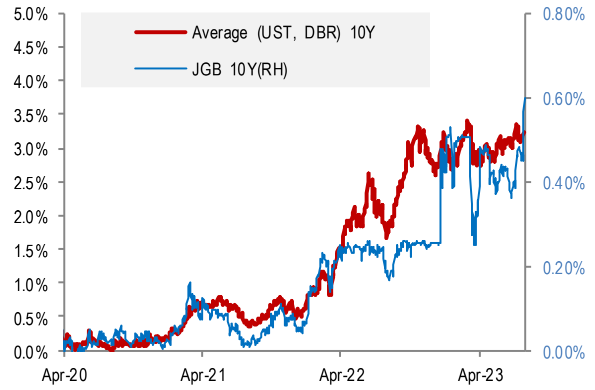
(%)	BEI	10Y yield	Real yield	YCC Revision / Elimination
Scenario ①	**1.50**	0.75	-0.75	Revision not yet needed? (However, BOJ allows rise above 0.75% → BOJ does not increase *Rinban* operations even amid rise over 0.75%)
Scenario ②	**1.75**	1.00	-0.75	YCC elimination? (BEI staying power?)
Scenario ③	**2.00**	1.00	-1.00	Strong possibility of YCC elimination

Source: Compiled by Daiwa Securities.

◆ Relatively calm market reaction to YCC revision

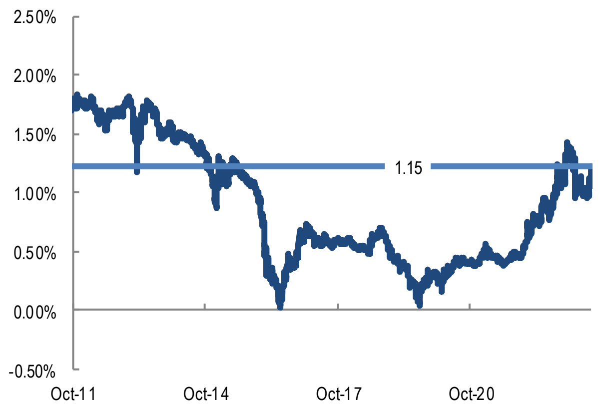
On 28 July, the day of the YCC revision, the 10-year JGB yield rose to around 0.58% and the 20-year JGB yield to around 1.15%. These were relatively large upswings from the previous day of close (+15bp and +10bp, respectively), but these movement were within the range of our previous yield curve estimate at the time of the YCC revision. Furthermore, viewing these moves against last December's YCC revision helped to contain any market turmoil. While there may be various factors such as advance positioning, we were left with the strong impression that the market overall calmly reacted to this YCC revision.

10Y JGB Yield, Overseas Yield



Source: Bloomberg; compiled by Daiwa Securities.

20Y JGB Yield



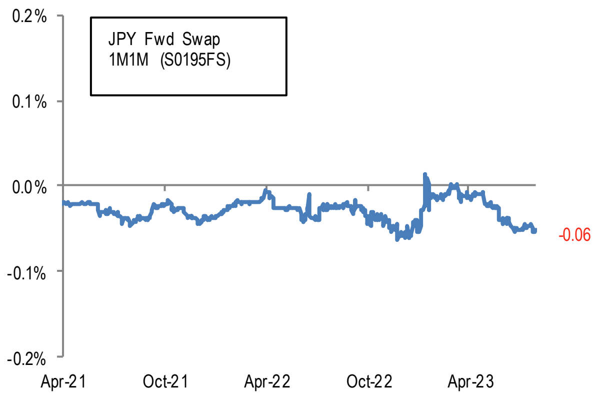
Source: Bloomberg; compiled by Daiwa Securities.

For the December revision, the 10-year JGB yield was excessively pushed lower due to its balance with rising overseas bond yields. As such, even though a major move occurred at the time of the YCC revision (upper left chart), the move this time was in response to rising domestic inflation expectations. In other words, it seems like this move was less disruptive compared to that after the December revision in terms of the gap (balance) with overseas bond markets.

[2] Maintain "Quantitative and Qualitative Monetary Easing with Yield Curve Control" until the point necessary to achieve and sustain the "price stability target" in a stable manner.

