Daiwa's View

BOJ's Bond Market Group meetings (Day 1)

- JGB purchasing reduction plan through Mar 2026 likely to maintain current pace
- Sense somewhat strong possibility of JGB purchases slowing to around Y200bn from Apr 2026
- In order to proceed with “reduced JGB purchasing operations” while ensuring that market participants maintain predictability, must have broad-view discussions on “excess reserves to target over long term” (equivalent to appropriate balance sheet size)

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The 20-year JGB auction conducted yesterday posted a record low outcome. Yesterday also saw the first day of the Bond Market Group meetings held by the BOJ, as well as the disclosure of information from pre-meeting inquiries held in the lead up to the interim assessment at the June Monetary Policy Meeting (MPM), and examples of specific opinions. We would like to provide an overview of the Bond Market Group meetings.

Poor outcome at 20-year JGB auction

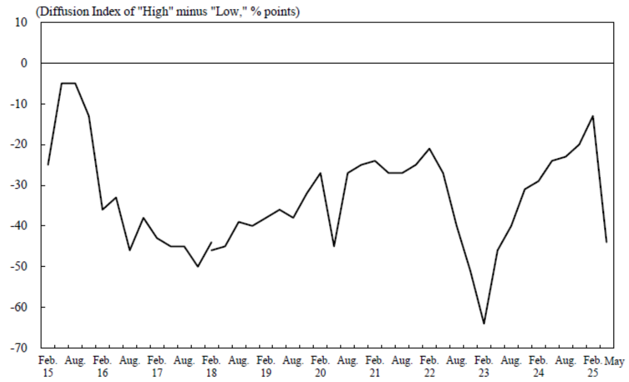
The 20-year JGB auction held yesterday posted a record-low outcome—with a cut-off price of Y98.15 (vs. a preliminary projection of Y99.80), a bid-to-cover ratio of 2.5X (the lowest since 2012), and a tail of Y1.14 (the longest since 1987). Following this outcome, JGB yields in the afternoon session became active once again throughout the entire superlong zone. The 30-year JGB yield jumped to 3.125% (up 15bp d/d), hitting its highest point since the market was established in 1999.

Also noteworthy yesterday was the fact that, in response to this surge in superlong yields, the 10-year yield followed along at about one-third that pace immediately after the auction. If this trend continues, greater attention will have to be given to how things develop going forward. This is because, if the fragmentation currently observed between the superlong zone and shorter zones were to spread to the 10-year zone, the BOJ could become more cautious in its decision making. Purchase operations in the superlong zone are essentially implemented in order to influence the 10-year yield, where the effects of monetary easing are large (not to push down superlong yields themselves). If turmoil in the superlong zone begins to affect the 10-year zone, the BOJ's judgement regarding its monetary policy stance—whether it was appropriate to maintain a wait-and-see approach up until now—will be put to the test.

Functioning of bond market

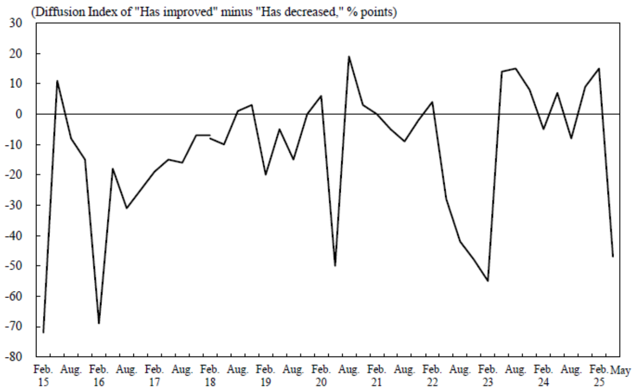
In this context, it is also notable that the DI for bond market functioning in the Bond Market Survey (released on 19 May) plunged to –44. The key point from this survey is that we appear to have seen the end of the virtuous cycle that had continued since the removal of the Yield Curve Control (YCC) policy in which reductions in JGB purchases by the BOJ led to an improvement in the bond market functioning DI. If the functioning of the bond market has rapidly deteriorated in line with the deepening of market fragmentation amid the continued reduction in purchase operations, it would be safe to assume that the BOJ is at a point where it needs to stop and carefully examine the situation, including what is currently happening in the superlong bond market.

