Japan Rates Watch

Growing expectations for BoJ pivot could steepen 2yr10yr curve

01 February 2024

Rates Research
Japan

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January MPM drives up expectations for NIRP exit

JGB market participants see an exit from negative interest rate policy (NIRP) as increasingly likely. The hawkish Summary of Opinions from the BoJ's January monetary policy meeting (MPM) also implied that it could remove its inflation-overshooting commitment when it exits NIRP. We see room for the 2yr10yr curve to steepen given that (1) the market is increasingly factoring in the end of NIRP and (2) the BoJ could scale back its outright purchase (rinban) operations.

Hawkish January MPM

We think the BoJ's generally hawkish January MPM (for details, see Japan Watch: Japan Watch: BoJ review: One step closer to normalization 23 January 2024) heightened expectations for policy changes at the March and April meetings. 90% of respondents to QUICK's 23-25 January survey of bond market participants expected the BoJ to end NIRP in March or April.

NIRP exit's impact

We think the financial market impact of the BoJ's exit from NIRP will differ depending on its choice of tiering structure for interest rates on excess reserves (IOER; for details, see Japan Rates Viewpoint: Post-NIRP IOER tiering structure and market implications 23 October 2023). Whichever structure it opts for, we would expect Japanese banks to engage in arbitrage by borrowing funds from investment trusts at below the IOER lower bound via the call market and using them to boost their current account balances. This is because domestic banks, securities companies and money market brokers hold current account deposits with the BoJ where they can earn IOER, while investment trusts and life insurers do not, and all these entities participate in the call market.

We would therefore expect Tokyo overnight average rate (TONA) to rise to near 10bp if the BoJ opts for a single +0.1% tier[1] when it exits NIRP. However, if it opts for two tiers of +0.1% and 0.0% and does not allow TONA to remain negative, we would expect it to guide TONA to around 2bp-5bp via fund-absorbing operations.

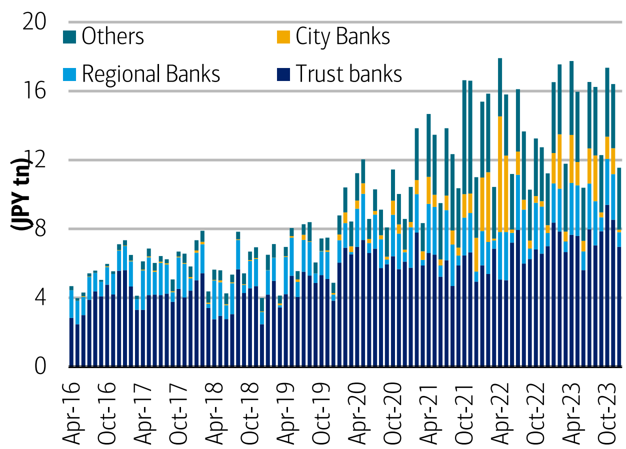
[1] We think the banking sector would object to a single 0.0% tier given the prospective ¥180bn negative impact on domestic private-sector banks' aggregate revenue. This makes a single +0.1% IOER more likely if the BoJ shifts to a single tier.

Single IOER tier could drive 2yr JGB yield above 15bp
Prospects for a rise in TONA also imply that intermediate JGB yields are set to rise. If the BoJ opts for a single 0.1% tier, this would enable Japanese banks to continue accumulating surplus funds in their BoJ current account deposits, making 0.10% the de factor floor for the 2yr JGB yield. However, we would expect the 2yr yield to rise to above 15bp including term premium if the BoJ opts for a single tier.

Two-tiered structure could result in 2yr yield of c.10bp
If the BoJ opts for a two-tier structure, banks' abundant excess reserves suggest that TONA would remain near the lower bound of IOER, resulting in a lower 2yr JGB yield than a single-tier structure. We think two tiers of +0.1% and 0.0% would result in a 2yr yield of around 10bp.

NIRP exit would take effect from 16th of following month
We note that if the BoJ exits NIRP at its 18-19 March MPM, the new IOER tier(s) would only take effect from 16 April (16 May if it exits at the April meeting[2]).

Exhibit 1: Uncollateralized call market lenders' balances (end-month)
Main lenders are investment trusts



Source: BoJ, BofA Global Research
Note: Trust banks include investment trusts, which represent the majority
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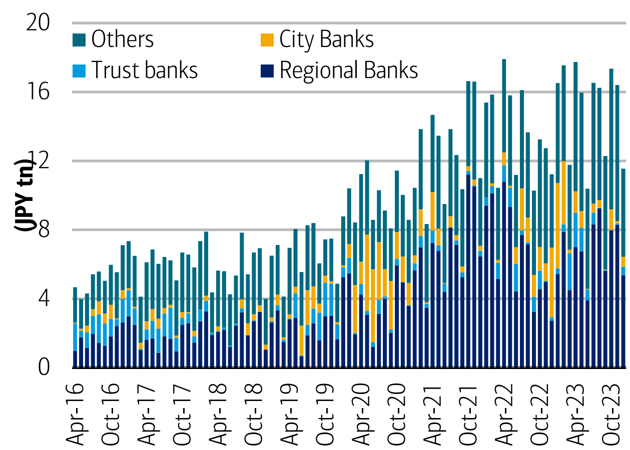
Exhibit 2: Uncollateralized call market borrowers' balances (end-month)
Main borrowers are regional banks



Source: BoJ, BofA Global Research
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Potential end to inflation-overshooting commitment
The Summary of Opinions from the BoJ's January MPM also noted the need for deliberations on its policy of expanding the monetary base (its "inflation-overshooting commitment"[3]), suggesting that it could abandon this commitment when it exits NIRP (for details, see Japan Watch: BoJ Watch: Jan MPM Summary of Opinions: further signals for Mar/Apr policy change 31 January 2024). We do not think this would signify a precipitate move toward quantitative tightening (QT), which we do not expect to begin in earnest until at least 2025. In short, we expect the BoJ to maintain the size of its balance sheet in the near term given its rinban operations' considerable impact on the JGB market.

About ¥70.4tn of the BoJ's JGB holdings are scheduled for redemption during 2024, an average of ¥5.8tn per month; the scale of its recent outright purchase (rinban) operations has been broadly in line with monthly redemptions. We therefore think the

[2] When the BoJ introduced NIRP on 29 January 2016, it indeed took effect from 16 February.
[3] *"Now is an important time to consider whether to adjust the degree of monetary easing down from the current extremely powerful level. In considering this, it is necessary to discuss the treatment of yield curve control and of the negative interest rate policy and to deliberate on the inflation-overshooting commitment.*"https://www.boj.or.jp/mopo/mpmsche_minu/opinion_2024/opi240123.pdf

market could begin to factor in a further cut to outright purchases, though it is unlikely in the near term.

Expect 2yr10yr curve to steepen

Our FX and Rates Sentiment Survey (for details, see FX and Rates Sentiment Survey: Hung jury 12 January 2024) indicates that the consensus is for 10yr JGBs to trade above 1% after the BoJ exits NIRP and YCC. The 2yr TONA swap rate also factors in the end of NIRP and subsequent rate hikes, but we would not expect the BoJ to raise rates again until Oct-Dec out of a desire to avoid policy discontinuity.

Based on the above, we recommend 2yr10yr TONA swap steepeners. Our recommendation has an entry of 68.5bp, target of 80.0bp, and stop loss of 62.7bp. The key risk to our view is that the BoJ may miss the timing for the policy normalization if the global economy slows down in 2024.

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