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## How will the Bank of Japan manage yield curve control?

Our baseline expectation is that the BoJ will adjust the parameters of its yield curve control framework by July. Widening the tolerance band around the 10-year JGB yields to at least +/- 75bps is one option. But there is the risk that speculators will attack the new peg, forcing the BoJ into a de facto crawling yield peg.

### Key Takeaways

- The incoming Bank of Japan (BoJ) Governor Kazuo Ueda's comments on his policy intentions have been carefully worded throughout the recent parliamentary hearings.
- However, Ueda acknowledged that some "surprise" policy shifts are necessary to avoid persistent speculation.
- The window for action is narrow as the economic data will shift meaningfully over the next 6 months, with inflation pressures likely to fade rapidly.
- Our baseline expectation is that the BoJ tweaks the parameters of yield curve control (YCC) by the July meeting. One option is to widen the tolerance band around 10-year JGB yields to at least +/-75bps.
- Communication of the new policy stance is key. Any change must be accompanied by a clear statement of next steps and associated waymarks to help manage investor expectations.
- Targeting the yield level of shorter maturity bonds - perhaps the 5-year sector – is also a possibility, as the BoJ may find it has more control over shorter maturity bonds.
- A successful policy change would help re-anchor yields at a credible new level and improve market functioning.
- However, there is a strong risk of the new peg also lacking credibility and facing sustained speculative attack.

### The BoJ's attempt to manage market distortions swiftly backfired in December

Through 2022, the BoJ has become a monetary policy outlier. Significant monetary tightening by major central banks around the world caused wide yield differentials between Japanese government bonds and those elsewhere. This in turn resulted in significant yen depreciation.

Combined with the prospect of a new governor on the horizon, this outlier status led to heightened speculation around the sustainability of the BoJ's flagship policy of YCC.

Serious deterioration in market functioning, as reflected in poor liquidity and price discovery, made for a very difficult trading environment.

The BoJ attempted to resolve these issues through a surprise decision at the December monetary policy meeting to double the permissible trading band to "around zero +/- 50bps". The official communication stated the move was not intended as policy tightening or an exit from the current regime.

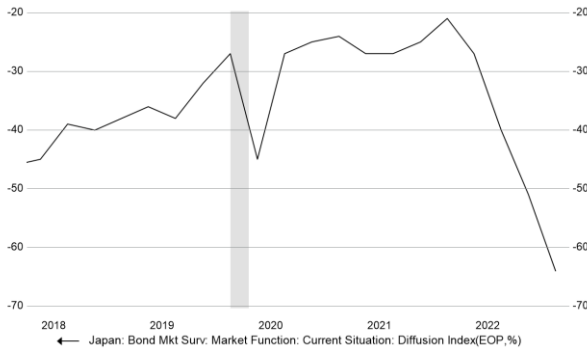
However, bond market dysfunction merely intensified in response (see Figure 1). In addition to the regular Rinban and 10-year JGB fixed-rate bond-buying operations, the BoJ was forced to ramp up the purchase of bonds through unscheduled Rinban operations and expand fixed-rate bond purchases across all tenors, not just the 10-year on the run JGBs.



Moreover, the decision increased investors' scepticism of the central bank's communication strategy, and expectations of eventual policy tightening increased.

Thus, the BoJ was left with tighter financial conditions without any commensurate increase in market functioning.

**Figure 1: The Q1 bond market survey shows further deterioration in market functioning following the policy change in December**



Source: BoJ, abrdrn, March 2023

**What do we know about the incoming BoJ governor?**

A highly respected MIT-educated academic and former BoJ board member between 1998 and 2005, Ueda is considered one of Japan's foremost experts on monetary policy.

He has maintained a neutral tone through the parliamentary hearings, sticking closely to the BoJ's official line, but acknowledged that the negative side effects of YCC could not be overlooked.

The key points from Ueda's hearing include:

- Suggesting that BoJ should consider normalising policy if the underlying inflation outlook improved further.
- Arguing that current inflation pressure is mainly due to transitory cost-push factors rather than domestically generated inflation.
- Pointing out that the BoJ has employed various measures to help alleviate the side effects of YCC and will continue to monitor their effectiveness.

