【Fixed Income Commentary - JGB Market Compass】

# Risk scenario: Initial reaction to a June 16 surprise YCC revision

(original Japanese report issued on May 18, 2023)

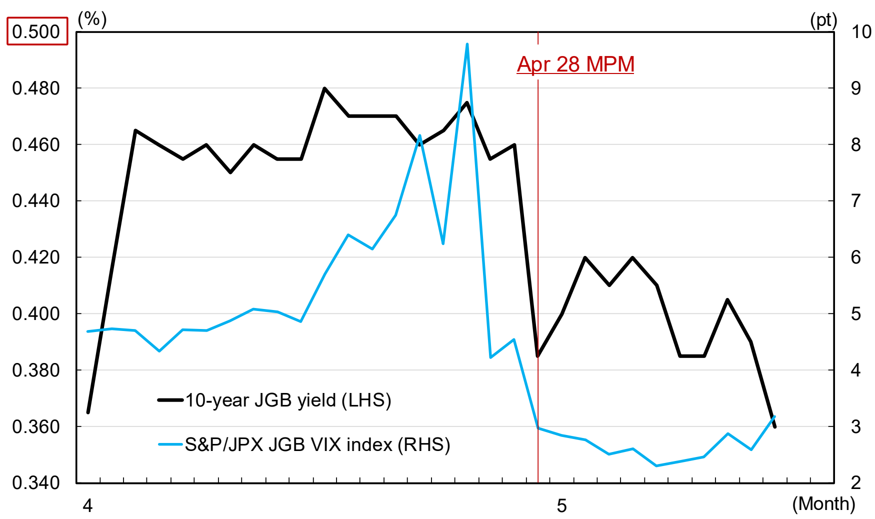
**Key points**

- Market expectations for early YCC revision receding, but caution about possible surprise revision still smoldering
- Surprise revision possible if BoJ finds side effects still deeply rooted based on its Bond Market Survey
- See 10yr JGB yield topping 0.70% if BoJ expands permissible trading range to ±0.75%, rising to around 0.6% if BoJ eliminates target

**Early YCC revision expectations receding after Apr 28 "Outlook Report" meeting**

Expectations for early yield curve control (YCC) policy revisions (including outright elimination) are clearly receding due to the results of the April 28 Monetary Policy Board meeting, which included the release of the Outlook for Economic Activity and Prices Report ("Outlook Report"). The BoJ presented a cautious price inflation outlook in that report.[1] During his post-meeting press conference, the new BoJ Governor Kazuo Ueda stated that the expanded 10-year JGB yield trading band and flexible Securities Lending Facility (SLF) operations are helping to form a smoother yield curve (elimination of distortions). The 10-year JGB yield since then has averaged 0.397%, well below the 0.50% upper limit of the BoJ's permissible trading range (as of May 17, Graph 1). The S&P/JPX JGB VIX index, which represents implied volatility for 10-year JGB futures, likewise briefly dropped 2.31pt (Graph 1).

Graph 1: 10yr JGB yield, 10yr JGB futures implied volatility around time of April 28 "Outlook Report" meeting




Note: An index reading of 3.0pt means the market expects the price of 10-year JGB futures to fluctuate by an annualized rate of 3.0% over the next 30 days.
Source: MUMSS, from Bloomberg data

[1] CPI forecasts (median Policy Board members' forecasts; YoY) were +1.8% for FY23, +2.0% for FY24, and +1.6% for FY25. As for risk balance, the report said, "Risks to prices are skewed to the upside for fiscal 2023, but are skewed to the downside for fiscal 2025."

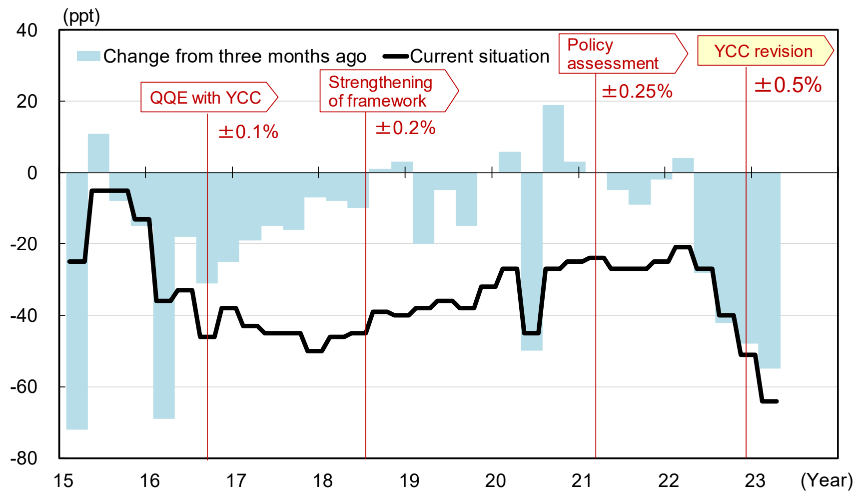
**Caution about surprise YCC revision still smoldering**

On the other hand, caution about a so-called "surprise YCC revision" still continues to smolder. This is because BoJ Governor Ueda has made such statements as "We cannot make an announcement (about YCC revisions) until the last minute" (April 24 Diet hearings) and "Of course, the side effects (of YCC) have not disappeared entirely" (April 28 press conference). Below, we simulate the risk scenario[2] of a "surprise YCC policy revision" at the next Monetary Policy Board meeting (June 15-16).

