20 June 2024
Japanese report:20 June 2024

Daiwa Securities

Daiwa's View

FICC Research Dept

"Communication" to stabilize term premium

- MOF is expected to consider optimizing JGB issuance maturities
- Positive in terms of (1) relationship with BOJ's policy of reducing JGB purchases and (2) fundamental measures for coping with structural changes among investors
- Combination of QT and fiscal expansion was potential threat to JGB term premium, but concerns have diminished

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

Daiwa Securities Co. Ltd

While the Advisory Council on Government Debt Management itself is scheduled to be held on 21 June, there was a report in the news yesterday that Japan was said to be considering issuing bonds with shorter maturities, explaining that the MOF was considering a plan to shift more of its bond issuances to shorter maturities based on a proposal from experts as the BOJ moves to reduce the amount it purchases. The movement of JGB yields has changed substantially from bear steepening to bull flattening due to this news ahead of the council. The news is welcome, and is seen as serving as a factor in lowering JGB volatility (stabilization factor).

This "communication" is welcome

The combination of QT and fiscal expansion is a potential factor in destabilizing the term premium. In our report on 7 June, the author warned that "if we see a delay in optimization of JGB issuance, for which the progress is expected in line with the pace of QT, while the BOJ's balance sheet reduction (which virtually has an effect of QT) proceeds at a fast pace, concerns about the term premium of JGB yields would persist."

This latest news has diminished the concerns described above, and is positive in terms of (1) establishing a dialogue with the BOJ and (2) the issuer side's response to structural changes on the investor side. When demand is weakening due to QT, establishing a dialogue with the government/fiscal side is an important issue. While the BOJ decides on a policy of reducing its JGB purchases (≒ de-facto QT), if the issuer side were to respond to that, and also start to respond to the structural change on the investor side (weaker demand for superlong bonds), that would lessen the risk of a malignant surge in the term premium (≒ quasi-Truss shock) due to an abrupt reduction and/or concerns about an increase in bond issuance.

"Bond Market Group" meetings with BOJ are likely to be productive

The media report was good news for encouraging productive discissions at the BOJ's "Bond Market Group" meetings scheduled to be held by the July Monetary Policy Meeting (MPM) with respect to the reduction of JGB purchases by the BOJ, for which only the reduction amounts Y4tn, Y3tn, and Y2tn have been speculated. It is virtually nonsense to only consider the best (JGB purchase) reduction amount for the market on the demand side without considering the response by the supply side. There were concerns that regardless of how detailed considerations were, a plan to increase bond issuance might cancel out such considerations. (The BOJ would have been forced to conclude that the reduction plan should include great flexibility.) The timing of yesterday's news can be said to have been good in that sense, as well, because the BOJ was able to learn the intentions of the issuer side early on.

Responses to weaker demand for superlong bonds

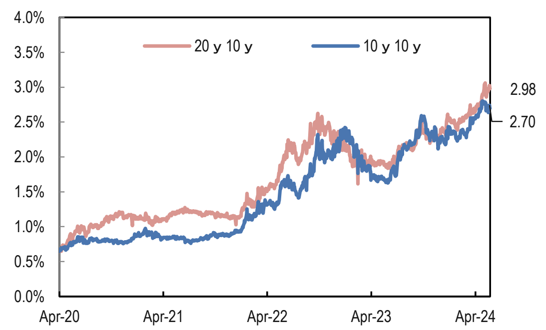
During the ten years of extraordinary easing, demographics have changed (low birthrate and longevity), and financial regulations have become more sophisticated. Normally, it would not have been unusual for the JGB issuance amount to have been changed much earlier. However, the bond market was overwhelmed by purchase operations by the BOJ, leading to a delay in the response that needed to be taken under normal conditions.

In particular, the decline in the need for insurance coverage for death, in line with an aging society with fewer children, has been reducing the need for asset duration at life insurers. In addition, while the response to the new regulations by FY25 (the introduction of economic value-based solvency margin ratio) appears to have almost ended, a decline in demand for investment in superlong bonds has been observed, pushing up superlong forward yields close to the 3% mark.

Of course, in the early 1990's, when Japan's potential growth rate was around 4%, a JGB yield of 3% was no problem at all. However, 3% now seems too high, as the potential growth rate has declined to around 0.5%. Rather than reflecting the estimated neutral rate, this has created concerns about the possibility of the emergence of a situation that has been indicated by Waseda University Professor Junko Koeda in which yields in the superlong zone would rise and the yield curve would face steepening pressure once supplies of superlong JGBs needed to be absorbed by arbitrage traders due to limited demand from investors holding JGBs to maturity.

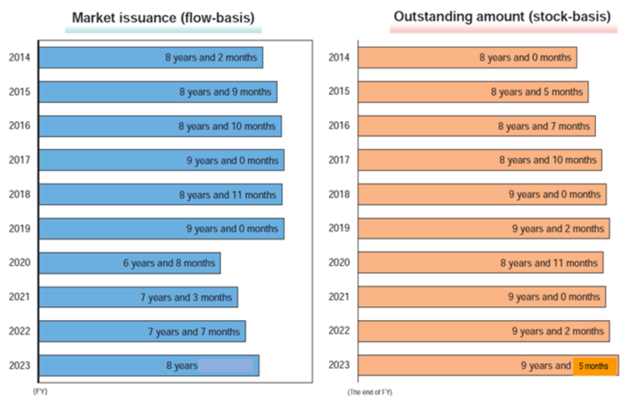
In this regard, yesterday's news stated that life insurers were unlikely to increase their JGB holdings substantially over the medium/long term. As such, the authorities have accepted the structural changes in a straightforward way, and will likely take fundamental measures (adjustments to the issuance amount) instead of perfunctory responses via *Rinban* operations by the BOJ. This is a favorable factor allowing the market to feel reassured regarding the supply/demand of superlong JGBs in the future. Of course, sound fiscal operations are the key to continuous restraint (adjustments) with regard to the issuance amount. Needless to say, we therefore need to monitor the situation to see if (1) the very large fiscal expenditures that became lax during the pandemic continue in Japan, and (2) the populism emerging in Europe and the US has a negative impact on fiscal operations in Japan.

JGB Superlong Forward Yields



Source: Bloomberg; compiled by Daiwa.

Average Maturity of JGBs



Source: MOF's "Debt Management Report 2023"; compiled by Daiwa.

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