

# Daiwa's View

## JGB yield outlook (revised on 12 Apr)

- Anticipating 10-year JGB yield at 0.3% level and 20-year yield at 0.9% level at end of 2023 amid decline in US yields

Fixed Income Research Section  
FICC Research Dept.

Chief Strategist  
**Eiichiro Tani, CFA**  
(81) 3 5555-8780  
eiichiro.tani@daiwa.co.jp



Daiwa Securities Co. Ltd.

### Anticipating 10-year JGB yield at 0.3% level and 20-year yield at 0.9% level at end of 2023 amid decline in US yields

### JGB yield outlook (revised on 12 Apr)

#### ◆ JGB yield outlook

Following revisions to our outlooks for US yields and the BOJ's monetary policy, we have revised our JGB yield outlook. We now anticipate a 10-year JGB yield at the 0.3% level and a 20-year yield at the 0.9% level towards the end of the year, assuming a scenario of lower US yields towards end-2023.

In his inaugural press conference, BOJ Governor Kazuo Ueda stated that it was appropriate to continue the (YCC) policy given current economic, price, and financial conditions. This leaves us feeling that he does not intend to rush into implementation of measures to deal with the side effects of removing the YCC policy and expansion of the trading band. Of course, the BOJ will discuss policy revisions while drafting the *Outlook for Economic Activity and Prices* report (*Outlook Report*) until October. However, as we anticipate a further decline in US yields towards 2H 2023, we think the possibility has diminished substantially that removal of or revisions to YCC will create upward pressure on JGB yields (at least by end-2023).

Regarding the distortion of the yield curve, new BOJ Governor Kazuo Ueda said at his inaugural press conference that it had become smoother overall compared to before. I also estimate that the recent JGB yield curve is, generally, close to the appropriate level. Even if Governor Ueda were to abruptly remove YCC or make it become ineffective, the possibility of that putting strong upward pressure on the current 10-year JGB yield would be small, unless such a move led to a series of speculation about upcoming tightening.

### JGB Yield Outlook (%)

		FY23											
		Apr-Jun			Jul-Sep			Oct-Dec			Jan-Mar		
		Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
Japan	IOER	-0.10	-0.10		-0.10	-0.10		-0.10	-0.10		-0.10	-0.10	
	10y	0.25	1.00	0.45	0.25	1.00	0.40	0.20	1.00	0.35	0.15	1.00	0.32
	20y	0.90	1.50	1.10	0.85	1.50	1.05	0.70	1.40	0.95	0.65	1.30	0.90
	30y	1.10	1.80	1.40	1.05	1.80	1.35	1.00	1.70	1.25	0.95	1.65	1.20
US	10y	3.00	4.10	3.50	2.75	4.10	3.25	2.30	4.00	3.00	2.15	3.91	2.85

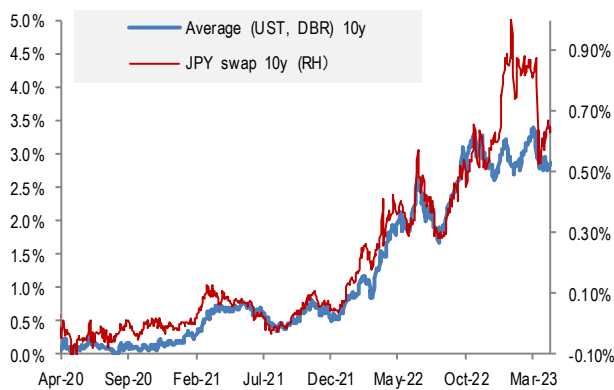
Source: Compiled by Daiwa Securities.

◆ 10-year JGB yield appears to generally be at appropriate level

We estimate that the current level of the 10-year JGB yield (JB370) at around 0.45-0.50% is generally appropriate from the standpoint of several factors. Due to the Funds-Supplying Operations against Pooled Collateral that was expanded at the January Monetary Policy Meeting (MPM), the JGB yield curve up to the 5-year sector has stabilized. And, superlong JGB forward yields have declined owing to lower overseas yields since the SVB shock. Moreover, the YCC attack in FY22 and the BOJ's operations to deal with the attack strengthened the stock effects from cumulative bond purchases, which appears to have shifted the appropriate level of JGB yields downward.