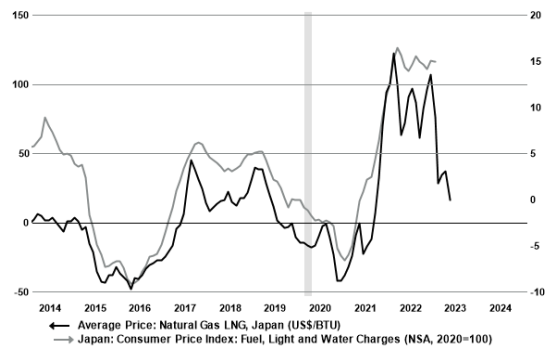
**Inflation has likely peaked in Japan**

Headline inflation has trended higher over the past year. But the latest Tokyo CPI signals the peak is likely to have been reached.

We continue to expect disinflationary forces to dominate this year as the lagged impact of energy base effects (see Figure 2), supply chain improvements, and broader goods price disinflation starts to feed through (see Figure 3).

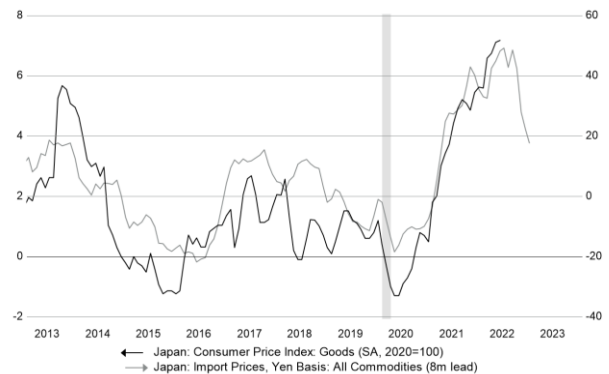
Domestically generated inflation is yet to convincingly take hold. Services inflation has edged back into positive territory, but it remains lacklustre at best.

**Figure 2: Energy base effects likely provide a sharp drag on headline and core ex-fresh foods**



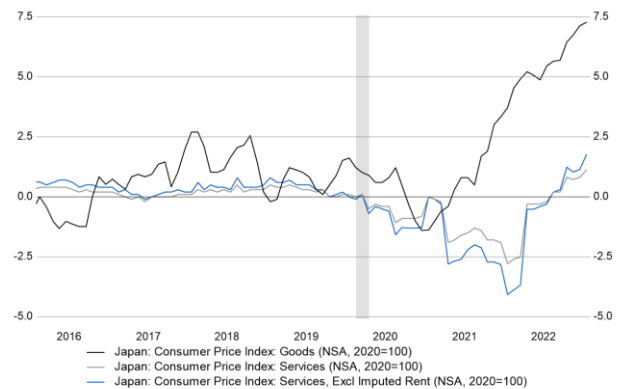
Source: BoJ, abrdrn, March 2023

**Figure 3: Goods inflation also peaking**



Source: BoJ, abrdrn, March 2023

**Figure 4: Services inflation back in positive territory but still no sign of sustainable trend**



Source: BoJ, abrdrn, March 2023

**Wage negotiations off to a strong start**

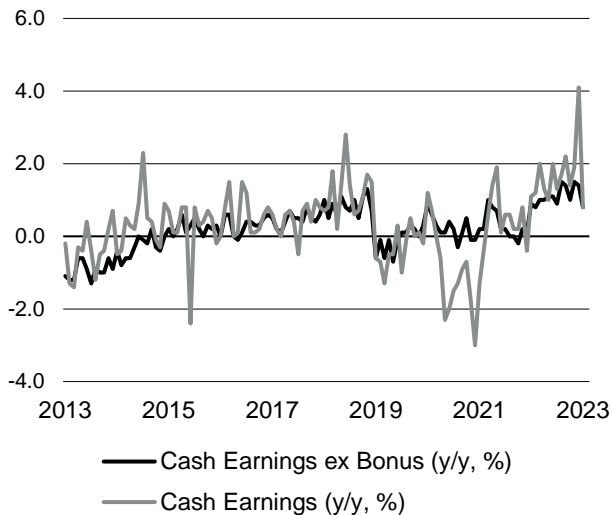
The Shunto spring wage negotiations will be one of the key drivers of the inflation and policy outlook.

The Japanese Trade Union Confederation has so far released data from around half of the unions that submitted demands for pay hikes. The headline wage revision rate currently signals 4.49%, more than the 2-3% range that dominated the past three decades, and the first time it has exceeded 4% in 25 years.



