【Fixed Income Commentary - Japan Economic & Financial Weekly】

Revised scenarios for monetary policy and JGB yields

(original Japanese report issued on May 2, 2023)

Key points

- Ueda emphasizes BoJ will "patiently continue with monetary easing," reducing likelihood that YCC will be wound down in near-term future
- We now expect Bank will discontinue YCC in Oct-Dec 2023, when underlying trend of prices into FY24 can be confirmed
- Supply/demand seen curbing upward pressure on yields after YCC is scrapped; 10-year JGB yield more likely to fall in sympathy with decline in 10-year UST yield

[Policy Watch] We revise our scenarios following first meeting of Ueda BoJ

We revise our monetary policy scenario in response to the results of the April 27-28 Policy Board meeting and Governor Kazuo Ueda’s post-meeting press conference. Our previous baseline scenario saw the BoJ winding down yield curve control (YCC) as early as the June 2023 meeting, but we now expect the policy to be discontinued in Oct-Dec 2023.

(1) Governor Ueda emphasizes that Bank will patiently continue with monetary easing

The primary reason for the revisions is that Governor Ueda stressed more strongly than expected that the BoJ would "patiently continue with monetary easing." Although the Bank removed the forward guidance for policy rates (including the easing bias) from its policy guidelines, it added a new passage at the top of the guidelines declaring that "the Bank will patiently continue with monetary easing" and that, "by doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases" (Table 1). At his press conference after the meeting, Governor Ueda expressed the view that "the risk that premature tightening will prevent us from achieving the 2% inflation target is greater than the risk that a delay in tightening will lead to sustained inflation in excess of 2%, and the costs of waiting for the underlying rate of inflation to rise are not large." Now that the governor has emphasized his intention to patiently continue easing, we find it more difficult to envision YCC being wound down in the next month or two.

Table 1: BoJ adjusts policy guidelines at April MPM

Policy stance	
Newly added	With extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. By doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases.
Continuation of YCC (unchanged)	The Bank will continue with "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner.
Inflation-overshoot commitment (unchanged)	It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all item less fresh food) exceeds 2 percent and stays above the target in a stable manner.
Clause of "will not hesitate" (left as separate sentence)	The Bank will continue to maintain stability of financing, mainly of firms, and financial markets, and will not hesitate to take additional easing measures if necessary

"Forward guidance for policy rates" deleted

For the time being, while closely monitoring the impact of COVID-19, the Bank will support financing, mainly of firms, and maintain stability in financial markets, and will not hesitate to take additional easing measures if necessary; it also expects short- and long-term policy interest rates to remain at their present or lower levels.

Source: MUMSS, from BoJ

(2) Ueda acknowledges that side effects have not disappeared entirely

That said, Governor Ueda noted at his press conference that while a pick-up in inflation expectations would put further downward pressure on real interest rates, "such a phase would also be accompanied by side effects" from YCC. He said that while the decline in overseas yields starting in March and the modifications made to the BoJ's Securities Lending Facility (SLF) had helped form a smoother yield curve, "side effects have not disappeared entirely" (Table 2). In the passage that was added to the policy guidelines, the BoJ said it would "nimbly [respond] to developments in economic activity and prices as well as financial conditions" (Table 1). The nature of YCC is such that the policy becomes difficult to maintain if the market starts to expect higher inflation or higher bond yields. We suspect the Bank wanted to remove the forward guidance before YCC came under fresh attack and thereby ensure greater flexibility for future monetary policy.

