Daiwa's View

BOJ succeeded in controlling yield curve, but facing rocky road ahead

- Cooperation between gov't and central bank (policy mix) indispensable

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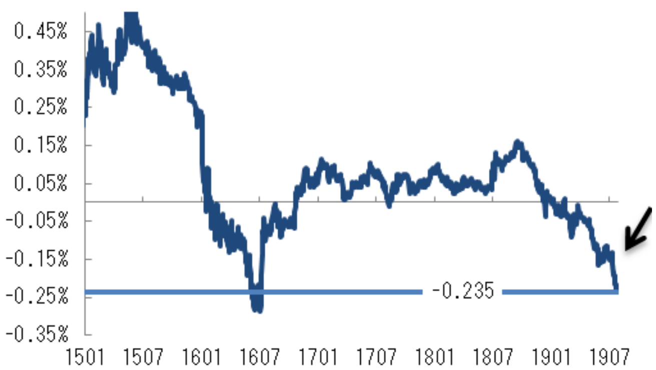
Amid the 10-year JGB yield sliding to –0.25% at one point on 16 August, the BOJ cut the offer amount in the 5- to 10-year zone by Y30bn to Y450bn from Y480bn in the previous operation.

Although this response was close to the minimum level of the market consensus[1], the BOJ reduced the JGB purchase amount two weeks in a row. We can say that the central bank took action at any rate to maintain the yield curve control (YCC) policy. Reflecting the BOJ's action, the JGB futures price declined to 154.85 (down Y0.06 d/d) and the 10-year JGB yield rose to –0.235% (up 0.005% d/d) on 16 August. Given the 3-5bp drop in the 10-year US Treasury yield overnight on 15 August to Tokyo time on 16 August, we can say that the BOJ succeeded in curbing an excessive yield decline for now.

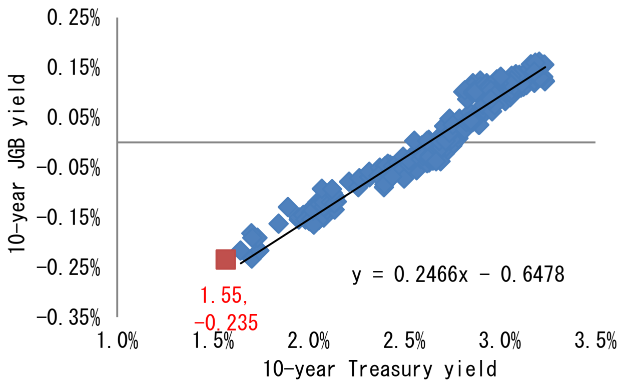
However, the recent trend of global yield declines has occurred amid the dovish shift by global central banks (toward further monetary easing) under structural low inflation. If the BOJ fixes the lower end of the JGB yields against this trend, the relative JGB yield level could become conspicuously high, a risk factor. It is not realistic that the BOJ alone resists the global yield downtrend in the long term, putting aside a short-term move.

Chart: 10-year JGB Yield



Source: Bloomberg; compiled by Daiwa Securities.

Chart: 10-year Yields in Japan and US (from Apr 2018)



Source: Bloomberg; compiled by Daiwa Securities.

[1] As initial reaction, 10-year JGB yield temporarily declined to –0.255%. See our 19 Aug report *JGB Insight*.

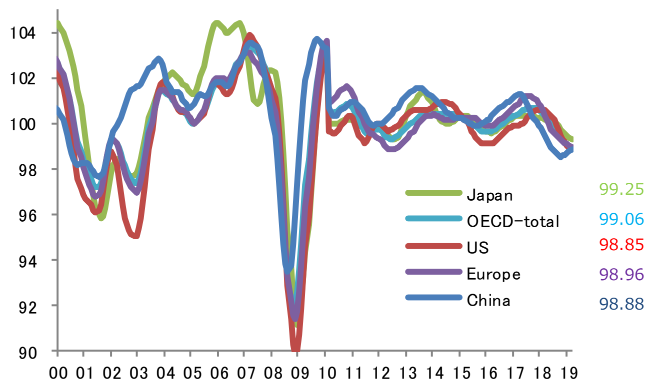
In order to make the BOJ's YCC policy effective over the long term, we think that either (1) a pause in the downtrend of overseas yields or (2) a policy mix (cooperation with fiscal policy) is needed. Without relying on the former, which cannot be controlled by the BOJ, it is vital for the central bank to choose the latter, in which requirements can be fulfilled via self-help efforts—cooperative measures with the government.

In that sense, the news on German fiscal spending, which served as a market driver last Friday, has had a substantial impact. Since last Friday when a German magazine reported that the German government is preparing for deficit spending in case of a recession, yields and stock prices have surged. This gave us the impression again that the market is now strongly expecting the policy mix. We recall the volatile move on 8 August—the 10-year Treasury yield rose by 5bp at one point in response to the news that Germany was considering further bond issuance via green bonds. Currently, the market is very sensitive to fiscal policy.

As yields of many global bonds have fallen into negative territory, effective tools via monetary policy alone have been limited. In such a situation, we have been focusing on the importance of government fiscal spending. For example, on 15 April, we quoted Poul Thomsen, director of the IMF's European Department on 12 April—"we continue to see a case for Germany to increase spending or cut taxes to boost growth," and "looking forward, given the fiscal space Germany has, we can see reforms over several years that would boost spending." Moreover, we also pointed out the possibility of German fiscal spending in May, introducing the IMF's Staff Concluding Statement of the 2019 Article IV Mission for the nation.

These examples prove that we have been emphasizing the importance of the policy mix via fiscal spending. If the trend of focusing on policy mix/fiscal policy seen in 2016 again gains momentum, current concerns about a recession (which emerged for first time since 2016) would prove unfounded. This is likely to serve as one factor to enter a new risk-on market. At the very least, the market atmosphere would change, despite being dominated by concerns about a recession due to US-China conflicts.

Chart: OECD Composite Leading Indicator



Source: Bloomberg; compiled by Daiwa Securities.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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May 2018

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• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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