DI for Bond Market Functioning (current situation)



Source: Reprinted from BOJ materials.

DI for Bond Market Functioning (change from three months ago)



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However, I have at least two reservations regarding whether the latest outcome means an end to the virtuous cycle in which reduced JGB purchases lead to improved bond market functioning. First is the possibility that the cautious stance of JGB market participants may have been exacerbated due to the recent series of important events, namely the interim assessment at the June MPM and the Bond Market Group meetings on 20-21 May. It seems natural to me that investors would hesitate to take aggressive positions ahead of these major events that affect the supply and demand of JGBs.

Second is that the current deterioration in market functioning may be “birth pains” (a transitional phase), rather than the market moving backwards. As seen in some of the opinions from the Bond Market Group meetings that were disclosed, one remote cause of the yield curve steepening and market fragmentation since April is the significant difference between the share of the BOJ’s JGB holdings of bonds with residual maturities of up to 10 years and those over 10 years. Therefore, one could easily envision that one option for narrowing this gap would be to increase the BOJ’s share of JGB holdings in the superlong zone by increasing the amount it purchases. However, if the root problem lies not in the decline in the BOJ’s share of its JGB holdings in the superlong zone, but rather in the disparity in the BOJ’s share of JGB holdings across different zones, then it might actually be more aligned with the long-term policy direction to accelerate the reduction in purchase operations in tenors up to 10 years as a way to narrow the disparity while the BOJ reduces its involvement in the market. The former is like a temporary painkiller, while the latter is like a radical cure. The patient’s condition determines which is appropriate.

Bond Market Group meetings

Opinions at the Bond Market Group meetings regarding the current plan to reduce JGB purchases included views that (1) the pace of reducing purchases should be accelerated, (2) the current plan should be implemented, as planned, (3) the pace of reduction should be made more moderate, and (4) a large reduction should be made in one operation. However, it is highly likely that the current reduction plan will be maintained until March 2026, as shown by the BOJ’s statement — “… the Bank will conduct an interim assessment of the plan for the reduction of its purchase amount of JGBs” and “In principle, the Bank intends to maintain the plan for the reduction …” The examples of specific opinions included four opinions in support of maintaining the current plan.

◆**Bond Market Group meetings (22nd)**

Financial Markets Department Presentation Materials (20 May 2025)[1]

<Responses to Opinion Inquiries (current plan to reduce JGB purchases)>

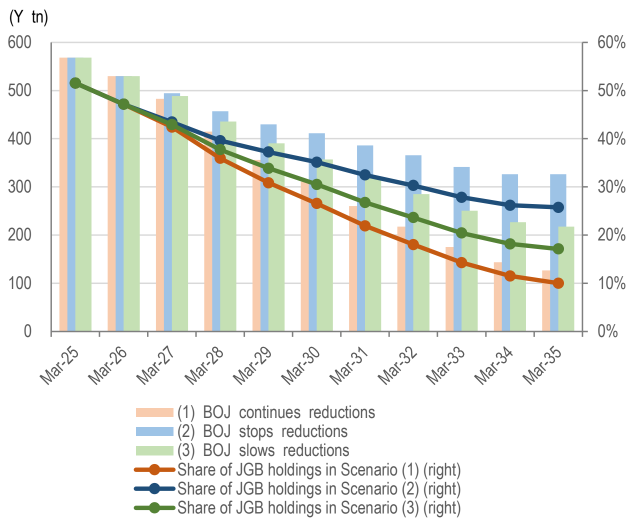
- Regarding the current JGB purchasing reduction plan, we have received opinions such as "pace of purchase reductions should be accelerated," "current plan should be maintained," "pace of purchase reductions should be slowed down," and "significant one-time reduction should be made."