Table 2: Ueda comments on YCC at April 28 press conference

- YCC does not have a strong accommodative effect while the underlying trend of prices is weak. Once the underlying trend of inflation picks up a little, inflation expectations also rise, and actions to suppress nominal interest rates serve to lower real interest rates, which are equal to nominal rates less the expected inflation rate, thereby enhancing the effect of easing on the economy. However, this phase is also conducive to the emergence of side effects. I think we have been in such a phase since last year, and at the risk of repeating myself I hope to closely monitor the situation while carrying out a detailed analysis of the effects and side effects of YCC.
- With regard to your question about the side effects of YCC, domestic interest rates have trended somewhat lower since March following the decline in overseas rates, and I think that has almost certainly helped reduce the side effects. I also think the widening of the target range for the 10-year JGB yield in December and the more flexible deployment of the SLF have contributed to the formation of a smoother yield curve. But as was noted at today's meeting, problems remain in some of the indicators of JGB market depth, so it is important to keep in mind that side effects have not disappeared entirely, and we intend to keep a close eye on the situation.

Source: MUMSS, from BoJ

(3) We now expect YCC to be wound down in Oct-Dec 2023, when underlying trend of prices into FY24 can be confirmed

It is difficult to project when the BoJ will discontinue YCC. If side effects increase, as they did last autumn, the Bank will have to consider scrapping the policy as a way of "nimbly responding to developments in economic activity and prices as well as financial conditions." If it is not forced to do so, when will the BoJ revise YCC?

One possibility is 2H FY23, when the underlying trend of prices into FY24 will become clearer. In the April Outlook Report, the Bank forecast core CPI inflation rates of +1.8% in FY23, +2.0% in FY24, and +1.6% in FY25 (Table 3). However, we see a high probability of the projection for FY23 being raised to around 2%, which is the current market consensus, in the July edition of the report (Graph 1). With regard to the output gap, which is one of the two factors determining the underlying trend of prices, the Bank expressed the view in the April Outlook Report that "the gap is likely to turn positive around the middle of fiscal 2023." In Japan, inflation expectations -- the other determinant of the underlying trend of prices -- tend to be formed via an adaptive (backward-looking) mechanism. As such, it would not come as a surprise if the BoJ were to decide to abandon YCC in 2H FY23, once it confirms that inflation has exceeded its expectations and a positive output gap has caused the underlying trend of prices to rise into FY24. This is why we now expect YCC to be wound down in Oct-Dec 2023.

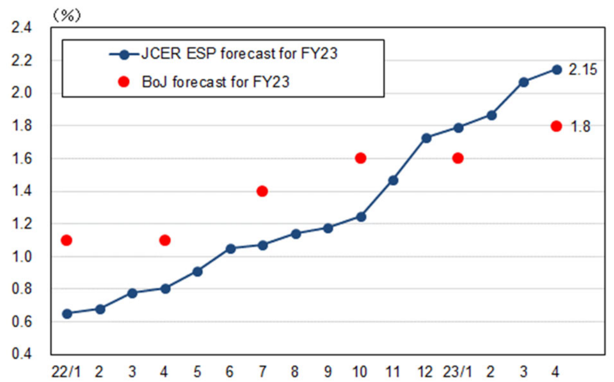
Table 3: April 2023 Outlook Report

(%, the median forecast, the forecast ranges of the majority members are in parentheses)

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
FY22	1.2 < 1.2 ～ 1.2 >	3.0	2.2
Jan	1.9 < 1.9 ～ 2.0 >	3.0 < 3.0 ～ 3.0 >	2.1 < 2.1 ～ 2.1 >
FY23	1.4 < 1.1 ～ 1.5 >	1.8 < 1.7 ～ 2.0 >	2.5 < 2.7 ～ 2.7 >
Jan	1.7 < 1.5 ～ 1.9 >	1.6 < 1.6 ～ 1.8 >	1.8 < 1.7 ～ 1.9 >
FY24	1.2 < 1.0 ～ 1.3 >	2.0 < 1.8 ～ 2.1 >	1.7 < 1.5 ～ 1.8 >
Jan	1.1 < 0.9 ～ 1.3 >	1.8 < 1.8 ～ 1.9 >	1.6 < 1.5 ～ 1.8 >
FY25	1.0 < 1.0 ～ 1.1 >	1.6 < 1.6 ～ 1.9 >	1.8 < 1.8 ～ 2.0 >

Source: MUMSS, from BoJ

Graph 1: Core CPI forecasts - BoJ vs. market consensus



Source: MUMSS, from BoJ, Japan Center for Economic Research

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8:30 JST, May 2, 2023

[JGB Outlook]

In view of the above revisions to our monetary policy scenario, we have also amended our baseline scenario for the 10-year JGB yield as noted below.