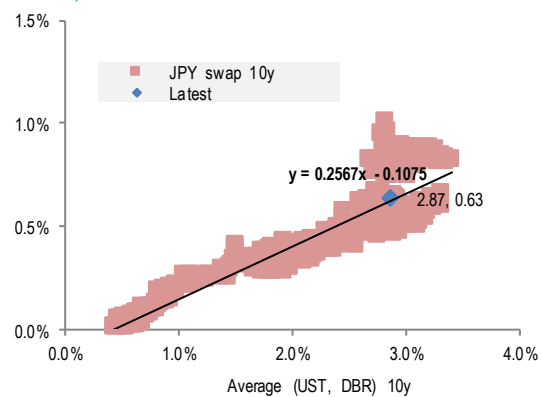
Confirming the scatter chart for the 10-year JGB yield and the US yield, JGB and overseas yields have resumed their correlation based on the previous relationship (beta) following the turbulent period that continued for a while after the abrupt expansion of the trading band in December 2022. The level of the 10-year JGB yield has returned to a level close to the line (in line with the past beta) formed in the absence of the 0.25% cap (left-hand chart below). The 10-year swap rate also surged and exceeded 1% due to the abrupt widening of the trading band in December 2022, being decoupled from overseas yields. However, since Governor Ueda's confirmation hearings and the SVB shock, the swap rate has declined to the 0.6% level, which is viewed as basically appropriate in terms of the relationship with overseas yields. As a result, the JGB/swap spread has now shrunk to 17bp, from the 49bp logged in January 2023.

10yr Swap Rate (vs. average for 10yr US and European yields)



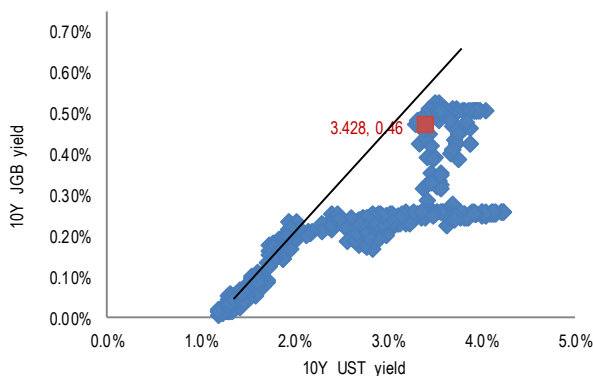
Source: Bloomberg; compiled by Daiwa Securities.

Estimated JGB Yield (vs. average for 10yr US and European yields, scattered chart)



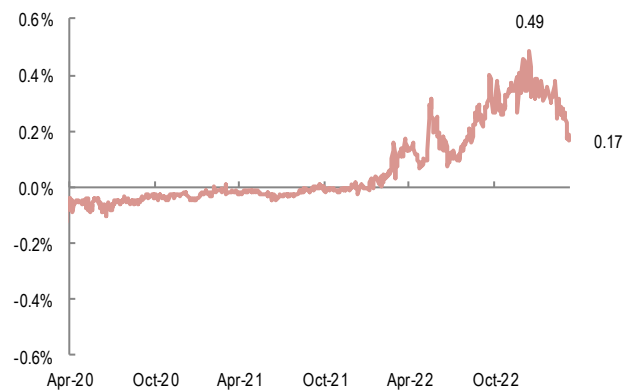
Source: Bloomberg; compiled by Daiwa Securities.

10yr JGB Yield (vs. 10yr US yield, scattered chart)



Source: Bloomberg; compiled by Daiwa Securities.

JGB/Swap Spread



Source: Bloomberg; compiled by Daiwa Securities.

Of course, given the fact that the swap spread was largely 0% before the YCC attack that flared up in 2022, one could think that there is still a gap to be resolved with the current spread between the 10-year JGB yield (around 0.45-0.50%) and the 10-year swap rate (at the 0.6% level). However, regarding this point, we need to give separate consideration to the scale of the BOJ's JGB holdings (stock effects), which surged due to fixed-rate purchase operations and *Rinban* operations to cope with the severe YCC attack in FY22.

Materials from the BOJ's assessment in March 2021 indicate estimations that a 1% rise in the BOJ's share of JGB holdings pushes down the level of the 10-year JGB yield by 2bp. Following the severe YCC attack in FY22, the outstanding amount of the BOJ's JGB holdings increased by more than ¥60tn (at least a +5% increase in its share of JGB holdings). It is highly likely that this change substantially reduced the level of the 10-year JGB yield by at least 10bp. When also considering the stock effects and the option feature of 10-year JGBs (i.e., the put option with which holders can sell at high prices to the BOJ), whose value increases at around 0.5%, I get the impression that a 10-year JGB yield in the upper 0.4% range is largely appropriate against a 10-year swap rate at the 0.6% level.

