Daiwa Securities

Daiwa's View

FICC Research Dept

Eiichiro Tani
81-3-5555-8780
eiichiro.tani@daiwa.co.jp

Ryoma Kawahara
81-3-5555-8777
ryoma.kawahara@daiwa.co.jp

Daiwa Securities Co. Ltd

BOJ's March policy meeting: Decision to exit NIRP

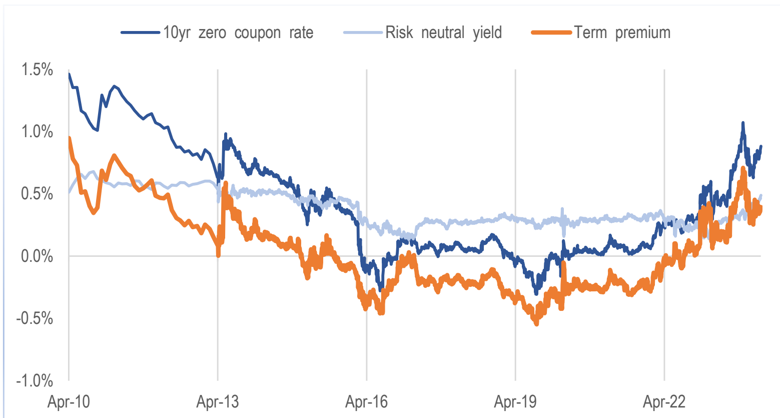
- Yields declined in reaction to the first rate hike in 17 years
- This change in framework has serious longer-term implications and we should not overemphasize the initial decline in yields supported by generous transition measures

At its policy meeting on 19 March, the BOJ changed to a new framework primarily guiding the short-term interest rate as its policy tool, stating that quantitative and qualitative monetary easing with yield curve control together with its negative interest rate policy "have fulfilled their roles." Deputy Governor Uchida has long argued that "a world with interest rates is not something that can be achieved by the BOJ hiking rates. It only becomes possible once economic and price conditions have improved enough to make raising rates appropriate," and it appears that Japan has finally met those conditions. We welcome the fact that Japan, which has been derided for its "forever zero" rates, has finally been able to hike rates. With our Chief Market Economist Mari Iwashita having published her comprehensive evaluation in a separate report, this report will focus on the highlights from a market perspective.

Serious longer-term implications

Because the market had already fully priced in the exit from NIRP, investors were already well-positioned before the announcement, and the BOJ had provided ample indications of what was coming to ensure there was no lack of continuity, price action in the JGB market on the day of the policy meeting was subdued. We expect to see more "buy the fact" moves in the near term. In your author's opinion, however, although the BOJ's decision will not have much market impact over the near term, it will have significant implications over the medium- to long-term. This becomes nearly self-evident when separating the long-term yield into its risk-neutral yield and term premium components.

10yr JGB Yield (zero rate), Risk Neutral Yield, Term Premium



Source: MOF; compiled by Daiwa.

The term premium should gradually normalize
Quantity is the most important factor affecting the term premium, and it is the BOJ's outright JGB purchase (*Rinban*) operations that determine quantitative easing. In this regard, the BOJ's written statement stated clearly that the "Bank will continue its JGB purchases" at "broadly the same amount as before," just as leaked by the media last week. Attached to this was a footnote stating that the "amount of JGB purchases is currently about 6tn yen per month," and the statement also said "In case of a rapid rise in long-term interest rates, it will make nimble responses by, for example, increasing the amount of JGB purchases and conducting fixed-rate purchase operations of JGBs – both of which can be done regardless of the monthly schedule of JGB purchases – and the Funds-Supplying Operations against Pooled Collateral." With such generous supply-demand considerations during the transition period, the term premium on JGBs is unlikely to rise sharply anytime soon (the term premium on 10yr JGBs declined by about 5bp to start the week).

However, the removal of the QQE measures that had been pushing the risk premium lower for so long should be having a widening (normalizing) impact on the term premium and on corporate bond risk premiums. The risk premium narrowed the day before yesterday, a contra-intuitive market move that we think was a consequence of the overly generous measures taken by the BOJ to ensure that a major policy change, exiting QQE, did not cause a loss of continuity. We do not think the decline in yields the day before yesterday should be seen as reflecting the longer-term implications of the BOJ changing its policy framework.

The BOJ announced regarding its purchasing plans for Apr-Jun 2024 that it "will continue its JGB purchases" at "broadly the same amount as before." We therefore do not expect a rapid widening of the term premium through Apr-Jun, although the BOJ has largely a free hand in conducting operations from Jul-Sep, and the market must keep an eye on the stance on operations signaled by the BOJ's Financial Markets Department. Although the term premium had fallen into deeply negative territory during the process of QE, QE2, and YCC, it has already risen above zero and has been trading at around 0.4% recently. During the period after the global financial crisis and before QQE, the term premium averaged around 0.6%, which would mean it has room to rise by another 20bp if the expectation is that it will return to its pre-QQE level. Although 20bp is not an insignificant amount, if the increase is gradual over time, it is not that large either. If the BOJ continues reinvesting while cautiously reducing its operations, one possibility is that the risk premium will normalize as the term premium inches up by 20bp over several years, by which point the 10yr JGB yield will have risen to around 1%.

Will the risk-neutral yield rise?
Between the two, it is the risk-neutral yield that will receive more attention when looking at the 10yr JGB yield. When asked about the potential for additional rate hikes, BOJ Governor Ueda answered that "a clear increase in the price outlook or an increase in upside risks to the median forecast even without much of a move" would be reasons for changing policy. The risk-neutral 10yr yield is now trading at 0.46%, suggesting the market does not currently expect the BOJ to raise the IOER to a level over 0.5%. This can probably be attributed to the historical fact that for the roughly 30 years since 1995, the policy rate has not gone above 0.5%. In other words, if the market were to start expecting a rate hike above 0.5%, the risk-neutral yield component of the 10yr yield could rise substantially. Key to whether the 10yr yield rises (and remains) above 1% will be the risk neutral yield, i.e., the rate hike trajectory. These questions will be addressed in our upcoming webinar on 4 April, to which we have invited former BOJ Executive Director and now President and CEO of Chiba Bank Research Institute, Eiji Maeda.

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