Previous scenario for 10-year JGB yield

Our previous baseline scenario for the 10-year JGB yield was as follows (from March 24 *JGB Market Compass*, "Rethinking our JGB yield scenarios in view of Western financial system concerns"):

The Ueda BoJ decides as early as the June Policy Board meeting to scrap its target of around 0% ±50bp for the 10-year JGB yield. The 10-year yield responds by correcting to around 0.7%, which is consistent with fundamentals at the time (0.1%

expected potential growth rate + 0.6% expected inflation rate). The 10-year yield subsequently trades sideways in a range of 0.5% to 0.8% with a downward bias. Contributing factors include a continued flight to safety, dip-buying by domestic investors, and a downward trend in the 10-year UST yield.

Revised scenario

Our revised scenario is as follows (see Graph 2 and "Market Forecast" at end of report):

The 10-year JGB yield trades sideways between now and Jul-Sep 2023 on conflicting views of the appropriate level and direction of yields. The Ueda BoJ scraps its target for the 10-year JGB yield in Oct-Dec 2023. There is upward pressure on the 10-year yield, but it fails to bring it to a level that is more consistent with the fundamentals because foreign speculators unwind their huge short positions[1] and domestic investors quickly move to buy the dip. The central bank's flexible purchases of long-term JGBs also help. From Jan-Mar 2024 onward, the 10-year JGB yield moves lower in sympathy with the downtrend in the 10-year UST yield and trades with a downward bias in the existing range of 0.2% to 0.5%.

We also revise our forecast ranges for other key JGB maturities. Our projections for the 2- and 5-year JGB yields are based on their behavior in FY22, while our forecasts for super-long JGB yields are based on historically appropriate levels vis-à-vis the 10-year JGB yield as derived from long-term correlations using a quadratic regression model (Table 4).[2]

Graph 2: 10-year JGB yield forecast range

Note: End-of-week values. "Short-term policy rate" refers to uncollateralized overnight call rate prior to adoption of QQE in April 2013, interest rate paid on excess reserves (IOER) after that, and rate paid on so-called "policy-rate balances" since NIRP was introduced in February 2016.
Source: MUMSS, from Bloomberg data; MUMSS estimates

[1] Foreigners' cumulative net sales of long-term coupon-bearing JGBs since January 2022, when speculation of BoJ policy revisions began to pick up, amounted to about JPY15.6 trillion as of March 2023.

[2] For details, see our January 16 *JGB Market Compass* ("Outlook for JGB curve in event of further changes to YCC").

Table 4: Historically appropriate JGB yields for given 10-year yield

(%)

2-year	5-year	**10-year**	20-year	30-year	40-year
0.02	0.26	**0.70**	1.31	1.68	1.89
-0.01	0.19	**0.60**	1.20	1.56	1.77
-0.04	0.12	**0.50**	1.09	1.43	1.63
-0.07	0.05	**0.40**	0.98	1.30	1.48
-0.09	-0.02	**0.30**	0.87	1.15	1.32
-0.11	-0.06	**0.25**	0.81	1.07	1.23
-0.12	-0.09	**0.20**	0.76	1.00	1.14
-0.13	-0.13	**0.15**	0.70	0.92	1.05

Note: The range of 0.20% to 0.60% for the 10-year JGB yield represents our forecast of where it will trade after the long-term yield target is scrapped.
Source: MUMSS, from Bloomberg data

