Daiwa's View

Divine power of BOJ's pooled-collateral operations

➢ Expected effect already taking hold as of signaling stage

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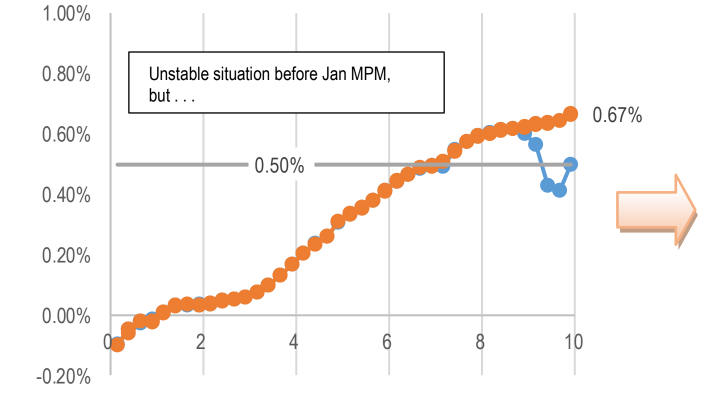
Expected effect already taking hold as of signaling stage

While maybe not as strong as the longer-term refinancing operations (LTRO) put forth by former ECB President Mario Draghi in 2011-2012, the BOJ's decision at its January Monetary Policy meeting (MPM) to enhance its Funds-Supplying Operations against Pooled Collateral ("pooled-collateral operations") seems to have produced a quite powerful effect. Indeed, yields on the 2-year and 5-year JGBs dropped to -0.01% and 0.19%, respectively. Yields on short-term JGBs with remaining maturities of up to three years are hovering around 0% and we see yield curve stability starting from the short-term zone and spreading to the medium- and long-term zones.

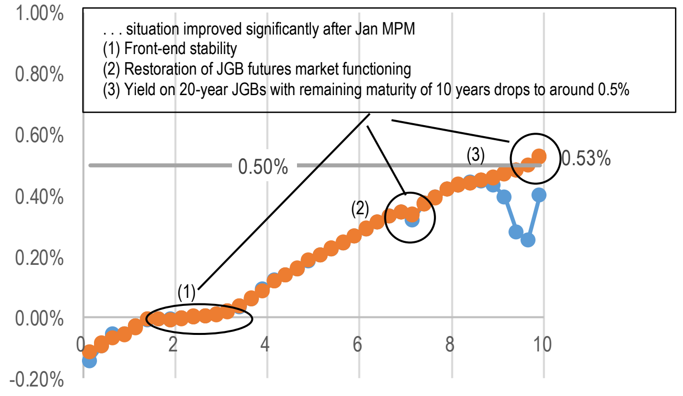
It is particularly noteworthy that the yield on the 7-year JGB, which corresponds to the cheapest-to-deliver JGB future, has fallen to the mid-0.3% range, far removed from the 0.5% line of the BOJ's fixed-rate purchase operations. It will take some time, but if the 7-year JGB yield continues to diverge from 0.5% for some time, we could expect a gradual recovery for the functioning of the JGB futures market. In that case, the restoration of JGB futures market functionality would also contribute to "swap normalization → corporate bond market normalization" as the need to use swaps as a yield hedge would decline.

JGB Yields (compound yield basis as of 17 Jan)



Source: JSDA; compiled by Daiwa Securities.

JGB Yields (compound yield basis as of 233 Jan)



Source: JSDA; compiled by Daiwa Securities.

We suspect BOJ may be struggling with its decision on how much to offer

The BOJ's pooled-collateral operations are highly effective in driving down yields through the arbitrage behavior of private finance. Still, we were somewhat surprised by the large market impact that emerged even though the 5-year operation scheduled for today (23 Jan) is still in the "notified and not yet executed" stage. Perhaps the BOJ's intended effect already permeated the market as of just the signaling phase, and a large offer today could be overkill. On the other hand, if the BOJ scales back its offer by too much, the market could doubt the seriousness of the Bank's intentions and the desired effect that has already been created in the market could drop off. We suspect the BOJ may be struggling with its decision on how much to offer today.