Estimates suggest that, for the economy as a whole to register wage growth of around 3%, the Shunto base pay would need to increase by more than 3.2% and the scheduled wage hike would need to exceed 4.8%. This would be the largest increase since the early 1990s. We think wage growth is likely to come in well below this level.

**Figure 5: Core earnings still within historic range. Bonus payments drove headline wage growth.**



Source: Haver, abrdrn, March 2023

**A policy announcement is expected in June or July**

Given the likely evolution of the data over the next six months, the BoJ faces a narrow window of opportunity to make any “surprise” tweaks to policy.

As expected there was no change at the March policy meeting and Governor Kuroda reflected on his tenure. The timing was too early for clarity over the Shunto wage negotiations and too close to the end of the fiscal year, risking market turbulence stemming from a policy change.

The April 28<sup>th</sup> meeting is just before the Golden Week holidays, so again market volatility would not be well timed for financial institutions.

This suggests the June or July meetings would be the best time for an announcement. However, we would not entirely rule out the possibility of an inter-meeting surprise announcement.

**We expect a widening of YCC band to at least +/- 75bps**

The fate of YCC is finely balanced, but we think there is a 60% chance that a change will be made to it of one form or another once Ueda takes over as governor. We believe the most likely change is widening the tolerance band for the 10-year JGB trading range to +/-75bps.

Targeting the yield level of shorter maturity bonds - perhaps the 5-year sector – is also a possibility, as the BoJ may find it has more control over shorter maturity bonds.

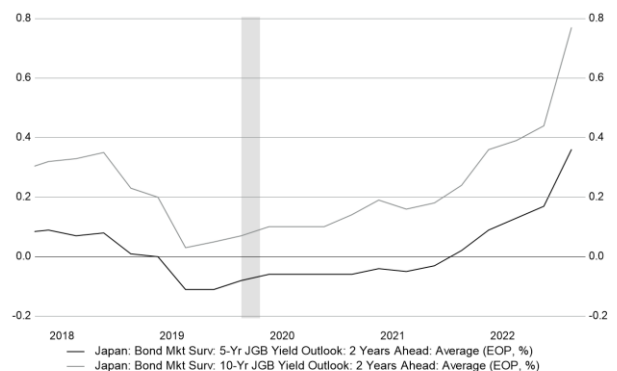
Were the band to be widened, yields will likely settle at the top end of the band immediately. Swap rates would likely overshoot this level temporarily as they price in the risk of a possible future removal of YCC policy.

Longer-term fair value estimates for 10-year JGB yields range between 80-120bps. Estimation methods vary from models based on neutral rates plus term premia, to models that incorporate inflation expectations and US Treasury yields.

Given that many central banks are drawing towards the end of their hiking cycle and we think they will begin cutting by the end of this year, the yield differential between JGBs and other bond yields should start to close. This will be supportive of JGB valuations.

Indeed, the same bond market survey that signalled a sharp deterioration in bond market functioning shows that investors are expecting yields to settle at around 80bps in 10y sector over the next 2 years.

**Figure 6: Longer-term bond market outlook not so aggressive despite current YCC related drama**



Source: Haver, abrdrn, March 2023

**Clear communication is key**

The new BoJ leadership team will need to be extremely mindful of how any move is communicated. A clear overview of the next steps with associated economic and market waymarks will help manage investor expectations of the future policy path.

A successful policy change could help re-anchor yields at a credible new level and improve market functioning.

However, the risk is that speculators will attack the new peg, with the BoJ losing rather than gaining credibility in tweaking the policy, in which case the economy will end up with tighter financial conditions without any commensurate improvement in market functioning.

**Investment implications**

- We think the BoJ will widen the YCC band to +/-75bps, with JGB yields moving rapidly to the top of this new range. Swap yields will likely move higher, and the currency will appreciate in the first instance.



- Alternative scenarios include widening the range to +/- 1%, or targeting the yield on shorter maturity bonds. The wide range of possible outcomes means that the volatility of Japanese assets is likely to remain unusually high.
- If the BoJ aims to reduce market turmoil, then a decision is most likely to be made in June or July. However, Ueda

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has talked about the virtue of a “surprise” move, and, given the BoJ’s poor communication recently, it is certainly possible that the central bank will make the announcement via a shock inter-meeting decision.



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