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10:00 JST, May 2, 2023

Market Forecast

			FY21	FY22 (forecast) Apr-Sep	FY22 (forecast) Oct-Dec	FY22 (forecast) Jan-Mar	FY23 (forecast) Apr-Jun	FY23 (forecast) Jul-Sep	FY23 (forecast) Oct-Dec	FY23 (forecast) Jan-Mar	FY24 (forecast) Apr-Jun	FY24 (forecast) Jul-Sep	FY24 (forecast) Oct-Dec	FY24 (forecast) Jan-Mar	FY25 (forecast)
Japan	Real GDP	Annualized QoQ	—	—	0.1	2.8	1.8	1.4	0.8	0.1	0.5	0.8	0.8	1.0	—
		YoY %	2.6	1.4			1.4				0.7				0.9
	Core CPI	YoY %	0.1	2.7	3.7	3.5	2.7	2.3	1.5	1.4	1.9	1.4	1.4	1.3	1.3
BoJ	New policy interest rate	End of term (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
	Uncollateralized O/N rate	End of term (%)	-0.020	-0.073	-0.022	-0.030	-0.030	-0.030	-0.030	-0.030	-0.040	-0.040	-0.040	-0.040	-0.040
	3-month yen TIBOR	End of term (%)	0.067	0.054	0.063	0.075	0.075	0.075	0.075	0.070	0.065	0.065	0.065	0.065	0.065
	Long-term interest rate / policy variable	End of term (%)	Around 0%	Around 0%	Around 0%	Around 0%	Around 0%	Around 0%	Discontinued	—	—	—	—	—	—
	10-yr yield permissible trading range	ppt	±0.25	±0.25	±0.50	±0.50	±0.50	±0.50	Discontinued	—	—	—	—	—	—
JGB yields	2-year JGB yield	Range (%)	-0.145--0.015	-0.105--0.035	-0.075-0.035	-0.080-0.040	-0.100-0.040	-0.100-0.040	-0.100-0.040	-0.100-0.040	-0.100-0.040	-0.100-0.040	-0.100-0.040	-0.100-0.040	-0.100-0.040
		End of term (%)	-0.040	-0.050	0.030	-0.055	-0.030	-0.030	0.000	-0.030	-0.030	-0.030	-0.030	-0.030	0.000
	5-year JGB yield	Range (%)	-0.135-0.065	-0.040-0.090	0.035-0.240	0.060-0.320	0.000-0.165	0.000-0.250	0.100-0.350	0.050-0.250	0.050-0.250	0.050-0.250	0.050-0.250	0.050-0.250	0.050-0.250
		End of term (%)	0.025	0.065	0.225	0.090	0.100	0.050	0.150	0.100	0.100	0.050	0.050	0.050	0.050
	10-year JGB yield	Range (%)	**0.000-0.250**	**0.160-0.255**	**0.225-0.480**	**0.250-0.500**	**0.250-0.500**	**0.250-0.500**	**0.250-0.600**	**0.200-0.500**	**0.200-0.500**	**0.200-0.500**	**0.200-0.500**	**0.200-0.500**	**0.200-0.500**
		End of term (%)	**0.210**	**0.240**	**0.410**	**0.320**	**0.400**	**0.350**	**0.450**	**0.400**	**0.400**	**0.350**	**0.350**	**0.350**	**0.350**
	20-year JGB yield	Range (%)	0.375-0.810	0.700-1.045	0.945-1.320	0.905-1.400	0.800-1.150	0.800-1.100	0.800-1.200	0.750-1.200	0.750-1.200	0.750-1.200	0.750-1.200	0.750-1.200	0.750-1.200
		End of term (%)	0.670	1.000	1.290	1.010	1.050	1.000	1.100	1.050	1.050	1.000	1.000	1.000	1.000
	30-year JGB yield	Range (%)	0.625-1.070	0.930-1.470	1.315-1.655	1.145-1.655	1.100-1.450	1.100-1.450	1.100-1.550	1.000-1.450	1.000-1.450	1.000-1.450	1.000-1.450	1.000-1.450	1.000-1.450
		End of term (%)	0.920	1.395	1.605	1.240	1.400	1.350	1.450	1.400	1.400	1.350	1.350	1.350	1.350
