Daiwa Securities

Daiwa's View

10-year JGB yield when YCC and negative interest rates are eliminated

➢ Around 1.15% in a scenario with US yields at current levels

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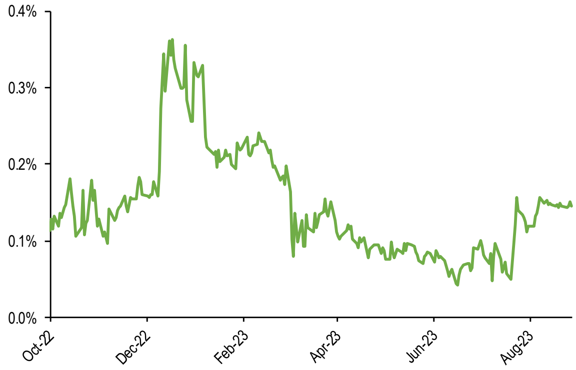
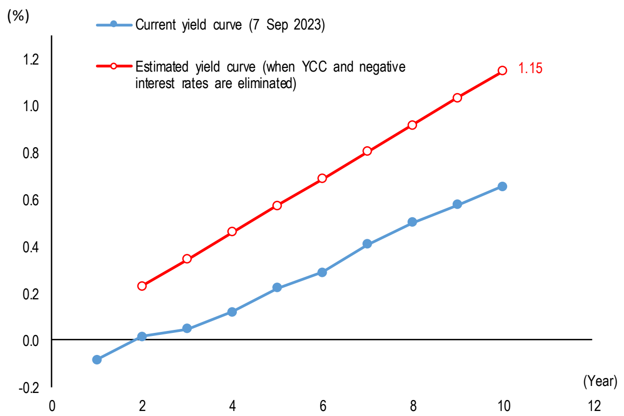
After flexibility was added to the Yield Curve Control (YCC) in July, the 1-year forward 1–month JPY OIS rate rose by around 10bp. Since then, the rate has remained around the same level. The market is continuing to factor in a future change to the short-term interest rate policy to some degree. Therefore, we think some benefit could be gained by conducting a scenario analysis examining what yield levels will be when YCC and negative interest rates are eliminated. In this report, we conducted simple simulations assuming some hypothetical scenarios to see to what degree the 10-year JGB yield would rise when policy changes were made. As a result, we estimate that the 10-year JGB yield will rise to around 1.15% when YCC and negative interest rates are eliminated.

1Y1M JPY OIS Rate



Source: Bloomberg; compiled by Daiwa Securities.

Estimated Yield Curve



Source: Bloomberg, compiled by Daiwa Securities.

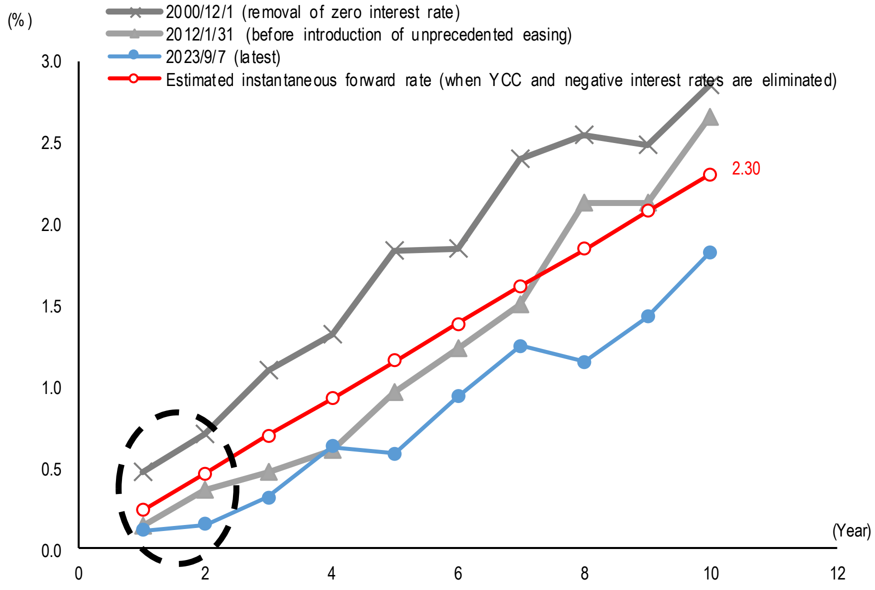
- Starting point of instantaneous forward curve
  The path of the instantaneous forward rate, upon which estimations are based, differs greatly from scenarios in which negative interest rates are maintained. The instantaneous forward rate shows the market's pricing in of the policy interest rate level in the future. Therefore, elimination of negative interest rate policy changes the point at which the market starts to factor in continuous rate hikes in the future.

