

【Fixed Income Commentary - Japan Economic & Financial Weekly】**Will lull in foreigners' attacks on YCC continue?**

(original Japanese report issued on May 19, 2023)

JGB yield and yield curve scenario for May 22-26

The 10-year JGB yield fluctuates with little sense of direction this week. If the 10-year UST yield tests the upside due to optimism over the outcome of the US debt ceiling debate and growing speculation of a longer period of Fed rate hikes, the 10-year Japanese bond yield rises in sympathy. However, it takes on a downward bias if expectations of early revisions to YCC fade further, prompting foreign investors to cover their short positions. The 10-year JGB yield assumes an upward bias ahead of the 40-year JGB auction on May 25 but turns lower once the offering goes smoothly and reassures buyers. The 20-year JGB yield follows a similar path, with the 20s10s spread continuing to hover around 60bp (Graph 6).

Forecast range: 10-year JGB yield: 0.360%–0.420%

20-year JGB yield: 0.970%–1.020%

Key events**Key events**

The Ministry of Finance plans to offer JPY250 billion in 10-year JGBi's on May 23 and JPY700 billion in 40-year bonds on the 25th. We expect the 40-year offering will go smoothly, with the coupon expected to be substantially higher. If the sector looks cheap on the curve, the auction will probably receive support from life insurers seeking to extend duration and from market expectations regarding life insurers' plans to increase their holdings of domestic bonds. In the US, the Treasury Department will offer 2-year UST notes on May 23, 5-year notes and 5-year floating rate notes (FRNs) on the 24th, and 7-year notes on the 25th.

In addition to its daily fixed-rate purchase operations, the BoJ has four operations scheduled on May 24. It plans to buy JPY350-650 billion in JGBs maturing in 1-3 years, JPY425-725 billion in bonds coming due in 3-5 years, JPY475-875 billion in JGBs with a remaining maturity of 5-10 years, and JPY100-500 billion in bonds set to mature in 10-25 years.

In upcoming US data, the Bloomberg-compiled consensus as of 8:00am JST on May 19 was that April new home sales (May 23) had slipped 3.4% MoM to an annualized rate of 660,000 units after rising in March. The April PCE deflator (May 26) was forecast to rise by 0.3% MoM, up from an increase of 0.1% in the previous month, and to add 4.1% YoY, off slightly from a gain of 4.2% in March.

On May 24 the Fed will release the minutes of the May 2-3 FOMC meeting, where it decided to take the guidance range for federal funds to 5.00% - 5.25% with a 25bp hike, an outcome that was largely expected. In the official statement, it deleted the passage saying it "anticipates that some additional policy firming may be appropriate" and indicated instead that "in determining the extent to which additional policy firming may be appropriate...the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." At his press conference, Chair Jerome Powell tried to discourage those expecting

an end to rate hikes, saying that while the removal of this passage represented "a meaningful change," future policy decisions would be "driven by incoming data meeting by meeting."

In Japan, the Nikkei QUICK-compiled consensus as of 8:00am JST on May 19 was that the Tokyo CPI print for April (May 26) would show the headline index climbing 3.3% YoY and the core index rising 3.4%, both down only slightly from increases of 3.5% in the previous month. Upward pressures on food prices remain strong, and higher accommodation fees due to the gradual phase-out of a government program to subsidize domestic travel are also expected to lift the index. Meanwhile, we project the reduction of the renewable energy levy in May will lower the price of electricity and, by extension, energy prices in general.

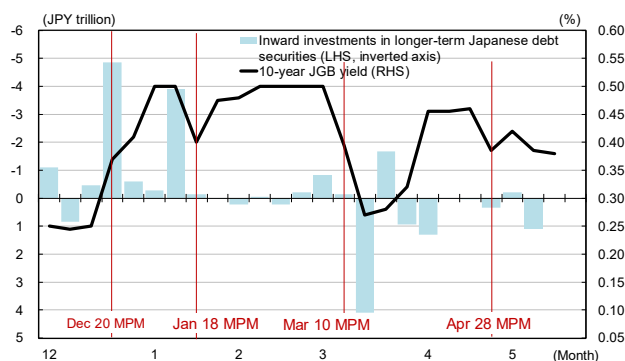
Lull in foreigners' attacks on YCC

Recently foreigners have paused their "attacks" on YCC, which refers to the targeted selling of long-term coupon-bearing JGBs and JGB futures in an attempt to force the BoJ to scrap its target for the 10-year JGB yield or otherwise revise YCC. Inward portfolio investment data released by the Ministry of Finance for the week of May 7-13 indicate that nonresident investors were large net buyers, with purchases exceeding sales by JPY1,075.5 billion. Graph 1 shows that foreigners have mostly been net buyers since the BoJ opted against modifications to YCC at the March 9-10 Policy Board meeting, with cumulative net purchases since the week of March 12-18 amounting to JPY5,914.4 billion.

