

Daiwa's View

“Misunderstanding”?

- Upward revisions to neutral rate expectations
- Government's distrust of the market and optimism about rising yields

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Is the rise in long-term yields a “misunderstanding”?

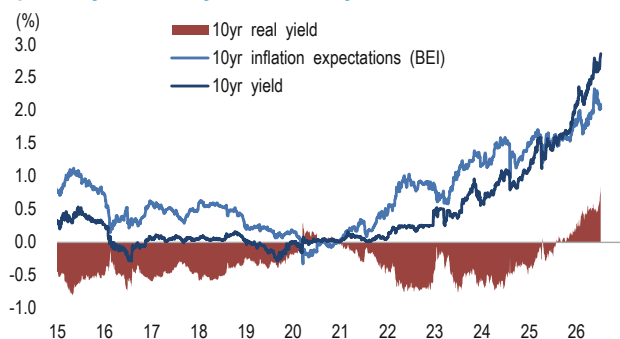
The yield on the newly issued 10-year JGBs temporarily rose to 2.850% on 7 July (simple yield basis), reaching its highest level in roughly 30 years. In response to these moves in the bond market, Minoru Kiuchi, Minister of State for Economic and Fiscal Policy, explained that the market's interpretation of the draft of the Basic Policy on Economic and Fiscal Management and Reform (“Basic Policy” hereafter) was “different from what was intended and therefore reflected a misunderstanding.”

However, it is difficult to dismiss the latest market reaction simply as a “misunderstanding.” This is because the market is not pricing the government's explanatory wording itself, but rather the broader policy direction underlying it.

Indeed, the recent rise in yields cannot be fully explained by typical “concerns over a deterioration in JGB supply/demand conditions.” In Japan's yield curve, while the short-term sector has remained relatively stable, the medium- to long-term sector has risen sharply, resulting in bear steepening.

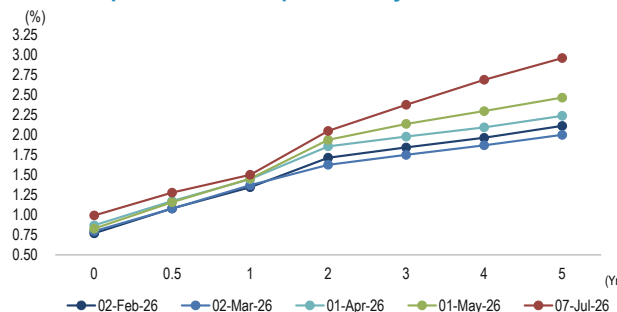
To be sure, over the past week, the rise in long-term yields has been driven by real yields, meaning that the market has been pricing in a certain degree of concern about fiscal expansion. However, what the market is truly concerned about is not so much an increase in JGB issuance itself, but rather the upward revision to neutral rate expectations and inflation risks arising from interaction between fiscal and monetary policy. Another factor is that real yields are rising despite relatively stable global inflation expectations¹.

Japan: 10yr Yield, 10yr BEI, and 10yr Real Yield



Source: Bloomberg; compiled by Daiwa.

Market Expectations for Japan's Policy Rate



Source: Bloomberg; compiled by Daiwa.

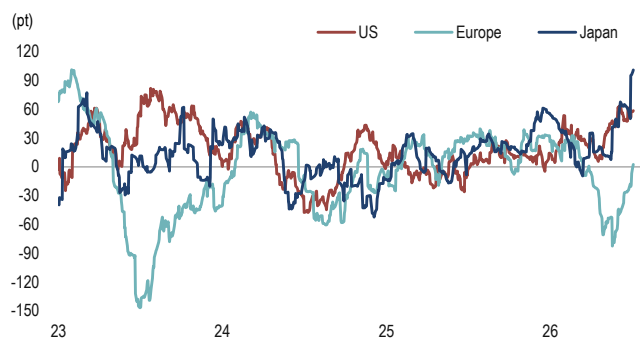
¹ At present, it is difficult to accurately assess and interpret movements in inflation-indexed JGBs (BEI), partly due to speculation over a potential consumption tax cut on food products and the impending CPI base-year revision.

Rate hike expectations have not increased

What is interesting is that near-term rate hike expectations have not risen significantly, despite the strong BOJ Tankan survey, including business sentiment, spending plans, and inflation expectations, as well as continued solid economic indicators. Looking at the OIS market, market views on the BOJ's terminal rate over the next two years or so have not changed significantly. The view has taken hold in the market that the BOJ will proceed with rate hikes at a gradual pace of about once every six months. This reflects, in part, repeated government messaging that can be interpreted as discouraging rate hikes, not solely out of concern for economic conditions.

