Daiwa Securities

Daiwa's View

Surge in 30yr JGB yield, and interview with BOJ policy board member Koeda

- 30yr JGB yield hit record high on compound basis; Factors behind higher yields and steepening are complex and interrelated, and synched with global topics
- Dip-buying predominant with US yields; Worst-case scenario (expansion of term premiums in Japan/Europe being amplified and recirculating) avoided
- In the first solo interview with BOJ policy board member Junko Koeda since her appointment, she comments that food prices have risen more than expected, and that the BOJ is closely monitoring impact on underlying inflation

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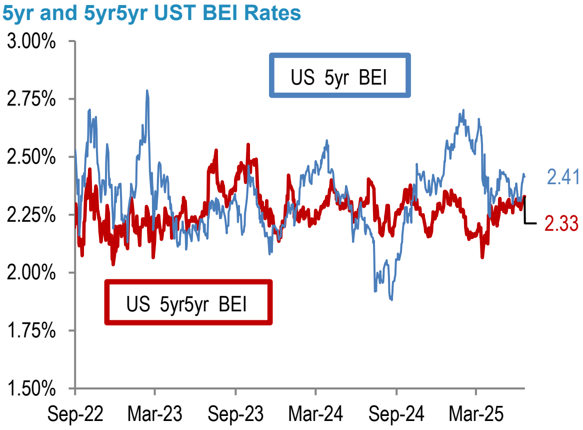
Yesterday, the US 10-year and 30-year yields initially followed the surge in term premiums that occurred in Japan and Europe, momentarily rising to 4.43% and 4.97%, respectively. However, gains rapidly narrowed toward the close, and ended at around 4.40% and 4.92%, respectively. Fortunately, the rise in yields that started in Japan and Europe did not become amplified in the US market and flow back to Japan.

Dip-buying predominant with US yields

To grasp the current conditions with long-term US yields, we conducted an analysis by decomposing long-term yields into four factors, dividing the maturity zones into "5-year (5yr)" and "5-year forward 5-year (5yr5yr)" zones, and further dividing the yield components into "breakeven inflation rate (BEI)" and "real yields." In the 5yr zone, the BEI has risen to 2.41%, driven by factors such as the enactment of tax cuts and the impact from Trump tariffs, leading to the rise in the 5yr yield. However, the 5yr nominal yield stood at 3.96% (BEI of 2.41% + real yield of 1.55%), close to the projected FF rate range that factors in the Fed's two rate cuts within this year. Therefore, unless there are significant changes in projections for the inflation rate or the Fed's rate cuts, the upside of the 5yr yield will likely be somewhat limited going forward.

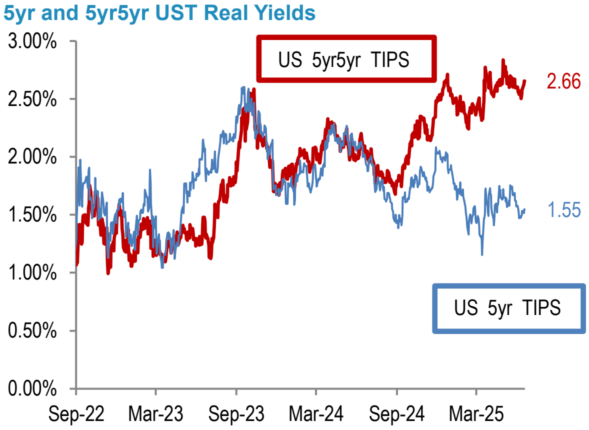
In the 5yr5yr zone, the BEI has been stable at around 2.3%, but the real yield has risen to 2.66% due to the tax cut bill and the surge in term premiums in Japan and Europe. As a result, the 5yr5yr yield is around 4.99% (BEI of 2.33% + real yield of 2.66%), approaching the 5% level that has functioned as a point of reference for the upper limit of the long-term forward yield since the pandemic. Overall, given the current outlook for rate cuts, we think the 5yr zone's 4% and the 5yr5yr zone's 5% are points of reference for their upper limits. Therefore, the basic structure, in which the 10-year yield will likely find it very difficult to rise significantly above 4.5%, has not changed.

5yr and 5yr5yr UST BEI Rates



Source: Bloomberg; compiled by Daiwa.

5yr and 5yr5yr UST Real Yields



Source: Bloomberg; compiled by Daiwa.

30-year JGB yield hit its highest level since 1999

Meanwhile, the 30-year JGB yield rose to 3.015% on a compound basis (+7.3bp d/d), surpassing 3.01% on 22 May and closing at its highest level since 1999. (The often-cited 3.15% figure in media reports is based on simple yields.) Furthermore, the 5-year/30-year JGB yield spread exceeded the key 200bp level, showing further steepening. In the forex market, the yen weakened yesterday, with the USD/JPY rate rising to the upper Y146 range and the EUR/JPY rate to the upper Y171 range. Since Japanese stocks rose slightly yesterday, a "triple sell-off" was avoided, but the market seems to have come close to that occurring.

30yr JGB Yield (compound basis)

Source: Bloomberg; compiled by Daiwa.

5yr/30yr JGB Yield Spread

Source: Bloomberg; compiled by Daiwa.