Cumulative net sales have already peaked and turned lower

Cumulative net sales from the start of 2022, when speculation of BoJ policy revisions began to pick up, peaked at JPY15,688.8 billion in the week of Feb 26 - Mar 4 (Graph 2). By last week they had fallen to JPY9,920.5 billion, marking the first drop below JPY10 trillion since the JPY5,319.6 billion reading for the week of Dec 11-17, 2022. It would appear that foreigners are gradually unwinding the short positions they built up in anticipation of further YCC revisions and higher bond yields. BoJ measures to fend off these attacks on YCC, including its tougher restrictions on short-selling, may have landed a body blow.

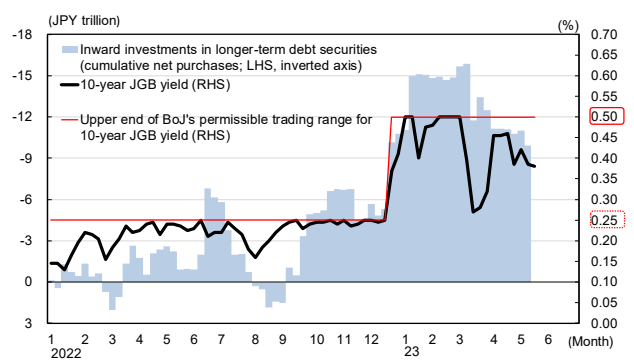
Graph 1: Net investment in longer-term debt securities by non-resident investors and the 10-year JGB yield



Note: Inward investments in longer-term Japanese debt securities by foreigners = purchases - sales. End-of-week basis for 10-year yields.

Source: MUMSS, from MoF and Bloomberg data

Graph 2: Inward investments in longer-term debt securities (cumulative net purchases) and the 10-year JGB yield



Note: Cumulative net purchases since January 2022, when speculation of BoJ policy revisions first emerged. End-of-week basis for 10-year yields.

Source: MUMSS, from MoF and Bloomberg data

Positive correlation between foreigners' short positions and 10-year JGB yield

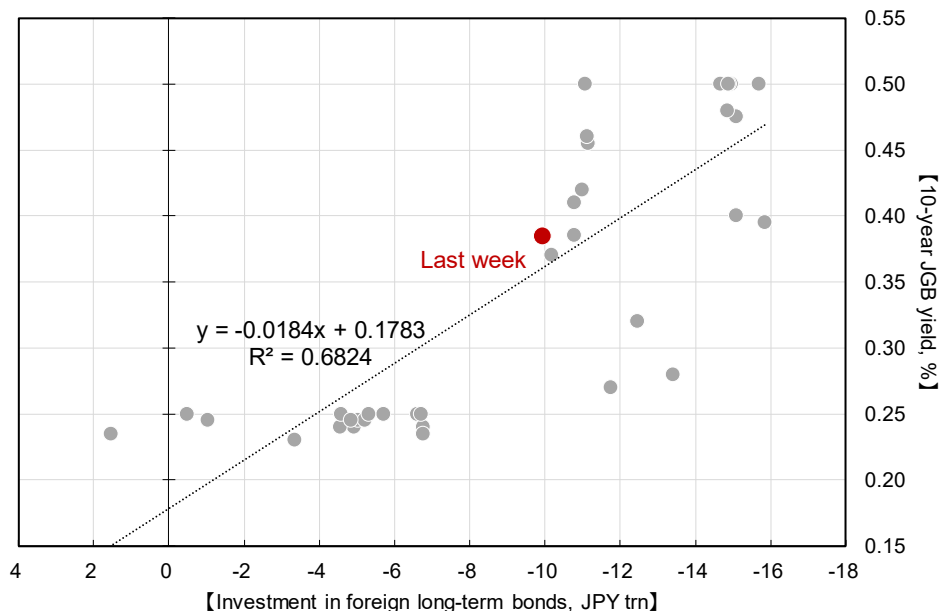
A correlation exists between foreigners' cumulative net sales (short positions) and the 10-year JGB yield. The correlation is typically positive, with the 10-year JGB yield tending to rise as short positions increase and fall as they decline (Graph 3). The coefficient of determination between the two variables since September 2022 is 0.68, which suggests the 10-year JGB yield would slip below 0.30% if buybacks were to take cumulative short positions below JPY7 trillion. Will foreigners' net buying continue, or will they resume their attacks on YCC and return to a trend of net sales? We will be closely watching the MoF data showing inward investment in long-term debt securities, which are valuable in part because they are announced the following week.