	40-year JGB yield	Range (%)	0.665-1.135	0.995-1.695	1.490-1.885	1.370-1.950	1.250-1.650	1.250-1.650	1.250-1.750	1.150-1.650	1.150-1.650	1.150-1.650	1.150-1.650	1.150-1.650	1.150-1.650
		End of term (%)	0.970	1.580	1.865	1.435	1.600	1.550	1.650	1.600	1.600	1.550	1.550	1.550	1.550
FX	Dollar/Yen	Range	107.48-125.09	121.67-145.90	130.58-151.95	127.23-137.91	125.0-139.0	124.0-138.0	123.0-137.0	122.0-136.0	120.5-134.5	119.0-133.0	117.5-131.5	117.5-131.5	117.5-131.5
		End of term	121.70	144.74	131.12	132.86	132.0	131.0	130.0	129.0	127.5	126.0	124.5	124.5	124.5
	Euro/Yen	Range	124.40-137.53	132.66-145.64	138.81-148.40	137.39-145.67	137.5-152.9	137.7-153.2	137.9-153.3	138.0-153.5	137.6-153.1	137.2-152.6	136.7-152.2	137.9-153.4	139.2-155.9
		End of term	134.67	141.88	140.41	144.09	145.2	145.4	145.6	145.8	145.4	144.9	144.4	145.7	148.2
US	Real GDP	Annualized QoQ (%)	—	—	2.6	1.1	0.2	0.0	-0.1	1.3	2.2	2.5	2.7	2.3	—
		YoY %	5.9	2.1			1.1				1.2				2.2
	FF rate (target)	End of term (%)	0.25-0.50	3.00-3.25	4.25-4.50	4.75-5.00	5.00-5.25	5.00-5.25	5.00-5.25	4.75-5.00	4.50-4.75	4.25-4.50	4.00-4.25	3.75-4.00	3.00-3.25
	10-yr Treasury yield	Range (%)	1.1722-2.4731	2.3822-3.9451	3.4169-4.2424	3.3698-4.0556	3.45-3.95	3.25-3.75	3.05-3.55	2.95-3.45	2.95-3.45	2.85-3.35	2.75-3.25	2.75-3.25	2.55-3.25
		End of term (%)	2.34	3.83	3.87	3.47	3.70	3.50	3.30	3.20	3.20	3.10	3.00	3.00	3.00
Euro zone	Real GDP	Annualized QoQ (%)	—	—	-0.2	0.6	1.1	0.6	-0.8	-0.4	1.0	1.6	1.7	1.7	—
		YoY %	5.3	3.5			0.8				0.4				1.6
	Deposit facility rate	End of term (%)	-0.50	0.75	2.00	3.00	3.50	3.50	3.50	3.00	2.50	2.25	2.25	2.25	2.25
	10-year German Bund yield	Range (%)	-0.52-0.73	0.51-2.23	1.740-2.574	1.924-2.773	2.35-2.85	2.25-2.75	2.15-2.65	2.05-2.55	1.65-2.15	1.65-2.15	1.80-2.20	1.80-2.20	1.90-2.30
		End of term (%)	0.55	2.11	2.57	2.29	2.60	2.50	2.40	2.30	1.90	1.90	2.00	2.00	2.10

Notes: 1) JGB, Treasury, and Eurozone bond yields are daily closing rates. Japanese 2yr - 40yr JGBs are newly issued. Exchange rates (from Bloomberg), the Nikkei Average, and the DJ IA are intraday-based.
2) Forecast ranges and end-of-term figures revised May 2, 2023 (previous revision April 28 2023).
3) BoJ's short-term policy interest rate is the rate of interest paid on "policy rate" balances; long-term interest rate target is 10-yr JGB yield. Core CPI excludes impact of consumption rate hike and tuition waivers
4) US FF rate is FRB's target level. US and Eurozone real GDP growth rates (calendar year) are against previous year.
Source: MUMSS, from Quick and Bloomberg data; MUMSS estimates

Appendix A

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