Daiwa's View

FICC Research Dept

Market insufficiently factoring in end of BOJ's negative rate at this stage

- Rate hikes were implemented in past after first factoring in hike of 0.5% or more
- Insufficient factoring in at this stage makes surprise more likely
- Is "assessment meeting" an option?

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A media report leaked on 11 December quoted BOJ officials as saying, "There is little need to rush ending negative rates or YCC this month." This pushes back market expectations for ending negative rates at the BOJ's December Monetary Policy Board meeting. These expectations were suddenly heightened by Deputy BOJ Governor Ryozo Himino's somewhat hawkish speech and the "challenging" statement from BOJ Governor Kazuo Ueda.

Of course, the same media report also noted that the cost of waiting until data confirms solid wage growth is not that high, so the option of ending negative rates itself has not been ruled out. This claim that there is no need for the BOJ to rush to end negative rates, made on 11 December, only applies to whether or not the BOJ will take such action in December of this year. While Himino's speech was certainly hawkish, the intent was not to signal a December rate hike, but rather to send a message that was more forward-looking. Of note, there is no change to our house view, prepared by Chief Market Economist Mari Iwashita, that negative rates will be lifted at the BOJ's January meeting.

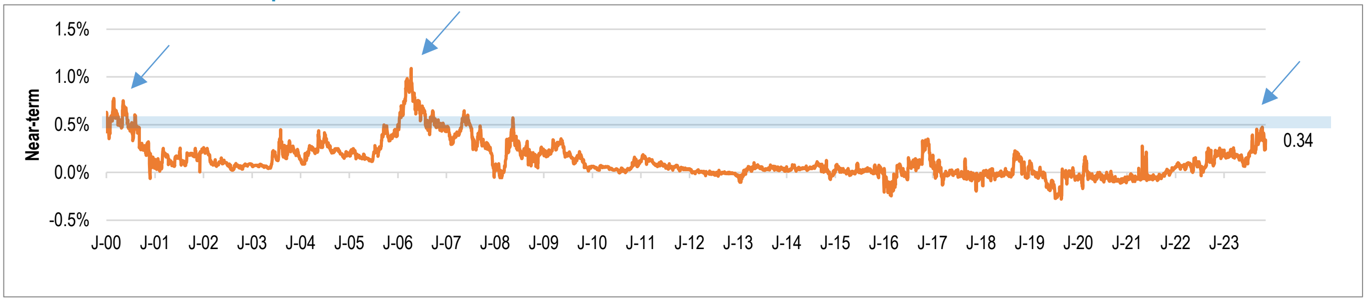
Market insufficiently factoring in Jan 2024 rate hike

From this point our discussions will be from the market perspective. When confirming the market's current assumptions, it appears that it has been lagging in terms of factoring in a potential rate hike at the BOJ's upcoming December meeting (next week), let alone at the January 2024 meeting. Unlike its yield curve control (YCC) policy, the BOJ appears to want to avoid surprises while maintaining a cautious dialogue with the market regarding rate hikes. That said, if the BOJ starts from the current situation and succeeds in raising interest rates in January without any surprises, it appears that it would need to go down one of the following paths: (1) Allow the market to anticipate a series of interest rate hikes at a relatively fast pace or (2) Make it known that the negative interest rate will be lifted, but will remain barely positive for the time being. Depending on which way the Bank leans, JGB yields could enter a rising or falling pattern.

Near-term forward spread yet to reach 0.5%

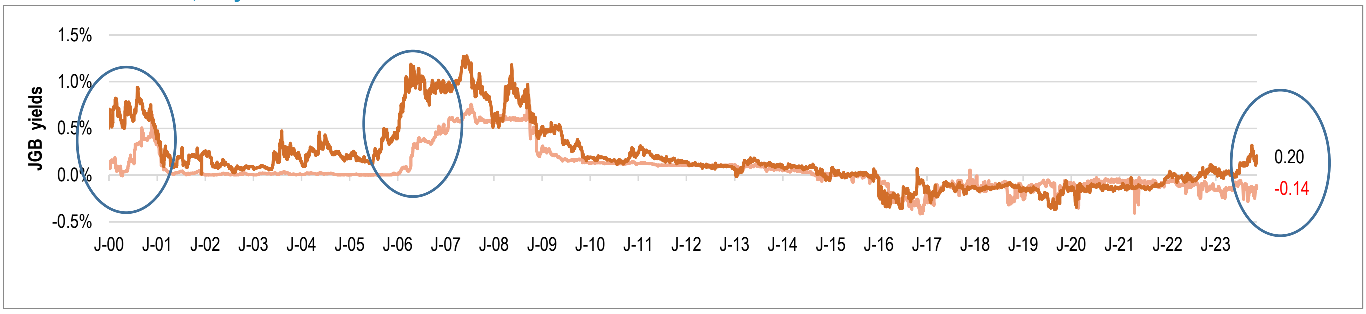
As we have discussed in this report several times in the past, one of the criteria used by the Fed to monitor the UST yield curve is the near-term forward spread. Specifically, this spread is calculated by subtracting the current 3-month Treasury bill yield from the 3-month forward rate 1.5 years from now. It reflects market participants' rate hike/cut expectations in the near future up to 1.5 years ahead. If we apply this near-term forward spread to JGBs, we can observe the expected value of the BOJ's interest rate hike for the next 1.5 years is 0.34% (3M: -0.14%, 1.5y3M: 0.20%) at this time (see charts on next page). This is a range roughly equivalent to lifting the negative interest rate (to +0.1%) plus one 25bp rate hike.