Bond Market Survey findings could trigger resumption of attacks on YCC

One catalyst that could prompt foreigners to resume their attacks on YCC is the May edition of the BoJ's Bond Market Survey, slated for release on June 1. If the bond market functioning DI (= "high" - "low"; see Graph 4), a barometer of the frequency and ease of transactions, were to confound expectations and remain at all-time lows,¹ we think bond market participants would quickly reconsider the possibility of further revisions to YCC as early as the June 15-16 Policy Board meeting. The BoJ itself is also closely watching this indicator. The Summary of Opinions for the April 27-28 Policy Board meeting, released on May 11, contained the following comment on monetary policy conduct:

"There are many views that market functioning has remained low, including the functioning of Japanese government bond (JGB) yields as reference rates. Yield curve control seems, in some aspects, to have hampered smooth financing, and attention is warranted on upcoming Bond Market Survey results."

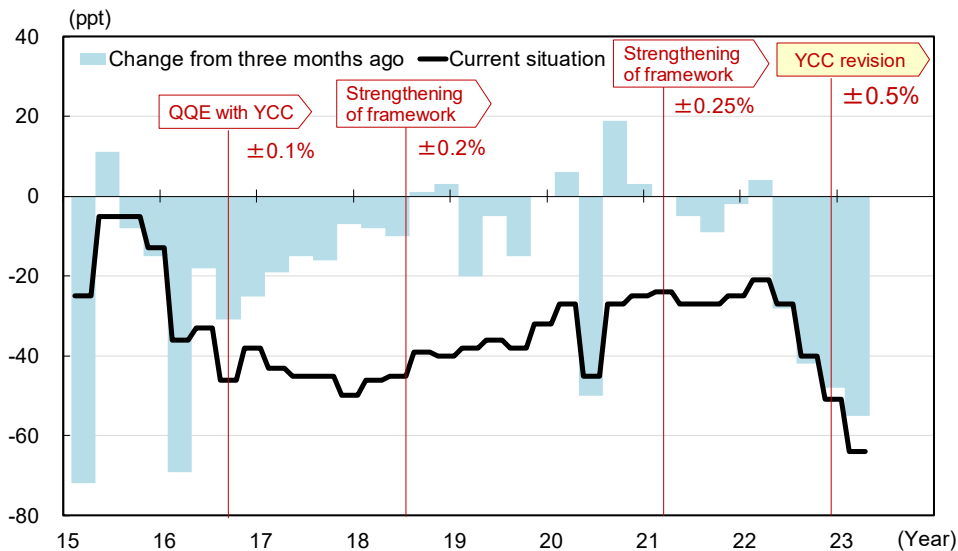
Graph 3: Inward investments in longer-term debt securities (cumulative net purchases) and the 10-year JGB yield (Sep 2022-)



Note: Weekly data; cumulative inward investment in longer-term Japanese debt securities since start of 2022. End-of-week basis for 10-year yields.
Source: MUMSS, from MoF and Bloomberg data

¹ We think bond market participants expect this DI to rise to some extent given Governor Ueda's remark on April 10 that "the shape of the yield curve has become smoother."