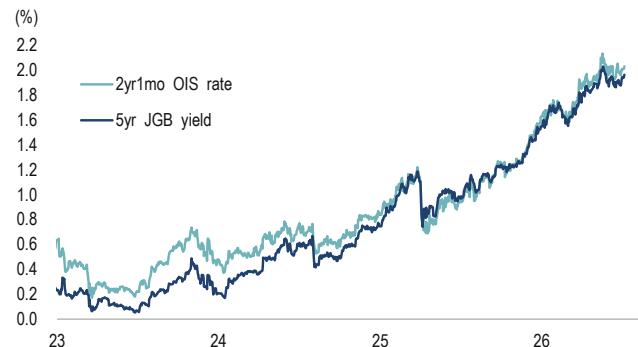
In the draft of the Basic Policy, wording was added stating that appropriate monetary policy management is “extremely important” for achieving a “strong economy.” [The government denies any intention of undermining the BOJ's independence, but the market reacts more to the government's past “actions” than to its “words.”](#) This is because, if political constraints on monetary policy normalization were to strengthen, including through BOJ personnel appointments, the market could conclude that the BOJ may not be able to respond to improvements in economic activity and inflation as promptly as warranted by its own assessment. As a result, terminal rate projections implied by the 2-year forward OIS rate and the 5-year JGB yield have not risen significantly.

Economic Surprise Index for Japan, US, and Europe



Source: Bloomberg; compiled by Daiwa.

Japan: 5yr JGB Yield, 2yr-forward 1mo OIS Rate



Source: Bloomberg; compiled by Daiwa.

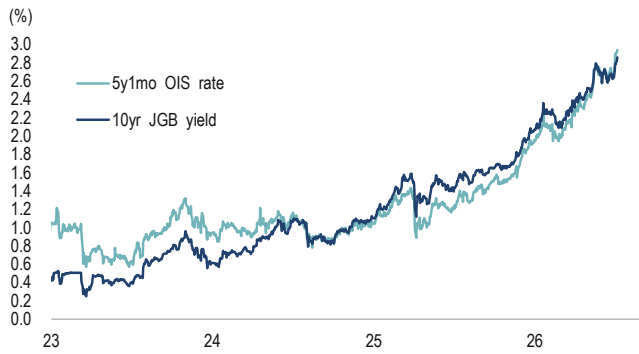
What is rising is the yield outlook “beyond that point”

By contrast, the neutral rate expectations implied by the 5-year forward OIS rate and the 10-year JGB yield have been rising (the same is true for the 5-year forward 5-year yield). While the 5-year yield mainly reflects the market-implied terminal policy rate, the 10-year yield has a stronger tendency to reflect the economic and price environment beyond that point—in other words, the outlook for the neutral rate.

For this reason, the widening of the 5-year/10-year yield spread means that the market believes “near-term rate hike expectations are broadly unchanged, but the interest rate level over a longer horizon will be higher.” Put differently, it suggests that the market believes “the BOJ can raise rates only slowly, but ultimately a higher level of interest rates will be required.” However, not all of this is a “bad” rise in interest rates, from the perspective of rising “nominal” growth expectations.

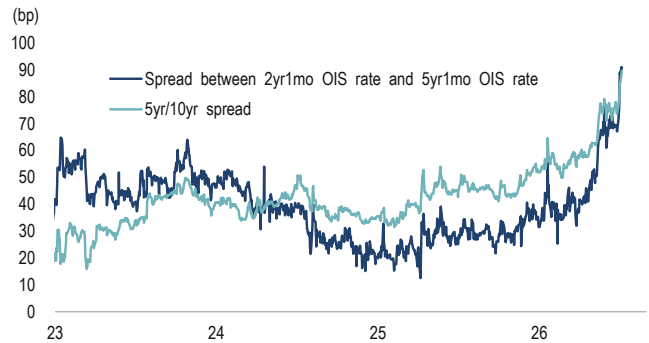
Even so, this is a form of typical behind-the-curve concern. Normally, if a central bank raises the policy rate flexibly in response to higher growth and inflation, neutral rate expectations tend to remain stable. However, once the market begins to believe that there are constraints on the speed of policy normalization, it develops the view that the current policy rate may not be sufficient to restrain future inflation or economic overheating. As a result, only long-term yields rise ahead of other sectors. The recent developments in Japan can be understood in this way.

Japan: 10yr JGB Yield, 5yr-forward 1mo OIS Rate



Source: Bloomberg; compiled by Daiwa.

Japan: 5yr/10yr JGB Yield Spread, Spread Between 2yr1mo OIS Rate and 5yr1mo OIS Rate



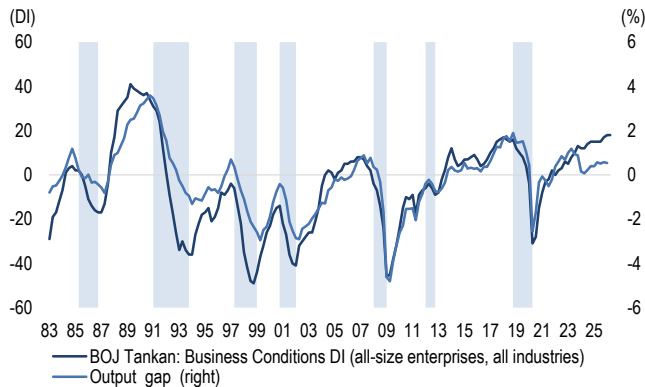
Source: Bloomberg; compiled by Daiwa.