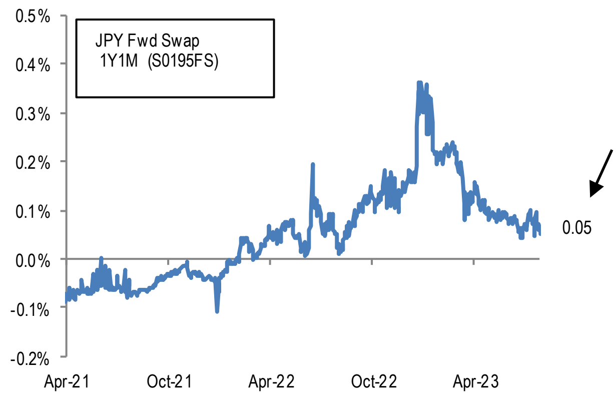
Another major factor behind the market's calm reaction was likely the 7 July *Nikkei* interview in which BOJ Deputy Governor Shinichi Uchida ruled out the possibility of lifting negative interest rates, for which speculation had been growing. When we observe market speculation about elimination of negative interest rates by using forward rates on one-month swaps, there have been no noticeable increases in either the one-month or one-year horizons around the time of the latest YCC revision. The December 2022 revision was viewed as a "BOJ move to raise policy rates" and the one-year forward one-month OIS forward rate rose to around 0.4% (which was equivalent to a 50bp rate hike). The fact that the short-term yields (= "foundation" of the yield curve) were not roiled may have contributed to this calm market reaction.

1M1M OIS Forward Yield



Source: Bloomberg; compiled by Daiwa Securities.

1Y1M OIS Forward Yield

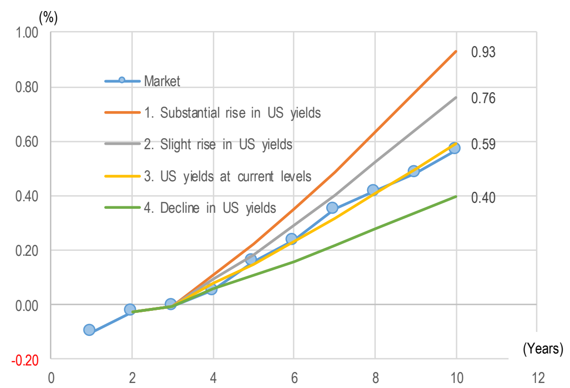


Source: Bloomberg; compiled by Daiwa Securities.

◆ <u>Around 0.6% (or lower) likely seen as fair value for now</u>

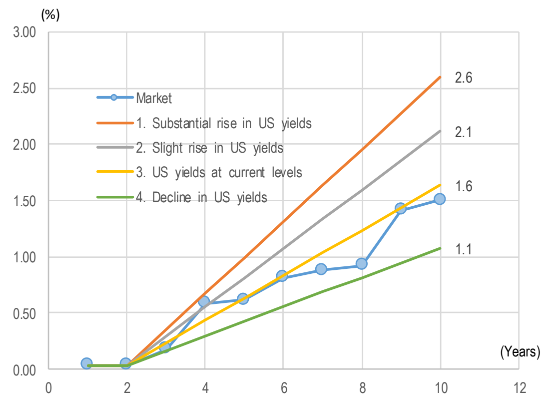
This elimination of the negative interest rate (= interest rate hike) is also crucial for creating the estimated yield curve. As long as this assumption holds up, the hurdle for the 10-year JGB yield to reach 1% is extremely high. The 0.75% 10-year JGB yield that is often mentioned in the market can only be viewed as sustainable when US Treasury yields rise further from here and the super-long JGB forward rate exceeds 2%. A 10-year JGB yield of around 0.6% (or lower) is likely a fair value under the current situation where speculation about eliminating negative interest rates has not increased and the super-long forward interest rate has declined by 0.3%~0.6% compared to December last year.

Estimated Yield Curves



Source: Bloomberg; compiled by Daiwa Securities.

Instantaneous Forward Rates

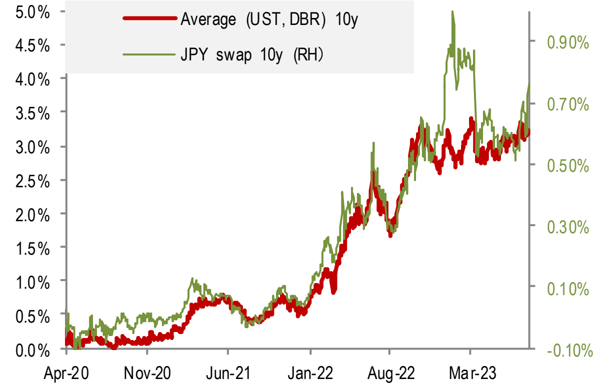


Source: Bloomberg; compiled by Daiwa Securities.