Graph 4: 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. " $\pm\%$ " refers to BoJ's permissible trading band for 10-year JGB yield.
 Source: MUMSS, from BoJ data

Jun Ishii,
 Senior Fixed Income Strategist
 Keisuke Tsuruta
 Senior Fixed Income Strategist
 Kazuya Fujiwara
 Fixed Income Strategist

10:00 JST, May 19, 2023

This Week's Economic Indicators

Date/Time		Indicator/Event	Our Forecasts / Past Results		Market Consensus	Comments	
5/22 (Mon)	8:50	Machinery orders (private sector exc. volatile orders)	Mar est.	MoM	-2.5%	+0.5%	Expecting positive growth for Jan-Mar for the first time in three quarters. Apr-Jun outlook looks reasonable given solid FY23 capex plans.
			Feb	"	-4.5%		
			Jan	"	+9.5%		
5/23 (Tue)	10:30	10-year Inflation-Indexed Bonds (JGBi) (planned issuance: 250 billion yen); announcement of results: 12:35					
5/24 (Wed)	10:10	BoJ JGB purchases: 1yr-less than 3yr (350-650 billion yen); 3yr-less than 5yr (425-725 billion yen) 5yr-less than 10yr (475-875 billion yen); 10yr-less than 25yr (100-500 billion yen)					
5/25 (Thu)	10:30	40-year JGB auction (planned issuance 0.7 trillion yen); announcement of results: 12:35					
5/26 (Fri)	8:30	Consumer Price Index Ku-area of Tokyo (mid-month preliminary data); excl. fresh foods (core CPI)	May est.	YoY	+3.2%	+3.4%	Recreational services likely to rise, but growth expected to slow mainly on lower electricity rates (reduced surcharges for renewable energy)
			Apr	"	+3.5%		
			Mar	"	+3.2%		
	8:50	Corporate Services Price Index (Apr)					
	10:20	3mo T-Bill auction (planned issuance: 6.3 trillion yen); announcement of results: 12:30					
	14:00	Indexes of Business Conditions (Mar; revised figures)					

Source: Compiled by MUMSS from various sources.

Japan Economic Outlook

(%)

	forecast																
	FY22				FY23 (forecast)				FY24 (forecast)				FY21	FY22	FY23 (est)	FY24 (est)	FY25 (est)
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3					
Real GDP	1.1	-0.2	-0.0	0.4	0.4	0.3	0.1	0.0	0.1	0.2	0.2	0.2	2.6	1.2	1.2	0.7	0.9
(QoQ annualized rate)	4.7	-1.0	-0.1	1.6	1.8	1.0	0.5	0.1	0.6	0.7	0.8	0.9					
(YoY)	1.8	1.6	0.4	1.3	1.0	1.4	1.4	1.2	0.7	0.6	0.7	1.0					
*Domestic demand	1.1	0.4	-0.4	0.7	0.3	0.3	0.1	0.0	0.1	0.2	0.2	0.2	1.8	1.8	1.0	0.7	0.7
*Private demand	0.9	0.4	-0.5	0.6	0.3	0.2	0.1	0.0	0.1	0.1	0.2	0.2	1.4	1.7	0.8	0.6	0.6
Private consumption	1.7	0.1	0.2	0.6	0.3	0.3	0.2	0.1	0.1	0.1	0.1	0.1	1.5	2.4	1.2	0.5	0.3
Residential investment	-1.8	-0.5	0.1	0.2	0.3	0.4	0.3	0.2	0.2	0.1	0.0	0.0	-1.1	-4.4	0.9	0.7	0.7
Capital investment	2.1	1.5	-0.7	0.9	0.5	0.5	0.3	0.3	0.5	0.6	0.7	0.8	2.1	3.0	1.5	2.2	2.6
*Private inventories	-0.3	0.1	-0.5	0.1	0.0	0.0	-0.1	0.0	-0.0	0.0	0.0	0.0	0.4	0.1	-0.2	-0.1	0.0
*Public demand	0.2	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.1	0.2	0.1	0.1
Government consumption	0.7	0.0	0.2	-0.0	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.1	3.4	1.1	0.4	0.3	0.3
Public investment	0.6	1.1	0.2	2.4	0.1	0.1	0.4	0.2	-0.3	-0.1	0.4	0.3	-6.4	-2.6	2.5	0.3	0.5
*Net exports	0.1	-0.6	0.4	-0.3	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.8	-0.6	0.3	0.1	0.2
Exports	1.5	2.5	2.0	-4.2	1.2	0.5	0.3	0.5	0.4	0.4	0.5	0.6	12.4	4.4	2.7	1.7	2.4
Imports	1.0	5.6	-0.0	-2.3	0.6	0.5	0.3	0.3	0.2	0.3	0.4	0.5	7.1	7.1	1.1	1.3	1.6
Nominal GDP	1.1	-0.8	1.1	1.7	1.1	0.6	0.4	0.2	0.4	0.4	0.5	0.5	2.4	1.9	3.3	2.0	2.2
(YoY)	1.5	1.2	1.6	3.4	3.6	3.4	3.3	3.0	2.2	1.8	2.0	2.3					
GDP deflator (YoY)	-0.3	-0.4	1.2	2.0	2.6	2.0	1.9	1.8	1.5	1.2	1.2	1.2	-0.2	0.7	2.1	1.3	1.3
Domestic demand deflator (YoY)	2.7	3.2	3.4	2.9	2.2	2.0	1.5	1.4	1.3	1.1	0.8	0.9	1.8	3.0	1.8	1.0	1.2
CPI core (excluding perishables, YoY)	2.1	2.7	3.7	3.5	3.0	2.2	1.6	1.5	1.8	1.5	1.3	1.3	0.1	3.0	2.0	1.5	1.3
BoJ core CPI (excluding perishables and energy, YoY)	0.9	1.5	2.8	3.5	3.8	2.8	2.0	1.4	1.0	1.0	1.0	1.0	-0.8	2.2	2.5	1.0	1.1
Industrial production (QoQ)	-2.7	5.8	-3.0	-1.8	1.3	0.3	0.1	-0.4	0.0	0.3	0.3	0.4	5.8	-0.2	0.0	0.3	1.7
(YoY)	-3.7	4.2	0.2	-2.5	0.4	-2.0	-0.1	1.3	0.0	0.0	0.2	1.1					