JGB: Near-term Forward Spread



Source: Bloomberg; compiled by Daiwa.

3-month JGB Yield, 1.5yr-forward 3-month Yield



Source: Bloomberg; compiled by Daiwa.

Meanwhile, when we confirm the situations in August 2000 and July 2006, when decisions were made by the BOJ to raise interest rates, the near-term forward spread at the time of the rate hikes was more than 0.5%. In other words, in the past, interest rate hikes were made only after the market had concluded that consecutive rate hikes of 0.5% or more were possible.

This is a noteworthy point. In his 2005 book "The Battle with Zero Interest Rates," Ueda said, "Once the interest rate is raised, it will not be too late (to factor in rate hikes) even after confirming that overnight rate hikes to around 0.5% to 1.0% are possible without any trouble." This is because Ueda also cites 0.5% as the minimum line. If this idea is still valid today, the 0.5% near-term forward spread may retain validity as an indication of the minimum degree to which the market needs to factor in rate hikes before the BOJ can start raising rates (currently this criterion is still not met).

◆ **Excerpt from Ueda's Book "The Battle with Zero Interest Rates" (2005); Nikkei Inc.**

"In light of the above, it appears that the BOJ will not lose anything by being a little patient when deciding on the removal of quantitative easing. As I stated earlier, the inflation forecast for fiscal 2006 is probably positive at this time, but after the actual inflation rate becomes stable and positive over the near term, we will once again assess the economic outlook from that point forward and there should be some upward momentum for the economy and inflation outlook. Accordingly, once the interest rate is raised, it will not be too late (to factor in rate hikes) even after confirming that overnight rate hikes to around 0.5% to 1.0% are possible without any trouble."

Running out of time

Of course, the January 2024 BOJ meeting is still more than month away. For now, executing a rate hike in January without any surprises by accumulating the Bank's messaging (= rise for short/medium-term rates) and factoring in its next move is possible. That said, there is the image that time is gradually running out. Alternatively, if the interest rate is hiked without any surprises, even though the market currently has not sufficiently factored in a rate hike, the BOJ could, for example, publicly acknowledges that Japan's market and economy need a long "rehabilitation period" to adjust to a "world with interest rates" after becoming accustomed to a decade of ultra-easy monetary policy. Here, the

BOJ could lift negative rates but promise to keep interest/overnight rates at narrowly positive levels for a while. In other words, the Bank may initiate communication encouraging a new and different approach to factoring in rate hikes, one that decouples "ending negative rates (narrowly positive rates)" from "subsequent positive rate hikes." However, while that may be possible by the January meeting, we still have the image that time is running out. For now, the Fed is moving closer to changing its stance and our impression is that the options for the BOJ's January meeting are narrowing somewhat.

We are also skeptical about the idea of an "interest rate hike while the Abe faction is away," which is a play on the proverb "mice will play while the cat is away," as some in the market call it. Politics is unpredictable and it is hard to believe that Ueda, who is a scholarly and cautious man, would prefer the approach of playing into political factionalism. (If the BOJ moves to take advantage of the current factional strife within the ruling party, it would put itself in a difficult position should the Abe faction again rise to power and capture the prime minister's seat). The political situation would be generally neutral, but if anything, and we think this situation is likely a factor that will allow the Bank to patiently wait a little longer to strengthen its argument based on the prevailing data.

What is an "assessment meeting"?

According to media reports, Ueda reportedly told Prime Minister Fumio Kishida at their meeting on 7 December that he would make assessments including whether "higher wages are spilling over into prices." Also, Ueda said in his book "The Battle with Zero Interest Rates" that once easing ends, the Bank should "Again assess the economic outlook from that point forward after real inflation is stable and positive in the near term." If BOJ wants to put aside the degree to which the market has incorporated rate hikes, for which time is now running out, and if they want the effects of ending negative rates to manifest themselves, the Bank may first choose to declare an assessment meeting in December and specify the timing of the announcement, as they did last time. Within the "assessment" declared at the December 2020 meeting, the timing for announcing the results, four months later in March of the following year, was provided in advance. In this manner, the effect of lifting negative rates could be manifested ahead of time (market will naturally factor in the lifting of negative rates), while allowing a little more time and flexibility for the Bank to make adjustments thereafter. In the first place, there is a mountain of issues to discuss both before and after a rate hike, including (1) handling of the monetary base expansion policy, (2) conducting *Rinban* (regular purchase) operations constrained by that policy, and (3) reworking the current accounts three-tier structure. Rapidly moving forward with rate hikes will not be possible unless these issues are first sorted out. There is a wide range of possibilities for future developments and we want to envision the various options without being judgmental.

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