Daiwa's View

FICC Research Dept.

Is there really a risk of JGB yields rising sharply due to BOJ's QT?

- Market factoring in stock effect drop off; real issue is 95% increase in JGB private-sector holdings
- Foreign investor participation as backstop for rising JGB yields

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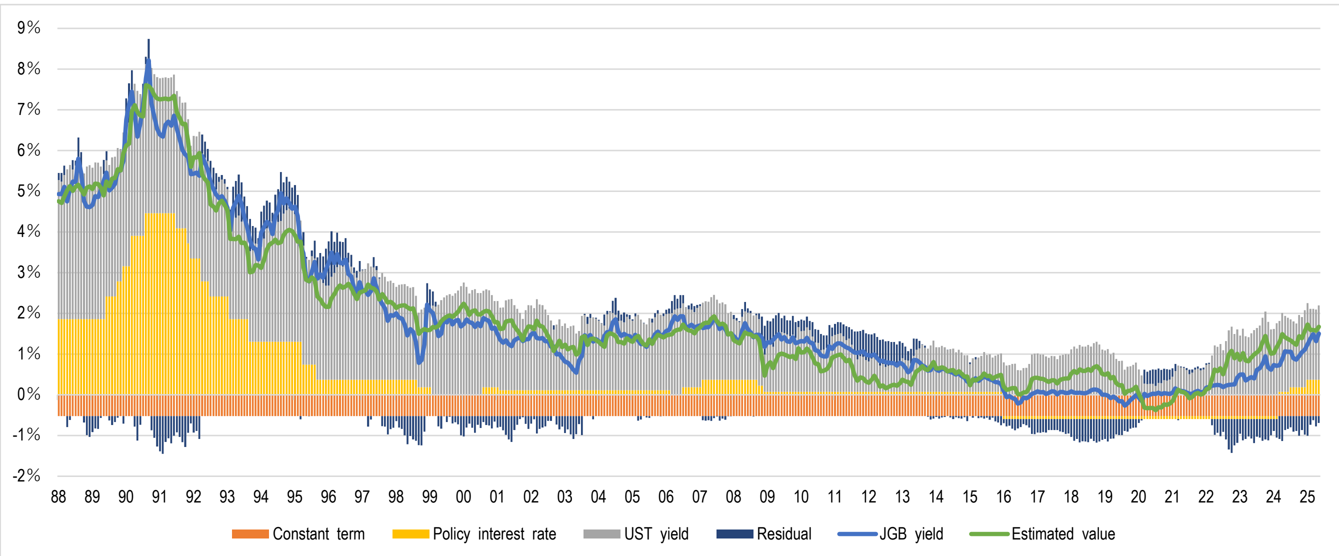
Verifying impact of 40% reduction in BOJ's holdings of JGBs

Even though the BOJ decided to decelerate its pace for quantitative tightening (QT) at its June meeting (Y200bn reduction each quarter), its holdings of JGBs are expected to decline by about 40% over the next five years taking into account redemptions. Even if the monthly purchase amount is kept at Y2.1tn from April 2027, such a significant decrease is unavoidable.

The BOJ has stated that its holdings of JGBs have had the effect of pushing down JGB yields (stock effect). This means that a rapid decline in these holdings could have the opposite effect of causing JGB yields to rise sharply. However, is that really the case?

When verified using a model that performs multiple regression analysis for 10-year JGBs based on two factors, namely 10-year UST yields and Japan's policy interest rates, the results demonstrate that the model has a high explanatory power, with a multiple correlation coefficient and a coefficient of determination of around 0.95 each. The actual value is lower than the post-QQE estimated value and this residual portion can be viewed as a stock effect. Certainly, there was a period when the effect was about 1%, as the BOJ said, but that effect has now declined to around 25bp.

Factor Decomposition of Long-term Yield



Source: Bloomberg; compiled by Daiwa.

If this interpretation is correct, it would mean that the market had already factored in the stock effect decline for JGB yields in anticipation of future QT. The risk of higher JGB yields due to the future stock effect drop off may not be as significant as market participants have feared.

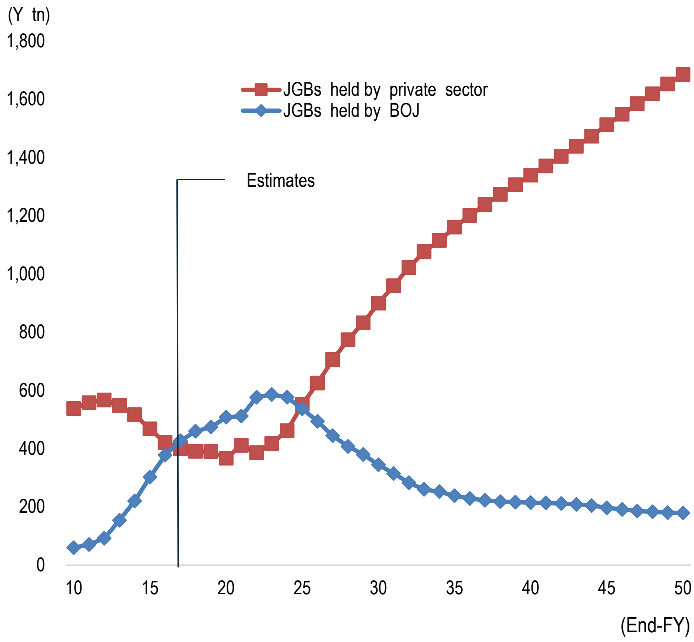
Also, when checking the factors that make up 10-year JGB yields, there is no doubt that an increase in policy interest rates is expected to apply upward pressure on 10-year JGB yields. However, at the same time, UST yields are expected to decline due to rate cuts, which will exert downward pressure on the 10-year JGB yield. Given both factors, we may not see a surge in yields.