Notes:

- 1) QoQ figures unless noted otherwise; rows beginning with asterisk (*) show QoQ contribution to GDP in percentage points.
 - 2) Assumes supplementary budget is formed for FY23 onward (for disaster recovery and others). CPI reflects our estimates for the impact of government subsidies to curb energy price increases (including scaling down of the support).
 - 3) Estimates as of May 19. GDP reflects Jan-Mar 2023 preliminary estimates; CPI estimates also revised.
- source: MUMSS, from Cabinet Office, MIC, METI, and other data; MUMSS forecasts

	USD/JPY (FY avg)	112.4	135.8	131.0	126.0	125.0
Crude oil (import-basis, USD/bbl)		76.3	102.6	93.0	91.0	90.0
Current account (trillion yen)		20.2	9.2	12.7	19.6	24.2
as % of nominal GDP		3.6	1.6	2.2	3.3	4.0
Trade balance (customs-cleared, trillion yen)		-5.6	-21.8	-18.0	-12.4	-8.3

Market Forecast

			FY21				FY22 (forecast)				FY23 (forecast)				FY24 (forecast)				FY25 (forecast)
			Apr-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	
Japan	Real GDP	Annualized QoQ	—	—	-0.1	1.6	1.8	1.0	0.5	0.1	0.6	0.7	0.8	0.9	—				
	YoY %	2.6	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	0.9	
BoJ	Core CPI	YoY %	0.1	2.7	3.7	3.5	3.0	2.2	1.6	1.5	1.8	1.5	1.3	1.3	1.3	1.3	1.3	1.3	
	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	-0.1	-0.1	-0.1	-0.1
FX	USD/JPY	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	—	—	-0.2	0.3	1.1	0.6	-0.8	-0.4	1.0	1.6	1.7	1.7	—				
	YoY %	5.9	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	1.6	
Euro zone	Real GDP	Annualized QoQ	—	—	-0.2	0.3	1.1	0.6	-0.8	-0.4	1.0	1.6	1.7	1.7	—				
	YoY %	5.3	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	1.6	

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 19, 2023 (previous revision May 12, 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

Investment Research Division, Mitsubishi UFJ Morgan Stanley Securities

Naomi Mugeruma, Chief Fixed Income Strategist
 Shuji Tonouchi, Senior Economist
 Kazuya Fujiwara, Fixed Income Strategist

Jun Ishii, Senior Fixed Income Strategist
 Keisuke Tsuruta, Senior Fixed Income Strategist

Appendix A

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Otemachi Financial City Grand Cube, 1-9-2, Otemachi, Chiyoda-ku, Tokyo 100-8127, Japan

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