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Daiwa's View

Fair value of JGB yields from the standpoint of fundamentals

- 10-year yield is likely to move at or below 0.8% in the near term, but rise to about 1% when negative interest rates are eliminated
- We have little grounds to think that superlong forward yields will continue to rise

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Fair value of JGB yields from the standpoint of fundamentals

Examination in terms of three elements—medium-term inflation, potential growth rate, and stock effects

Following the release of BOJ Governor Kazuo Ueda's interview, the 10-year JGB yield rose to 0.72% at one point. By using market-oriented yield curve estimates, we estimated last week that the fair value of the 10-year JGB yield would be 1.15% when negative interest rates are eliminated. This time, we offer an examination based on fundamentals.

In the near term, the 10-year JGB yield is expected to move at or below 0.8%

◆ In the near term, the 10-year JGB yield is expected to move at or below 0.7-0.8%

In his column in *Nikkei* on 24 August, former BOJ Executive Director Eiji Maeda (currently President of Chibagin Research Institute) expressed his opinion that it was possible to constrain the 10-year JGB yield to 0.7-0.8% or below in the near term by subtracting the approximately 1% push-down effect of JGBs held by the BOJ from the nominal interest rate of slightly above 1.5%, which is neutral to the economy and prices, on the assumption that current medium-term inflation is slightly above 1.5% and the potential growth rate is close to 0%. His trial calculations are suitable for the starting point of discussions at this stage in the sense that (1) the assumptions for the above-mentioned trial calculations by Mr. Maeda are different from our estimated yield curve that was used last week, not including the effects of overseas yield fluctuations, and (2) he examined the level of the 10-year JGB yield based on Japanese fundamentals. As Mr. Maeda pointed out, the 10-year yield is likely to move at or below 0.8% in the near term.

Former BOJ Executive Director Eiji Maeda (currently President of Chibagin Research Institute, 24 Aug 2023)
At this point, the BOJ assumes that medium-term inflation is slightly above 1.5% and the potential growth rate is close to 0%. Based on this, the nominal interest rate, which is neutral to the economy and prices, is calculated at slightly above 1.5%. By subtracting the approximately 1% push-down effect of JGBs held by the BOJ, it is possible to constrain the 10-year JGB yield to 0.7-0.8% or below in the near term. Fixed-rate purchase operations at 1% are grounds for positioning 1% as a "just-in-case" cap.

10-year JGB yield is expected to rise to around 1% when negative interest rates are eliminated

◆ 10-year JGB yield is expected to rise to around 1% when negative interest rates are eliminated

However, the values estimated by Mr. Maeda consist of three elements—medium-term inflation, potential growth rate, and stock effects. That means that a change in the level of each factor leads to a change in the derived yield levels. Based on this view, we examined what the fair value would be once the conditions for eliminating negative interest rates were in place, and found that we cannot assume that the 10-year yield will be constrained to 0.8% or below when negative interest rates are eliminated. That is because BOJ Governor Ueda stated in his interview (released on 9 Sep) that negative interest rates would be eliminated when a self-sustaining virtuous cycle with higher prices and higher wages was seen even without monetary easing and when the BOJ judged that the inflation target could be achieved even after eliminating negative interest rates. Of course, when negative interest rates are eliminated, medium-term inflation should rise to about 2%. Assuming that the potential growth rate is unchanged at a level close to 0%, the nominal interest rate, which is neutral to the economy and prices, is calculated at about 2%. By subtracting the approximately 1% push-down effect of JGB holdings, we estimate that the 10-year JGB yield will rise to around 1% when negative interest rates are eliminated. We understand that this rise in yields is consistent with the BOJ's current stance of accepting a rise in yields in line with a rise in underlying inflation.

- Japan's nominal interest rate = Medium-term inflation + Potential growth rate
- 10-year JGB yield = Medium-term inflation + Potential growth rate – Stock effects

Conversely, if the 10-year JGB yield were to stay at or below 0.8% when negative interest rates were eliminated, we suspect one of the following cases would apply: (1) the 2% inflation target would not have been achieved, (2) the potential growth rate would have declined, or (3) the stock effects would have increased significantly. As it is difficult to assume a change in the potential growth rate (Case 2), at least over the short term, the possibility of (1) or (3) would be high. In the case of (1), there would be increased suspicion that the BOJ, which is increasingly taking yen depreciation into consideration, had possibly been somewhat premature in judging that 2% inflation had been achieved[1].