Mini "Truss shock"

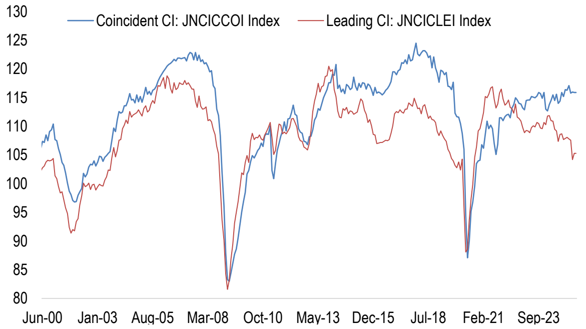
While some of the reasons for the Japanese market coming to close to seeing a "triple sell-off" yesterday probably include new factors such as the situation with the Upper House election (Sanseito gaining momentum), which became clear over the last weekend, and the notification of Trump tariffs, the cause of the phenomenon seems to have involved a complex web of interrelated factors, such as (1) global fiscal concerns and (2) sluggish economic sentiment in Japan (leading to expectations of rate hikes by the BOJ fading).

As briefly reported in *Daiwa's View* on 3 July, last week saw a surge in superlong UK gilt yields and a triple sell-off triggered by uncertainty over the future of UK Chancellor Rachel Reeves, who is pushing ahead with fiscal reforms. This triple sell-off, which could be called a "mini-Truss shock," serves as a reminder to the market that the series of major trends seen since the pandemic (or broadly since the Global Financial Crisis)—namely, the rise of populism fueled by wider disparity, limitless fiscal expansion driven by populism, and the resultant widening of term premiums—have yet to become a thing of the past. With people keenly aware of these major themes, it would be natural for the bond market to ring the alarm if we were to unexpectedly see indiscriminate fiscal policies once more being supported in Upper House election campaigns in Japan, as well.

Deterioration in Japan's economic sentiment (expectations of rate hikes by the BOJ fading)

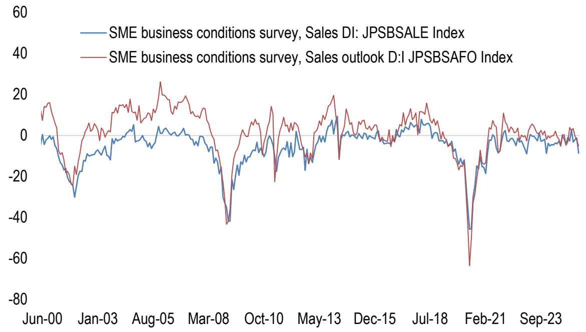
Other factors are the worsening economic conditions in Japan, which appear to have induced steepening (reversal of flattening) due to expectations that the BOJ will postpone rate hikes. We are somewhat concerned about the fact that the Cabinet Office lowered its economic assessment on 6 July to "Worsening" for the first time in four years and ten months. Confirming the coincident CI for business conditions, we think that the deterioration was limited, and that the judgement seems somewhat mechanical. However, the leading CI posted a relatively significant decline, which warrants close attention. Also, the small and medium-sized enterprise sales outlook DI by Japan Finance Corporation, recognized as an effective substitute for the BOJ Tankan survey, fell further to –5.1 in June. There may be an impact from rushed demand before Trump tariffs, and a subsequent reaction to that. Therefore, we need to continue to closely examine the data. Given the recent notification by the US that new reciprocal tariff rates will be applied, we need to keep in mind that it may have become even more difficult for the BOJ to implement additional rate hikes.

Indexes of Business Conditions (Cabinet Office)



Source: Bloomberg; compiled by Daiwa.

SME Sales DIs (Japan Finance Corporation)



Source: Bloomberg; compiled by Daiwa.

Interview with BOJ policy board member Koeda

With this situation as a backdrop, the media yesterday reported on the first interview given by BOJ policy board member Junko Koeda since taking office. She indicated a stance of not agreeing with excessive economic concerns, saying that, while some weakness had been seen in parts of the Japanese economy, the current assessment that it was recovering moderately had not changed, and that there were considerable risks of an economic slowdown in the future, but that she thought that the possibility of a severe global economic downturn was low.

Regarding inflation, she mentioned that she was continuing to monitor downside risks due to weakness in overseas economies, which is consistent with the opinion in the April *Outlook Report*. Immediately after that she said that she needed to watch for cost-push inflation due to supply constraints caused by trade policies in various countries, and that she was closely watching trends with the staple food rice, which may have secondary effects on Japan's inflation perception, household inflation expectations, and eventually underlying core inflation, and that, compared to the period during the April and May Monetary Policy meetings, recent hard data on prices, especially rice and food-related items, has been stronger than expected, which warrants attention. The wording "stronger than expected" brought to mind the 13 June media report saying that the BOJ was supposedly seeing inflation running stronger than expected due to continued price pass-through, based on sources from those in the know.

She supported existing opinions regarding the neutral interest rate, saying that, looking at the range of various estimates for the natural rate of interest, it was from –1% to +0.5%, and there was no strong objection to this range. Regarding the reductions in JGB purchases and an appropriate balance sheet size, she commented that, putting aside the issue of the pace of reductions in JGB purchases, she thought that JGB purchases had an ending point that was consistent with an appropriate balance sheet size, and that, by the beginning of next year, monthly JGB purchases were expected to fall below Y3tn, approaching that ending point. She said that you could think of it as like an autopiloted helicopter gradually descending, and finally landing gently while confirming the surrounding environment.

Overall, the interview was well balanced and appropriate for her debut. That said, her remarks included optimism about economic sentiment and caution about inflation, in what seems to have been an attempt to curb the excessive decline in market expectations for rate hikes by the BOJ. This may lead to revisions to risk balances in the July *Outlook Report*.

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