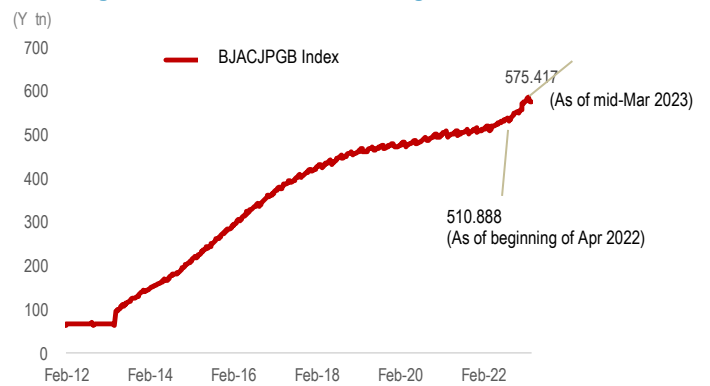
**10Y JGB Yield Model (Assessment in Mar 2021)**

Estimation Result

$$\begin{aligned}
 &\text{JGB yields (10-year, \%)} \\
 &= 0.25^* \\
 &+ 0.16^* \times \text{U.S. Treasury bond yields (10-year, \%)} \\
 &+ 0.45^* \times \text{Expected real GDP growth rate (\%)} \\
 &- 0.02^* \times \text{The Bank's share of JGB holdings (\%)}
 \end{aligned}$$

Estimation period: Jan. 2005 to Feb. 2021. Adjusted R-squared: 0.95.  
Newey-West standard errors are used.

**Outstanding Amount of BOJ's JGB Holdings**

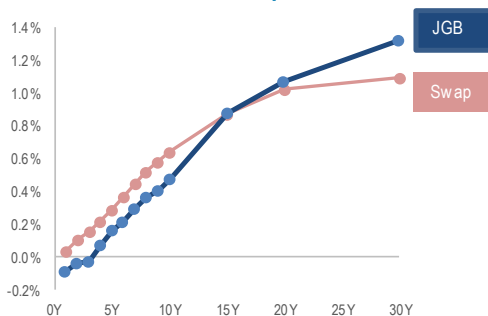


Source: Excerpted from BOJ materials.

Source: Bloomberg; compiled by Daiwa Securities.

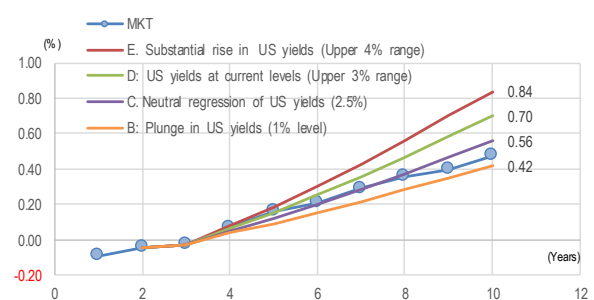
Furthermore, the shape of the current yield curve is a moderate upward-sloping curve without conspicuous distortions (excluding some specific issues), which also confirms the appropriateness of the current yield level. Currently, yields are largely consistent with the estimated yield curve at the time of the removal of the YCC policy, based on my provisional calculations. According to my provisional calculations, factors such as (1) the change in the level of superlong JGB forward yields, which are correlated with the decline in US yields since the SVB shock, and (2) stabilization of the yield curve up to the 5-year sector due to expansion of the Funds-Supplying Operations against Pooled Collateral contributed to the resolution of distortions in the curve. This estimated yield curve leads to the conclusion that the 10-year JGB yield will not rise significantly even if the BOJ were to remove the YCC policy or make it become ineffective in order to deal with the side effects. (Of course, the basic assumption here is that (1) the removal of the YCC policy or it being rendered ineffective is not associated with the beginning of the tightening process and (2) the amounts purchased in operations are not reduced.)

**Yield Curves of JGBs and Swap**



Source: Bloomberg; compiled by Daiwa Securities.

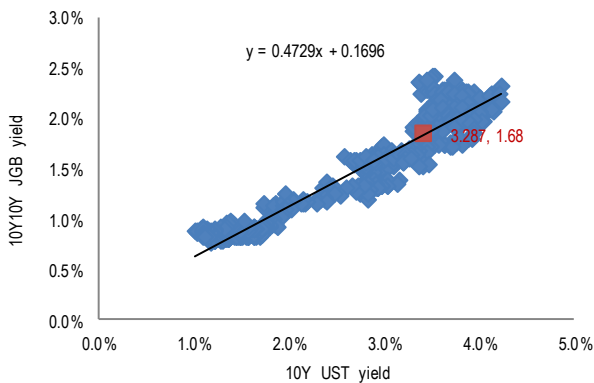
**Estimated JGB Yield Curves**



Source: Compiled by Daiwa Securities.

