BoJ Quarterly Update

GTSF Investments Committee | January 18, 2023

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Why does this matter?

If the Bank of Japan (BoJ) continues to reaffirm their yield curve control (YCC) stance, then Japanese investors will almost certainly move towards higher-yielding US treasuries especially following the near 16% rally in Yen in the past several months. A stronger Yen means that these investors will have stronger buying power in US treasury markets; this has already been seen as the US 10-year yield fell over 11bps (a drop in yields means an increase in prices) in the past day. The 10-year yield affects nearly every asset class, so a lower 10-year yield should theoretically mean a higher value for stocks.

Additionally and perhaps more importantly, mortgage rates are mostly determined by the 10-year yield (b/c this is the approximate duration of an individual mortgage), so as the 10-year yield may continue to fall, so will mortgage rates. Many investors fear a widespread housing market decline, but should the 10-year stay around this level combined with both a tightening in mortgage rate spreads to, say, 2% (as it historically has been) and the seasonality in the housing market (a lot of buying in Spring), the sell-off fears could be overblown as mortgage rates would be at a manageable 5%.

However, the inverse of everything stated above could also be true. Should there be an abandonment of YCC, this could lead to further sell-offs in treasuries (higher yields) and, thus sell-offs in stocks. This, combined with skyrocketing mortgage rates, could lead to an even bleaker housing market. Furthermore, it is essential to closely monitor the housing market, as historical trends indicate that it serves as a leading indicator for the overall economy during times of recession. Therefore, it is possible that the actions of the BoJ may exacerbate a recession in the United States or potentially prevent one altogether. This is why Japan is so important right now.

Background

In December of 2022, BoJ suddenly doubled 10-year yield bank to 50 basis points from 25 on either side of zero, loosening their YCC, which was first introduced back in 2016. In addition to that, traders have been putting pressure on the central bank by driving the 10-year bond yield above its range, since the Bank of Japan increased the upper limit for its yield curve control program last month.

For example, last week, investors have been exiting the market due to speculation that the YCC policy could be revised or even discontinued as early as this week. This caused the 10-year Japanese government bond yield to rise to approx. 0.54%, the highest level since 2015, and above the recent range set by the BoJ three weeks ago. The impact was felt across the yield curve, leading the BoJ to conduct two rounds of emergency buying, which together worth approx. $14 billion. Note that the central bank already holds a significant portion of some bond lines, ranging from 80% to 90%.

Speculations of the BOJ potentially unwinding its highly accommodative monetary policy has resulted in an appreciation of the value of the Yen. At the beginning of January Yen rose by more than 16% from its three-decade low of 151.95 per dollar set in October and has continued to gain value until recent developments. The primary concern for the BoJ was whether it will be content with the current shift or if it will choose to revert to its previous policy stance, potentially weakening the Yen by maintaining its current loose fiscal policy.

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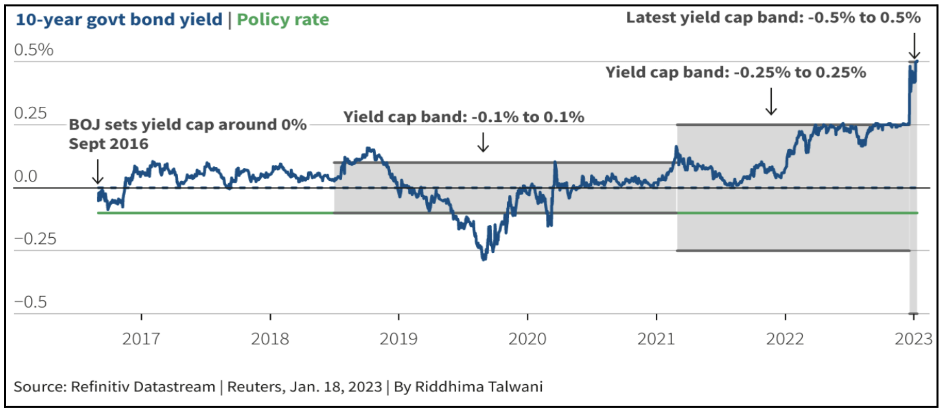
Recent Events

Following their most recent quarterly outlook report, BoJ has decided to reaffirm its YCC policy, setting target rates of -.1% for a short duration and 0% for 10-year yield. Looking at the graph to the right, you can see that since mid-2022, Japanese Government Bonds have mostly traded at the high end of the yield cap band, indicating minimal demand for JGB's outside of the BoJ. Interest rate differentials between US Treasury's and JGBs are one of the leading indicators for USD/JPY, and as JGB yields have remained artificially low and Treasury yields are rising, a reversal in USD/JPY to the 110-115 range it traded in 2021 shouldn't be expected until one of these central banks reverses course; either ending YCC policy in the case of BoJ, or cutting fed funds rate in terms of the Fed.



Effects & Outcomes

The consensus "on the street" is that the Bank of Japan will continue to uphold its ultra-loose monetary policy and yield curve control policy, at least until the tenure of Haruhiko Kuroda (head of BOJ), who is credited with implementing Japan's super-stimulus policy, concludes at the end of March. Additionally, due to the current lack of liquidity in the bond market, a gradual and cautious approach would be necessary in order to exit YCC without significantly increasing rates (one-to-two percent) in a short period of time.

The performance of the Japanese Yen was unexpected - initially, immediately following yesterday's news, USDJPY appreciated from approximately 128 to 131; however, it subsequently regained its value and is currently trading at around 128.8. It is possible that this was caused by traders who had speculated on the cancellation of the YCC and QE policies announcements from BoJ yesterday, and are now taking measures to recoup any losses, using the double-down strategy.

Additional Resources

YCC Walkthrough
https://www.reuters.com/markets/asia/how-does-japans-yield-curve-control-work-2023-01-16/

USD/JPY Relationship with Interest Rate Differentials
https://www.investopedia.com/articles/forex/09/japanese-yen-us-treasury-bonds.asp
https://en.macromicro.me/collections/59/jp-finance-relative/931/jp-yen-bond-yield

More Analysis
https://media.licdn.com/dms/document/C4E1FAQHsTgLLNaXPJw/feedshare-document-pdf-analyzed/0/1674050903111?e=1674691200&v=beta&t=4bs1AfKMCa50yBri-iQdxNbdm5Dlkeib-wACoOOvipg

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