<Examples of Specific Opinions>

- For the 10-year or shorter zones, the percentage of outstanding JGBs held by the BOJ remains high and, considering that market circulation is insufficient relative to investor demand and that the yield curve is distorted, there is the need to accelerate the reduction of JGB purchases, focusing on this zone.
- Given the current situation where the overall market risk tolerance is declining due to increased volatility, accelerating the pace of purchase reductions could actually impair market functionality. Therefore, changing the current plan is not advisable.
- As with the current superlong JGBs, when the liquidity of JGBs with specific maturities declines significantly, it is necessary to carefully consider the purchase reductions by remaining maturity as part of the breakdown. However, it is important to maintain the predictability of the scale and pace of reductions for JGB purchases and the current reduction plan itself should not be reworked.
- Under the current plan, reductions are progressing steadily without excessive volatility. There is no need to change the plan.
- Even though liquidity is now declining, this is due to factors other than the reduction in purchases resulting from the US tariff policy. As such, the reductions should proceed as planned.
- In light of current developments in the JGB market, reducing JGB purchases could potentially worsen liquidity, so the pace of reductions should be slowed.
- Due to the gradual reduction pace, improvements in market functions have been insufficient. Therefore, the gradual reduction should be discontinued and revised to a significant one-time reduction.

Regarding the pace of JGB purchases from April 2026, which is attracting greater attention from market participants, three opinions in favor of slowing the pace of JGB purchasing reductions were submitted. Also, a specific figure of Y200bn has been mentioned, which left the impression that the possibility of slowing the pace of JGB purchasing reductions is probably somewhat high. This corresponds to scenario (3), "JGB purchasing deceleration," in the QT simulation that we presented in the past (= quarterly purchasing pace reduced from Y400bn to Y200bn with this reduction maintained until end-FY27 with purchase reductions suspended in FY28 and thereafter, while monthly purchases of around Y1.3tn continue). Here, we could possibly arrive at a similar conclusion. Under this scenario, it is estimated that the BOJ's holdings of JGBs will be around Y217tn in ten years, accounting for around 17% of all JGBs (see our separate report).

QT Simulations



Source: BOJ, Cabinet Office; compiled by Daiwa.

[1] English translation provided by Daiwa.

◆Bond Market Group meetings (22nd)

Financial Markets Department Presentation Materials 20 May 2025

Responses to Opinion Inquiries (purchases of JGBs from April 2026 <pace>)

- For the period from April 2026, opinions were divided on whether the current pace of quarterly JGB purchase reductions (Y400bn) should be "accelerated," "maintained," or "slowed." Also, received opinions such as "reductions should be stopped" and "gradual reductions should be ended and a one-time large reduction should be implemented."
- Regarding how to indicate the JGB purchasing policy, the BOJ received opinions such as "extend for about one year and present plan for about two years" and "BOJ should indicate its policy to reduce the amount to the desired level within one year and maintain it at that level thereafter."

Examples of Specific Opinions

- In order to increase market circulation and realize freer yield formation at an early stage, the current pace of reduction should be accelerated.
- The current reduction pace is being absorbed by the market without major disruption. There is no problem maintaining a reduction pace of Y400bn each quarter.
- Maintaining the current pace of reductions seems appropriate from the perspective of predictability.
- In order to continue reducing JGB purchases while taking into account the risk of supply/demand deteriorating amid market instability, the reduction amount each quarter should be lowered to around Y200bn.
- Even under the current plan, reductions will proceed to an appropriate level, so the pace of reductions should be slowed down.
- Further reductions could exacerbate supply/demand concerns and lead to a risk of restrained investment, so a temporary suspension of reductions should also be considered.
- The gradual reduction policy should be ended and a significant one-time reduction should be executed.
- Extending the period by one year and then presenting a plan for the next two years, similar to the current plan, is desirable.
- Reduce JGB purchase amounts to the desired level within one year from April 2026. After that, the BOJ should indicate a policy for maintaining that same level.

As for JGB purchases (purchase amounts, others) from April 2026, a wide range of opinions were expressed, including "zero," "around Y1.0tn to Y2.0tn," and "around Y3.0tn." Among these, it seems that there is strong support for a range between Y1.0tn to Y2.0tn. As was indicated in the above (3) scenario, the market may be somewhat aware of a pace of around Y1.3tn per month that was in place before the introduction of large-scale government bond purchases.

