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Daiwa’s View

The desirable rejuvenation of superlong JGB futures

- The bifurcation of the JGB market and reduced liquidity of superlong JGBs is still a crisis
- However, with the BOJ in the process of gradually reducing its market presence, some bifurcation of the market is inevitable
- The key is not for the authorities to be quick to intervene, but rather to restore the functionality of hedges by rejuvenating superlong JGB futures to improve market liquidity

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The results of the 30-year JGB auction held on 13 May were firm and the yield dropped sharply to 2.875% (simple yield, down 7.5bp from the day prior). Meanwhile, the recovery sparked by China and the US being on verge of agreeing on tariffs pushed intermediate and long-term yields up by 6-7bp, narrowing the 5yr/30yr spread by around 15bp, from 205bp to 190bp. It is very unlikely that the sharp volatility seen thus far can be attributed to changes in Japan's economic outlook. As we wrote in *Daiwa’s View* report last month, rather than a twisted flattening, this is probably a product of incoherent price moves brought by the bifurcation of the JGB market.

The following two opinions about superlong JGBs included in the Summary of Opinions for the April policy meeting released by the BOJ on 13 May shows that policymakers view this as a serious issue. Superlong JGB prices have been volatile recently, fluctuating by as much as 5-10bp daily, and there seems to be broad agreement that the now crisis conditions in the superlong JGB market must somehow be addressed.

◆ Summary of Opinions at April 2025 Monetary Policy Meeting (released on 13 May 2025)

- During the market turmoil in April, the Japanese government bond (JGB) markets were divided by maturity, as seen, for example, in the significant rise in yields on super-long-term JGBs. In view of the interim assessment of the plan for the reduction of the purchase amount of JGBs, it is important for the Bank to carefully examine supply and demand conditions and liquidity of JGBs by maturity and the variety of views of market participants from different business types.
- Investors need to be cautious about investing in super-long-term JGBs when market expectations regarding the interest rates on these bonds are particularly high and the markets are nervous. While it is natural for central banks to take appropriate account of market views, if a central bank is continually over-flexible in response to these views, this flexibility itself could make the bank's responses less predictable, thereby increasing uncertainties in the markets. The Bank should avoid, as much as possible, actions that lead to such uncertainties.

What specific measures make the most sense?

If the current situation has been caused not by a structural change but rather by nothing more than a temporary worsening of supply-demand, the quickest and simplest solution would be for the BOJ to adjust supply-demand by increasing the amount of its temporary operations. However, if the changes currently happening in the superlong JGB market are not simply a minor case of a transitory worsening of supply-demand but rather reflects a process of structural change in which the JGB market, the primary participants of which had been domestic market participants, is becoming globalized (a new normal), simply resorting to increasing the amount of BOJ operations, there is a possibility that it would not only just have a fleeting affect on the market but also increase market uncertainty.

For example, although long-term and superlong yields rose sharply even in the US Treasury market in early April (see the recent report by our chief market strategist Shun Otani), Boston Fed President Susan Collins said "markets are continuing to function well" and that "we're not seeing liquidity concerns overall. US Treasury Secretary Scott Bessent also provided some calming words, saying that " I believe that there is nothing systemic about this — I think that it is an uncomfortable but normal deleveraging that's going on in the bond market." Direct intervention by monetary authorities should probably be limited to systemic problems.

Comparing the superlong zone, where the BOJ's reduction of holdings is further ahead, with the intermediate and long-term zones, where the BOJ still owns over 40% of issuance, some market bifurcation is inevitable during such a transition, and it is difficult to say for sure that the up-to-10-year zone is correctly priced and the superlong zone is erroneously priced (it may be the superlong zone that is correctly priced). Based on this view, the answer may be not for the BOJ to raise its holdings in the superlong zone, but rather for it to conduct operations to cut its holdings in the intermediate and long-term zones.

As also evident by the fact that it was long-term yields that were directly manipulated under YCC, it is important that the 10-year yield be stable to confirm the effects of monetary easing. At least under the BOJ's current stance of keeping monetary policy accommodative, we do not expect the BOJ to sharply reduce its JGB holdings in the long-term zone anytime soon. In other words, the current bifurcation of the JGB market may persist for a while. In that case, assuming the market remains bifurcated to some degree, this would require efforts to ensure market functionality. It may be desirable to provide adequate tools to ensure the functionality of hedges in the superlong zone, including so that the market does not continue in one direction.

Expectations of superlong JGB futures

Although this is just a "what if" scenario, if the superlong JGB futures that were first listed in 1988 can be rejuvenated, it may improve the situation to some degree. There was a period of time after former BOJ Governor Kuroda's bazooka when trading in these futures temporarily increased, but hardly any at all are being traded currently.

If, as before, there were no bifurcation of the market between superlong JGBs and long-term JGB futures, it would be effective to use long-term futures as a delta hedge for superlong JGB positions, but with that assumption having broken down, it has become difficult to establish hedge positions across zones. Existing hedging tools have become less effective, and if the inability to find new effective hedging tools is one factor currently acting to reduce market liquidity, rejuvenating superlong futures directly backed by superlong JGBs could help to normalize the liquidity premium by making it possible to flexibly create hedges in this zone at a low cost.

That is of course easier said than done, because such a market cannot be established without willing participants on both sides of the trade. Additionally, without a deep cohort of market participants, the market is likely to move in only one direction and render the futures inadequate as a hedging tool. Although we would caution against getting hopes up too high too early, with the JGB market now bifurcated like it has never been, we think a market for superlong JGB futures is facing a golden opportunity in the process of gaining a foothold in the JGB market, like Ultra Long-Term U.S. Treasury Bond Futures.

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