Desptie the YCC revision, which is a major event, swap rates and the balance between JGBs and swaps (swap spread) have also remained stable. Even though the yen swap rate increased by 12bp from 0.60% to 0.72% following the YCC revision, this is generally reasonable in terms of the balance with overseas rates. Also, the swap spread at the end of last week was close to the range's mid-point at 16bp.

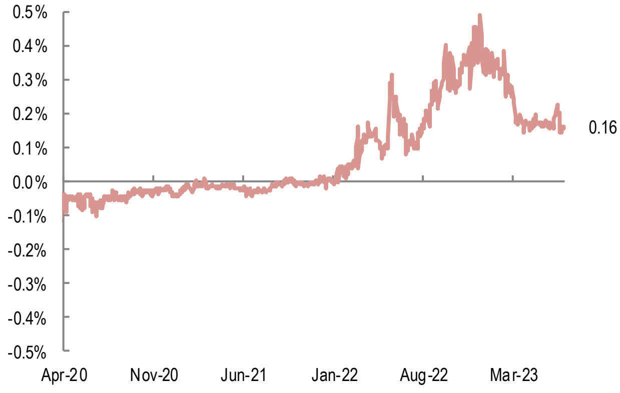
Given the swap rate level (0.72%) at the end of last week, if we subtract the recent swap spread of 15-20bp, our image for the 10-year JGB yield would be 0.52-0.57%, which is close to the current level.

JPY Swap Rate, Overseas Yield



Source: Bloomberg; compiled by Daiwa Securities.

JPY Swap Spread (10Y)



Source: Bloomberg; compiled by Daiwa Securities.

Taking the above points all into consideration, even though the 10-year JGB yield can now rise as high as 1.0% under the BOJ's new permissible trading range, the Bank went out of its way to provide an explanatory note that read, "No (purchase operation) bids are expected to be submitted under the current interest rate environment." A 10-year JGB yield of 1% is more like a symbol for now, rather than a realistic target for the immediate future.

However, this is the first policy revision in which the main focus has been on the domestic inflation expectations. It is also the first time that one step closer to the price target was taken. If the price target is reached and underlying inflation climbs to 2%, BEI will naturally rise to 2% and the real interest rate will also rise as the BOJ begins its exit strategy in earnest. At that time, the 10-year JGB yield will easily surpass 1%. Clearly, the need to invest in JGBs with this "what-if" scenario in mind is becoming more important than ever before.

◆ Continue or reduce purchasing of JGBs?

BOJ Governor Kazuo Ueda was asked if he intended to entrust yield levels to market forces and he responded, "There is the question of degree, but yes." The fact that the market will have a stronger role in determining JGB yield levels in the future should be welcomed. However, the BOJ said in its Statement on Monetary Policy that, "The Bank will continue with large-scale JGB purchases." So, it would probably be a mistake to assume significant reduction in *Rinban* operations right away. There have been some explanations that the lack of unscheduled JGB purchasing operations suggests a loosening of the Bank's monetary easing stance. However, if the yield curve is consistent with the "guideline for market operations," unscheduled JGB purchasing operations will not be conducted. It is possible that the JGB yield curve was consistent with the guideline for market operations as of 28 July.

Of course, the decision this time probably also included considerations for the pace of balance sheet expansion (percentage of outstanding JGBs held by BOJ). That said, what the BOJ probably has in mind is reaching a balance through cycles, rather than reducing *Rinban* operations right away. If we assume that inflation expectations will continue to rise and reaches 2%, and the BOJ reaches an exit, the Bank's balance sheet would temporarily expand during the process. Still, that would only be a "temporary expansion" (relatively small problem as goal is in sight). Meanwhile, in the case that inflation expectations decline in the future and an exit strategy is pushed back, the increased flexibility provided for the permissible trading range this time may make it a little easier for the BOJ to reduce *Rinban* operations when yields are declining.

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