  Looking at the term structure of the instantaneous forward rate that is currently factored in by the market, we find that the rate will remain low and stable over the next two years, and then exhibit a path that appears to be factoring in moderate rate hikes towards the neutral level (Chart below). This can be interpreted as a sign that the rate is reflecting expectations that the BOJ will maintain its commitment to the low-interest rate policy for the time being.

  However, in a scenario in which negative interest rates are eliminated, projections for the policy interest rate over the next several years would change, which is expected to create upward pressure on the long-term yield, with a rise in short-term/intermediate yields serving as a starting point.

  In fact, looking at the instantaneous forward rate before the introduction of unprecedented easing shows that the market had factored in that rate hikes would start sooner than estimated by the current instantaneous forward rate (Chart below). This tendency is particularly pronounced in the curve when the zero interest rate was eliminated as forward guidance was not applied to the short-term interest rate.

Instantaneous Forward Rate Estimates and Actual Rates at Different Points in Time



Source: Bloomberg, compiled by Daiwa Securities.

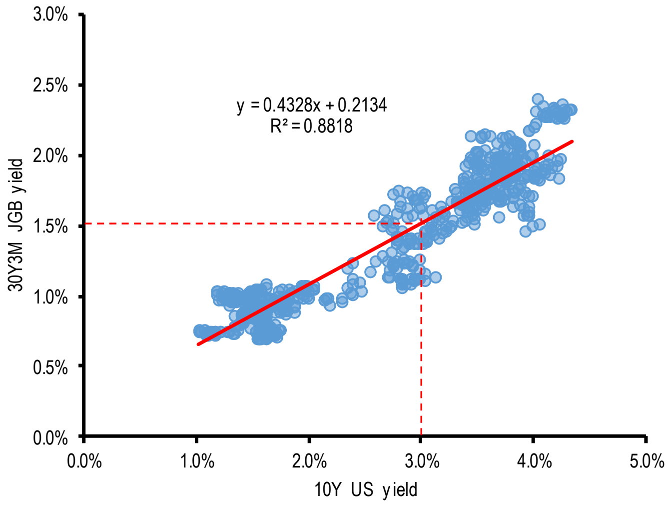
- End point of instantaneous forward rate
  What should be considered next is the terminal point of the instantaneous forward rate (approximately equal to superlong forward yields), which determines the levels for JGB yields overall. In this report, our estimations assume that the superlong JGB forward yield is 2.30%, almost the same as the actual level of the 30-year forward 3-month yield. This figure seems reasonable in terms of fundamentals based on an expected inflation rate of 2% and a potential growth rate of 0-0.5%.

◆ <u>Conclusion</u>

Based on the above-mentioned assumptions, we estimate that the 10-year JGB yield will be <u>around 1.15%</u>. Considerable caution is likely necessary, as the yield is expected to rise by around as much as 50bp from the current level.

For reference, our main scenario by Chief Market Economist Mari Iwashita forecasts that negative interest rates will be eliminated after US rate cuts come to an end. Assuming that the US long-term interest rate is 3% when the Fed's rate cutting comes to an end, we forecast that the end point of the instantaneous forward curve, upon which our trial calculations are based, will fall to around 1.5%, given a strong correlation between superlong JGB forward yields and the US long-term rate (Chart below). In this case, the estimated 10-year JGB yield is limited to around 0.75%.

Scatter Chart of 30Y3M JGB Yield and 10Y US Yield



Source: Bloomberg, compiled by Daiwa Securities.

The above-mentioned figures are just one set of reference figures calculated based on some hypothetical scenarios. That said, these results indicate the possibility that the impact of eliminating negative interest rates could be very significant. However, our estimations also indicated that the 10-year JGB yield might not rise much above current levels if negative interest rates were to be eliminated after the Fed switches over to cutting rates and the US interest rate falls to 3%. Assumptions regarding the external environment, such as overseas yields, are also important factors to consider with regard to the impact elimination of negative interest rates will have on the 10-year JGB yield.

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