Daiwa's View

FICC Research Dept

Jan MPM: BOJ presents market with positive stance

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- New wording added to *Outlook Report* that "The likelihood of realizing this outlook has continued to gradually rise"
- Governor emphasized in press conference that accommodative financial conditions would be maintained
- Upside for long-term rate will be limited as long as leeway for rate hikes is limited

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The outcome of the January Monetary Policy Meeting (MPM, which ended yesterday) was more hawkish than the market expected. The biggest point to note was the addition to the summary of the *Outlook for Economic Activity and Prices* report (*Outlook Report*) of wording stating that "The likelihood of realizing this outlook has continued to gradually rise."

There was an unexpected push back against the market, which had factored in that the policy interest rate would be maintained at 0% for the time being following the elimination of negative interest rates.

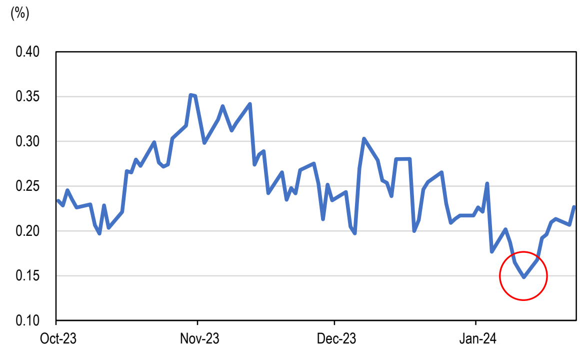
That said, we get the definite impression with regard to the market's pricing since the beginning of the year that, despite having taken into consideration the impact from the earthquake that occurred on 1 January, it wasn't sufficiently cautious regarding the January MPM.

Confirming expectations for future rate hikes via the forward OIS rate, we found that the 1-year forward 1-month rate has declined to 0.15% (as of 12 Jan) since the beginning of the year. This suggested stronger expectations for the BOJ to maintain the policy interest rate at 0% for the time being after the elimination of negative interest rates (Chart 1).

Our main scenario regarding the outlook for the policy interest rate assumes that the rate will be left at 0% this year. However, we think the market's pricing was too low, given (1) the risk of greater rate hikes being implemented than expected and (2) the existence of an upward bias with forward rates that factor in the policy interest rate under the assumption that negative rates will not deepen.

After the press conference by Governor Kazuo Ueda, the 2-year JGB yield rose to 0.05% (up 3bp).

Chart 1: 1yr1mo JPY Forward Swap Rate



Source: Bloomberg; compiled by Daiwa.

In his press conference, he stated repeatedly that the bank would avoid a policy that would cause discontinuity.

According to Governor Ueda's own explanation, this means that very accommodative conditions would continue for the time being even if negative interest rates were eliminated.

Looking back at comments about accommodative conditions in the October press conference, he mentioned that both short-term and long-term real interest rates remained negative, and sufficiently accommodative financial conditions were maintained.

Based on the above-mentioned remarks, he suggested that short-term and long-term real interest rates would be maintained in negative territory under policy operations after negative interest rates were eliminated.

Press conference by Governor Kazuo Ueda (31 Oct 2023)
The expected inflation rate has risen moderately since last year, with short-term and long-term real interest rates remaining negative. Sufficiently accommodative financial conditions are maintained.

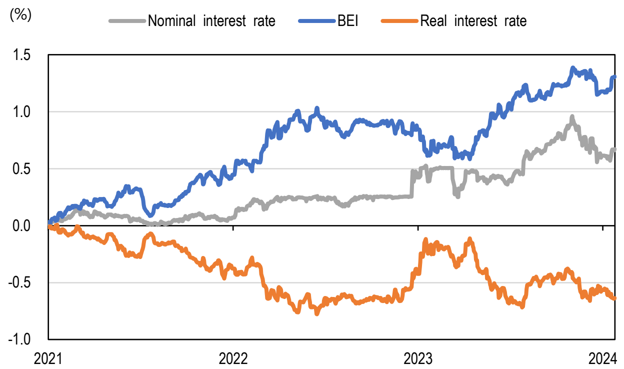
Currently, the long-term real interest rate has remained in negative territory. However, whether this level is maintained going forward depends on trends in the inflation rate expected by investors (BEI, Chart 2).

Looking back at data over the past year alone, we found a significant change in the levels of real interest rates and BEI. In Japan, where inflation expectations are not anchored at 2%, the outlook with regard to price trends is highly uncertain, as the BOJ has admitted.

If the BEI were to decline, real interest rates could rise. Therefore, the BOJ is unlikely to change its cautious stance regarding rate hikes.

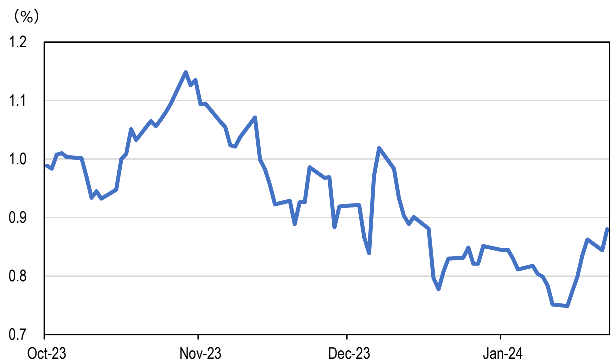
Accordingly, we maintain our view that leeway for rate hikes will remain limited.

Chart 2: Long-term Interest Rates



Source: Bloomberg; compiled by Daiwa.

Chart 3: 10yr JPY OIS Swap Rate



Source: Bloomberg; compiled by Daiwa.

Confirming the volatility calculated by swaption (1-month maturity), we found that the volatility of the long-term interest rate has declined rapidly since the beginning of this year. Therefore, similar to what was suggested by the short-term rate, there may have been insufficient caution regarding the January MPM. As a result, the 10-year OIS rate rose to 0.88% (up 5bp) after the press conference by Governor Ueda (Chart 3).

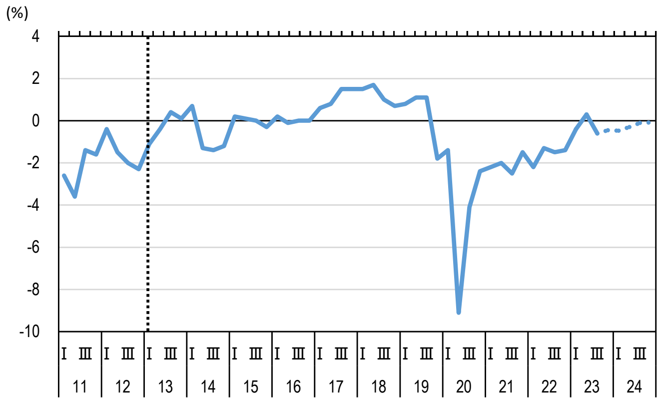
However, leeway for a rise from now on will likely be limited. If we assume that leeway for rate hikes is limited, it is highly unlikely that domestic factors will cause a rise in interest rates.

From the perspective of fundamentals, Japan's economy is in a difficult situation. Our estimate for the output gap based on our GDP forecasts shows that the output gap will remain negative this year (Chart 4).

Interest rates are unlikely to rise substantially as long as there is no clear way forward towards a full-scale exit from extraordinary easing via a declaration of an end to deflation. Provided fundamentals remain unchanged, any leeway for a rise in the JPY rate from now on will likely be triggered by a rise in US interest rates.

We feel that we have reconfirmed the importance of US interest rate trends as pertains to the future outlook.

Chart 4: Output Gap



Source: Bloomberg; compiled by Daiwa.

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