**Risk scenario of surprise YCC policy revision at next meeting**

In the BoJ's May Bond Market Survey released at 4:00 p.m. on June 1,[3] the degree of bond market functioning DI (= "high" – "low," indicates frequency and smoothness of transactions; Graph 2) bottoms and rebounds from the record low of -64 recorded in the previous (February) survey, indicating that market functionality is actually improving. This strengthens the JGB market expectations that there is almost no possibility of additional YCC policy revisions at the June meeting. This is because the BoJ decided to revise YCC at its December 20 meeting last year, when the opposite conditions were in play. Specifically, the BoJ decided to "modify the conduct of yield curve control," including an expansion of its 10-year JGB yield's permissible trading range, in order to "improve market functioning" and "enhance the sustainability of monetary easing" (from meeting statement) in response to the then-record low market functioning DI in its November 2022 Bond Market Survey. Meanwhile, Governor Ueda notes that while this DI has improved somewhat this time (June survey), it remains significantly negative. He also reaffirms the deep-rooted nature of YCC side effects and that they have "not disappeared entirely." The BoJ eventually decides on additional YCC revisions at the June meeting, with the aim of "enhancing the sustainability of monetary easing by ensuring nimbleness and flexibility for future monetary policy management." This comes as a surprise to JGB market participants, who had assumed there was almost no possibility of further policy revisions at that meeting.

Graph 2: Functionality DI (current situation) seen bottoming out in BoJ Bond Market Survey




Note: Current situation = "High" – "Low." Change from three months ago = "Has improved" – "Has decreased." Quarterly data converted to monthly data. "±%" refers to BoJ's permissible trading band for 10-year JGB yield.
Source: MUMSS, from BoJ data

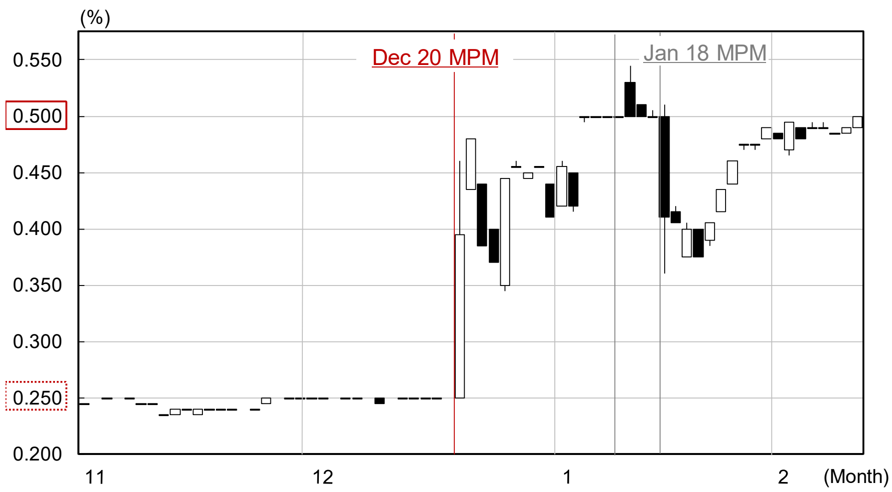
[2] We revised our forecast for the timing of the next YCC revision (elimination) from "June meeting at the earliest" to "October-December" in our May 8 *Japan Economic & Financial Weekly* ("Revised scenarios for monetary policy and JGB yields").

[3] The Bond Market Survey is conducted by the BoJ in February, May, August, and November.

**JGB market initial reaction to surprise YCC revision**

The following is our view of how the JGB market would initially react to such a surprise BoJ revision of its YCC policy. If this revision takes the form of further expanding its 10-year JGB yield permissible trading range to 0% ±0.75%, we would expect the 10-year JGB yield to rise in stages to a level above 0.70% (close to new upper bound) following another "attack"[4] on YCC by foreign speculators. Here, movements for the 10-year JGB yield around the December 20, 2022 meeting when the conduct of YCC was modified (10-year JGB yield permissible trading range expanded to 0% ±0.50%) can serve as a good reference (Graph 3). Meanwhile, if the Bank decides to modify its YCC policy by eliminating its 10-year JGB yield target, we would expect a similar yield rise, but with the rise surprisingly limited, with the yield reaching only around 0.6%. This is because foreign speculators, having lost their "target," would shift to short-covering instead of "attacking" YCC, while domestic investors would immediately start buying JGBs on dips.[5] In either case, there would probably be a certain yield-level correction due to the market's conditioned reflex.

Graph 3: 10yr JGB yield trends around Dec 20, 2022 surprise YCC revision




Note: 10yr JGB yield fell sharply on short-covering after no additional YCC revisions were made at the January 18, 2023 meeting.
Source: MUMSS, from Bloomberg data

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[4] Refers to speculative selling of long-term JGBs and JGB futures with the aim of forcing the BoJ to eliminate its 10-year JGB yield trading range upper limit (target).

[5] For further details on that view, see our May 15 *Japan Economic & Financial Weekly* ("Reasons for downward revisions to our post-YCC yield targets").

# Appendix A

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