What the market is wary of is not fiscal expansion itself

Another important point is that the market's concern is not a simple deterioration in JGB supply/demand conditions. Fund inflows from overseas investors into Japanese equities and JGBs have weakened since the deterioration in US-Iran situation. However, this is not an assessment that "fiscal expansion will boost growth expectations." Rather, it may include concerns that, with the output gap already in positive territory, if additional fiscal expansion and constraints on monetary normalization proceed at the same time, inflation and yen depreciation could become more difficult to control.

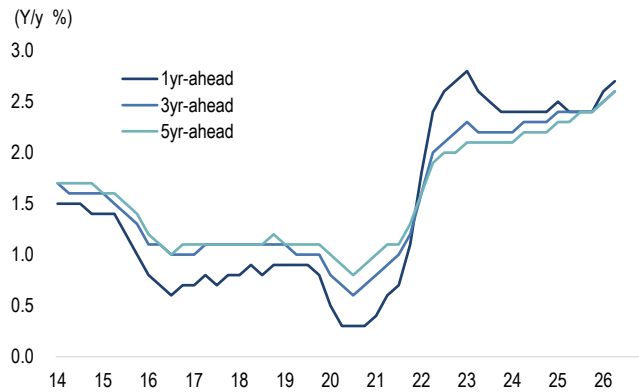
What the market is pricing in is not excessive JGB issuance itself, but rather the issue of policy consistency. If the government proceeds with aggressive fiscal policy, monetary normalization commensurate with that policy will be required. However, the market currently feels that this combination has not been sufficiently presented. As a result, [yen depreciation](#) and rising long-term yields are occurring simultaneously, and the yield curve is steepening.

Business Conditions DI (all-size enterprises, all industries) in BOJ Tankan, Output Gap (BOJ estimates)



Source: BOJ; compiled by Daiwa.

Inflation Outlook of Enterprises (all-size enterprises, all industries) in BOJ Tankan



Source: BOJ; compiled by Daiwa.

Not a "misunderstanding," but the market's assessment

Therefore, it would be more natural to understand the current rise in long-term yields not as a market "misunderstanding," but as the result of the market's assessment of policy management. The market is not simply reading the government's explanatory text. It is comprehensively pricing in the fiscal policy, monetary policy, forex rates, inflation, and the BOJ's reaction functions that lie behind it.

What is actually happening is not a rise in rate hike expectations. Rather, as the view that the pace of rate hikes will be restrained takes hold, only neutral rate expectations are rising, and the yield curve is steepening significantly. The 10-year yield of 2.850% is not the result of the market

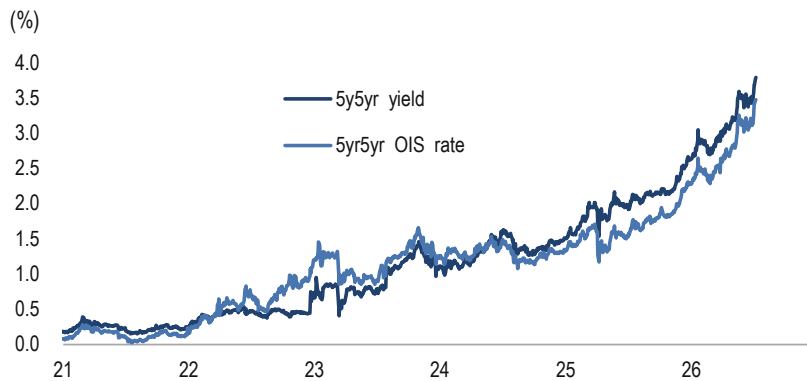
having “misinterpreted” the government’s explanation. It reflects not a market misunderstanding, but the market’s assessment of the current policy mix.

Against this backdrop, the *Asahi Shimbun* reported yesterday that “the government is considering revising part of the wording related to monetary policy in the draft of this year’s Basic Policy.” However, a Reuters report published on the same day quoted government officials as indicating that Prime Minister Sanae Takaichi and individuals close to her harbor skepticism toward the market and remain relatively sanguine about the rise in yields.

According to the Reuters report, there appears to be distrust of the market, with comments such as “Are market participants really reading the draft properly?” from one person involved in drafting the Basic Policy, and “It appears that the market is merely using this as an opportunity for speculation” from another official. The report further suggested that “Excessive optimism is spreading within the government that the rise in yields is temporary.”

The real issue is whether the policy mix of fiscal policy, monetary policy, and forex policy is consistent in an inflationary environment where the output gap has already turned positive. As long as doubts on this point remain, the “misunderstood” state of long-term yields and the yen exchange rates is likely to persist.

Japan: 5yr-forward 5yr OIS Rate, 5yr-forward 5yr Yield



Source: Bloomberg; compiled by Daiwa.

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