◆Bond Market Group meetings (22nd)

Financial Markets Department Presentation Materials (20 May 2025)

Responses to Opinion Inquiries (JGB purchases from April 2026 <purchase amounts>)

- As for purchase amounts (monthly) at the end of the plan period, we received opinions such as "zero," "Y1.0tn to Y2.0tn," and "around Y3.0tn." We also received such comments as "interim assessment should continue to be conducted," "the desired state of excess reserves should be indicated," and "situation must be carefully ascertained."

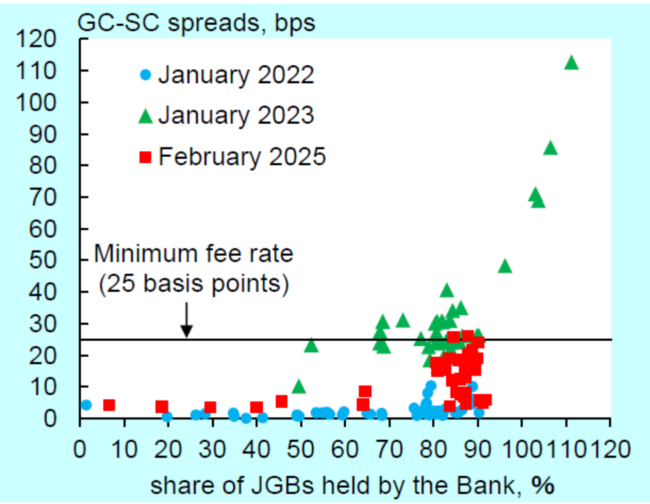
(Examples of Specific Opinions)

- The BOJ should continue reducing purchases until the amount reaches zero so that yields can be freely formed by the market.
- The current pace of reduction should be maintained for one year and reductions should continue until reaching a level of around Y1.0tn.
- The monthly purchase amount should be reduced to around Y1.0tn to Y2.0tn, the level before the significant increase in JGB purchases. Furthermore, from the perspective of market liquidity, it is better to secure opportunities to sell low-liquidity issues at this purchasing level, rather than having zero purchases.
- While taking into account the capacity of domestic investors to hold JGBs, in order to improve market functions through JGB purchase reductions, it is desirable to continue cautiously reducing the amount toward Y2.0tn.
- If the amount is around Y3.0tn, there is little risk of disrupting the supply/demand balance or destabilizing the financial system and the amount held by the BOJ will gradually decrease. So, maintaining this level for the time being is desirable.
- A flexible framework should be adopted, including interim assessment , for the period from April 2026 onward.
- When indicating long-term plans, excess reserve targets should also be indicated.
- It may be worth considering purchases from April 2026 after ascertaining whether the supply/demand deterioration for superlong JGBs will continue.
- The BOJ should reduce the pace to the desired level within one year from April 2026. It should indicate a policy for maintaining that same level after that.

Also, other opinions included the high ratio of BOJ holdings in the 10-year or shorter zones and the deterioration of supply/demand conditions in the superlong zone. Furthermore, some very interesting specific proposals were also presented, such as the integration of operation categories in the superlong zone, relaxing the upper limit of repurchase amount for the Securities Lending Facility, as well as expansion of the scope of eligible issues subject to relaxed requirements.

It is certain that operation segment integration for JGBs exceeding 10 years will eventually be implemented. If it is implemented at this point, it is likely that almost all slots would be filled within the 30-year to 40-year maturities. Given the possibility that distortions may arise again in terms of the ratio of JGB holdings by issue, it is unlikely that this will be implemented right away. Meanwhile, relaxing of the upper limit of repurchase amount for the Securities Lending Facility and expansion of eligible issues subject to a relaxing of requirements appear to be attractive options that would allow for both improved market liquidity and balance sheet reductions. As can be seen from the narrowing of the GC-SC spread and the decline in the winning bid amount for the Securities Lending Facility, extreme squeezing for individual issues is now rarely seen. As the next step, utilizing this tool as a means of actively release issues that are in high demand in the market seems worth considering. Of course, the reduction in supplementary supply measures effectively amounts to the BOJ selling JGBs, so certain restrictions will be necessary to manage the risk of unlimited use of these measures.