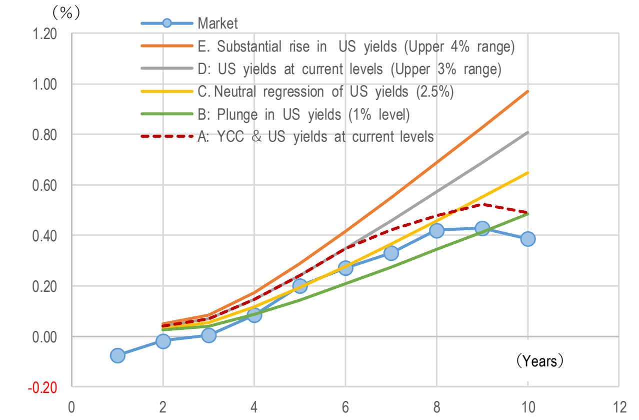
We continue to expect 10yr JGB yield of 0.8% when YCC eliminated, but . . .

Looking at the current JGB yield curve and the estimated yield curve at the time of YCC elimination, the status quo for JGB yields in the 2- to 8-year zone is now generally around the yellow line in the chart provided below (left side). In this case, we tend to imagine a 10-year JGB yield in a 0.6-0.7% range at the time of YCC elimination.

That said, if we closely examine the instantaneous forward interest rate, we can imagine a different conclusion. At this juncture, the super-long-term instantaneous forward interest rate remains in the low 2.0-3.0% range, and instantaneous forward interest rates in the 2-4 year zone are generally in step with the gray line in the chart. The enhancement of the pooled collateral operations and the 5-year notice are likely to have increased the degree to which the instantaneous forward interest rates for JGBs with remaining maturities of 5-9 years are suppressed from their original strength (this effect will be released once YCC is eliminated).

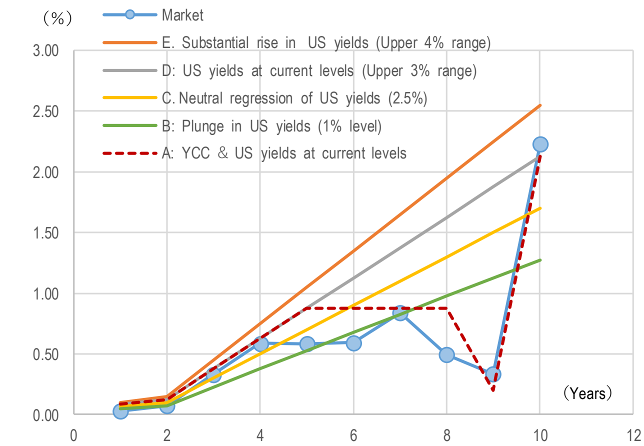
This suggests that if the BOJ abruptly eliminates its yield curve control (YCC) policy, we should continue to see the 10-year JGB yield hold around 0.8% (we have indicated in previous reports that the likelihood of an abrupt removal of YCC under BOJ Governor Kuroda decreased following the January MPM).

Estimated JGB Yield Curves



Source: Bloomberg; compiled by Daiwa Securities.

JGB Instantaneous Forward Rates



Source: Bloomberg; compiled by Daiwa Securities.

Somewhat reduced upside potential if YCC eliminated in 2H 2023

Under our main scenario, the BOJ eliminates its YCC in the second half of 2023. If our main scenario plays out, we should note that the 10-year JGB would likely not remain around 0.8% due to changes in assumptions for US Treasury yields.

FRB member Chris Waller, who is viewed as a hawk, said during a speech late last week that the US central bank's monetary policy was "pretty close" to an interest rate "sufficiently restrictive" to bring inflation under control. Waller's comments are an endorsement of FRB Vice Chairman Lael Brainard's speech last Thursday, which suggested a slowdown in the pace of rate hikes to 0.25% in February. As such, the FRB is now on track to further slow the pace of rate hikes at next week's scheduled February FOMC meeting. Also, there is a growing likelihood of a policy pivot to halting rate hikes in the first half of 2023, when the economy will reach this "sufficiently restrictive" territory. Such a pivot by the FRB would act as an important catalyst impacting global interest rates. Long-term US Treasury yields and super-long JGB forward yields will be subject to some downward pressure.

If so, even if the BOJ under a new governor eliminates YCC in Jul-Sep, after assessing Japan's spring management/labor wage negotiations, the base JGB super-long instantaneous forward interest rate may have fallen from the 2.0%-2.5% range to a 1.5% 2.0% range by that time. In that case, we would expect that the estimated 10-year JGB yield at the time of YCC elimination would decline toward 0.65% and potential for JGB yield upside would be somewhat diminished.

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