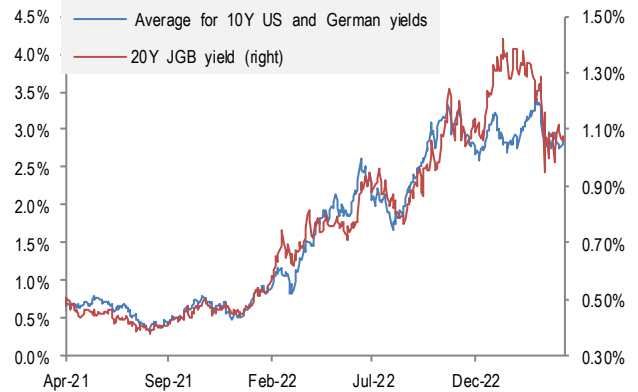
◆ Superlong yields have consistently been correlated with overseas yields  
 With the exception of the period when the market was temporarily confused by the abrupt expansion of the trading band in December 2022, superlong JGB forward yields have consistently been closely correlated with overseas yields with a beta of around 0.5. We assume that this will not change substantially. The 10-year forward 10-year yield, which is important when examining the 20-year JGB yield, is expected to decline to 1.5% in line with lower US yields, while moving in the 1.25-2.25% range. Meanwhile, due to a change in fundamental factors specific to Japan (i.e., local factors), it is now hard to imagine a decline in superlong JGB forward yields to previous levels below 1%. Accordingly, we expect the point of reference for the new lower limit of the 10-year forward yield to be 1.25%.

**10yr-forward 10yr JGB Yield**



Source: Bloomberg; compiled by Daiwa Securities.

**20yr JGB Yield**

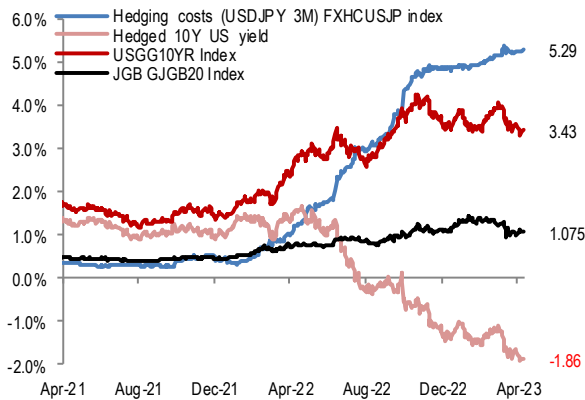


Source: Bloomberg; compiled by Daiwa Securities.

◆ Rise in hedging costs may make JGBs bullish  
 Based on current US yields, the 10-year JGB yield is 0.45% and the 20-year JGB yield is 1.1%. Towards the end of the year, they are expected to decline in line with a fall in overseas yields. One point to keep in mind is that we may see a slight decline in JGB yields (JGBs becoming bullish) relative to overseas yields, given hedging costs having deteriorated to this excessive extent.

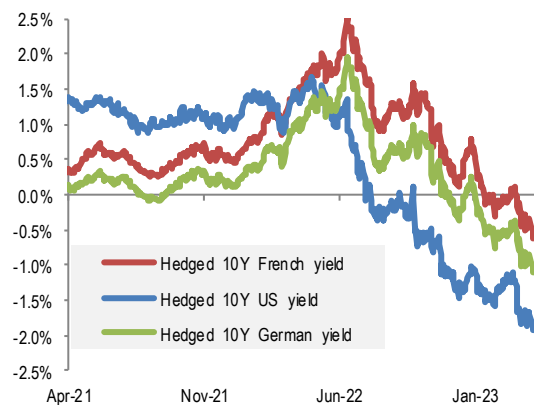
One topic in the market is that hedging costs are harsh when investing in foreign bonds from the yen due to substantial rate hikes by central banks in the US and Europe. With the spread between the 20-year JGB yield and the hedged 10-year US yield at nearly -300bp, we are seeing a historic reversal. Hedging costs remaining at a high level could serve as a factor in making Japanese investors return to yen bonds in FY23. Conversely, however, if the outlook for monetary policy were to become unstable, yen bonds could become bearish. We forecast that price movements will be largely correlated with overseas yields as both factors will offset each other.

**Hedged 10yr US Yield**



Source: Bloomberg; compiled by Daiwa Securities.

**Yields of Hedged 10yr Foreign Bonds**



Source: Bloomberg; compiled by Daiwa Securities.

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