Share of 10-Year JGBs Held by BOJ and GC-SC Spreads



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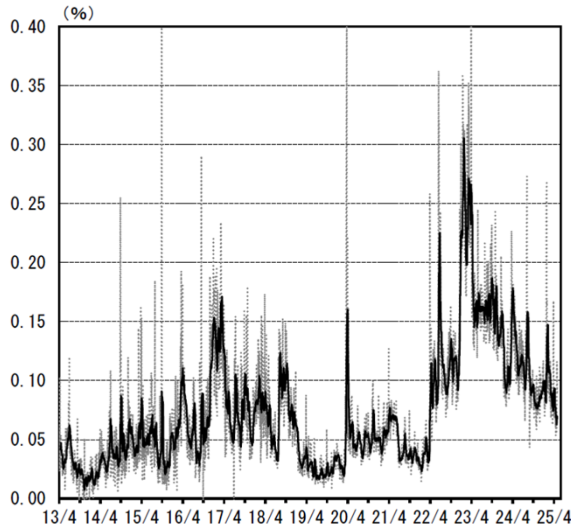
GC-SC Spreads



Source: Reprinted from BOJ materials.

◆**Bond Market Group meetings (22nd)**

Financial Markets Department Presentation Materials (20 May 2025)

Responses to Opinion Inquiries (others)

- Other comments included opinions on JGB purchase amounts, maturity categories by remaining maturity, flexible JGB purchases, and measures to improve the liquidity for those issues for which the BOJ has large holdings.

Examples of Specific Opinions

- In the superlong zone, where liquidity is significantly declining, flexible measures such as suspending purchase reductions, increasing purchase amounts, and integrating categories beyond the 10-year zone should be considered. Meanwhile, the BOJ's holding ratio is also high for 10-year and shorter maturities and purchase reductions should be prioritized mainly in areas where supply/demand conditions are tight.
- The supply/demand deterioration in the superlong zone is due to structural factors, namely low investor demand relative to issuance. So, there is little scope for the BOJ to address this issue fundamentally.
- When determining JGB purchasing amounts by remaining maturity, it is necessary to consider not only the flow but also the ratio of JGB holdings to outstanding issuance (= stock).
- The BOJ should consider an appropriate maturity structure for its holdings of JGBs and reflect this in its JGB purchasing policy.
- As future reductions progress, the amount offered per operation will decrease, making it necessary to review the frequency of operations and the classification of maturities.
- It is desirable to closely monitor market functions and liquidity. If necessary, take flexible measures such as conducting temporary purchases or changing the purchase amounts by remaining maturity.

- Issues with remaining maturities of 5 to 7 years, for which the BOJ's holding ratios are high, consistently trade at a premium. From the perspective of addressing yield curve distortions, it may be appropriate to consider flexible measures such as relaxing the upper limit of repurchase amount for the Securities Lending Facility, while expanding the scope of eligible securities subject to a relaxing of requirements.

Finally, based on our summary of the above points, we feel that in order to proceed with JGB purchase reductions while ensuring that market participants do not lose predictability, it is essential to deepen the broader discussions on "excess reserves to be targeted over the long term" (≈ appropriate balance sheet size). This is an important discussion that cannot be avoided, but it is also a difficult proposition that even the Fed (which is further ahead of the BOJ in terms of QT) has not yet resolved. At the very least, it will be a long time before the BOJ, which currently holds significant amounts of excess reserves, approaches the threshold for "ample reserves." Since the Fed is expected to reach a conclusion by that time, we will continue to closely monitor its discussions on this issue.

◆ Bond Market Group meetings (22nd)

Financial Markets Department Presentation Materials (20 May 2025)

- Excess reserve targets should also be included when indicating long-term plans.

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