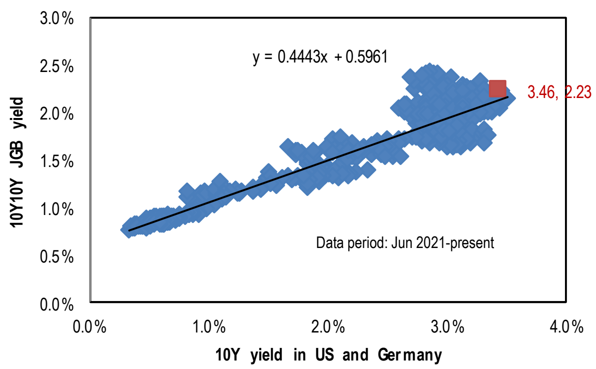
We have little grounds in terms of fundamentals to think that superlong forward yields will continue to rise

◆ Upside potential of superlong forward yields is limited

Next, we examine superlong forward yields. After the BOJ decided to add flexibility to yield curve control (YCC) operations at the July Monetary Policy Meeting (MPM), the levels of superlong yields rose substantially. Now, the 20-year JGB yield and the 30-year JGB yield have risen to 1.46% and 1.72%, respectively. Once negative interest rates are eliminated, will these superlong yields see rises similar to, or greater than, the 10-year yield?

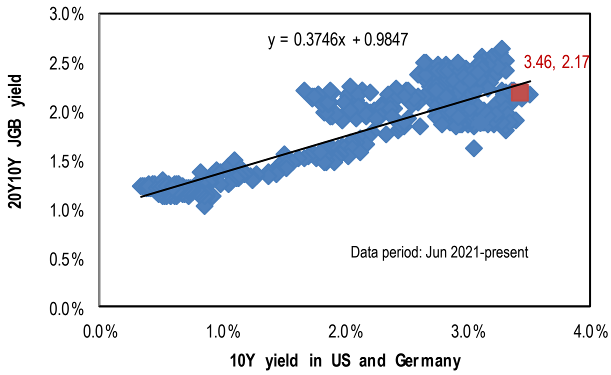
As superlong yields include the 10-year yield in the first half part, a rise in the 10-year JGB yield when negative interest rates are eliminated would, of course, serve as a factor in raising superlong yields. Meanwhile, looking at current superlong forward JGB yields, we find that the 10-year forward 10-year yield has risen to 2.23% and the 20-year forward 10-year yield has risen to 2.17%. They are already slightly above the estimated neutral nominal interest rate when negative interest rates are eliminated. In terms of fundamentals such as medium-term inflation and the potential growth rate, we appear to have little grounds to think that elimination of negative interest rates will trigger a surge in superlong forward yields. (However, one could, of course, discuss the matter differently in terms of supply/demand factors such as the term premium, which supplements fiscal risks.)

10Y10Y JGB Yield, 10Y Yield in US and Germany



Source: Bloomberg; compiled by Daiwa Securities.

20Y10Y JGB Yield, 10Y Yield in US and Germany



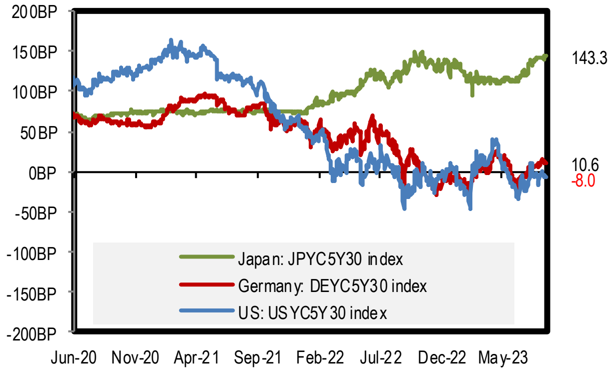
Source: Bloomberg; compiled by Daiwa Securities.

◆ Yield curve is likely to flatten

As Japan's interest rates have been zero (or negative) over the long term, we tend to think that elimination of easing would lead to steepening. However, as clearly shown by cases in Europe and the US, once rate hikes become imminent, there is a tendency for flattening pressure to begin to be exerted on the yield curve before rate hikes actually begin. In Japan, as well, fundamentals when negative interest rates have been eliminated have already been factored in with superlong forward yields. Therefore, as the actual hike in the short-term interest rate approaches, the JGB yield curve is likely to tend to flatten.

[1] Due to information superiority, the BOJ could notice that the 2% inflation target has been achieved ahead of the market. However, we doubt that information superiority at central banks is much greater than that among private-sector economists, as shown by the Fed's case.

5Y/30Y Spread in Japan, US, Germany



Source: Bloomberg; compiled by Daiwa Securities.

Yield curve steepens when conditions for rate hikes begin to fall into place, but it tends to flatten as actual rate hikes approach

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