Real issue is 95% increase in JGBs held by private sector

Meanwhile, the real issue involves the increase in JGBs held by the private sector, which is inextricably linked with the decrease in the BOJ's holdings of JGBs (two sides of the same coin). If the amount of JGB issuance continues to increase at the same pace as before, JGBs held by the private sector will increase 95% over the next five years, together with the decrease in JGBs held by the BOJ. The focus will be on who will absorb this enormous amount of interest rate risk.

MOF is now taking measures to encourage a wide range of investors, including individuals and condominium management associations, to hold JGBs, but how much issuance can be absorbed is unclear. An increase in holdings by deposit-taking institutions, which had significantly reduced their holdings of JGBs since the introduction of QQE, is also expected. However, the amount that can actually be absorbed is unclear when considering rising yield risks amid Japan's rate-hiking phase, as well as restrictions on JGB holdings imposed by regulations. If this interest rate risk cannot be absorbed, it will lead to upward pressure on JGB yields.

Amount of JGB Holdings (estimates)



Source: BOJ, MOF; compiled by Daiwa.

Foreign investors provide backstop function at appropriate level

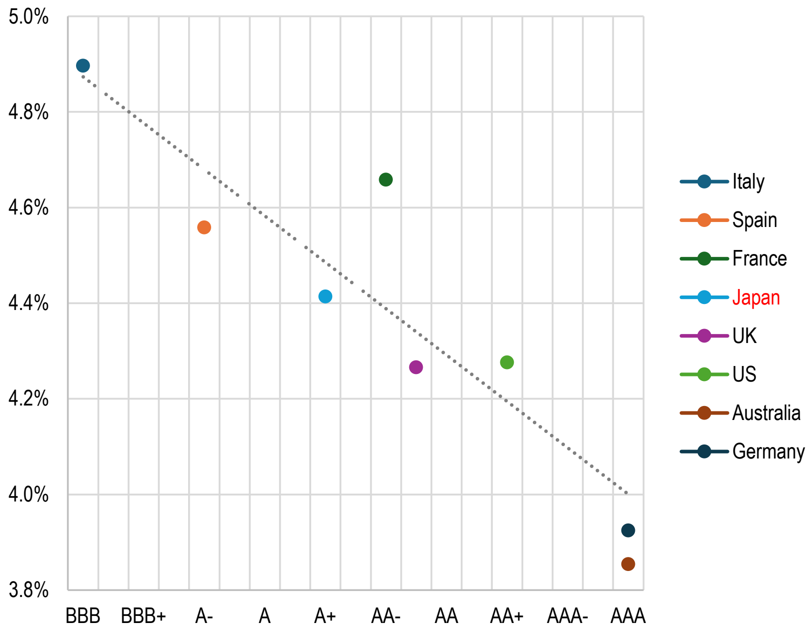
Under such circumstances, attention has focused on the recent expansion of the foreign investor presence in the super-long JGB market. If foreign investors start to influence 10-year JGB prices in the same manner, what would be the eventual level for the 10-year JGB yield?

When 10-year JGBs are denominated in US dollars and compared internationally by credit rating, as is the case with super-long JGBs, it becomes apparent that the 10-year JGB yield is almost at fair value. Indeed, the current level is only 5bp away from the regression line. Such assessments of appropriate levels from the perspective of foreign investors could serve as a backstop for rising yields.

Of course, there is a possibility that rising yields could trigger concerns about fiscal policy. However, when making estimations based on the relationship between credit ratings and yield levels, even just a one-notch downgrade would only result in a yield increase of around 11bp.

In conclusion, the market has already factored in the stock effect drop off caused by QT. Now, excessive yield rises may be suppressed by price formation progressing towards internationally appropriate levels with the increased market participation of foreign investors. The response to the real issue of a 95% increase in private-sector JGB holdings will be the key factor for determining future JGB yield trends.

10yr Bond Yields by Rating (dollar-denominated basis).



Source: Bloomberg compiled by Daiwa.
Note: Average for foreign currency long-term bond ratings by S&P (*) and Moody's (*).

(*) indicates unregistered credit rating agencies. Please see the disclaimer at the end of the document.

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