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BoJ preview: The clock is ticking

Key takeaways

- We expect no YCC changes at 6/16 MPM, though all meetings "live" given strength in underlying inflation. Our base case = July
- Rates: We do not expect the BoJ to make any changes in operations. The yen bond market remains subject to policy revisions.
- FX: Buy USD/JPY's dip if BoJ tweaks YCC but keeps dovish guidance on front-end.

By Izumi Devalier / Shusuke Yamada / Tomonobu Yamashita / Tony Lin / Takayasu Kudo

Chart of the day: Major scenarios for June BoJ MPM and expected market reactions
BoJ's YCC changes to raise yen interest rates but may not boost JPY

Scenarios	Policy YCC / long-rate target	JGB 5yr	 10yr	 30yr	FX USD/JPY	Equity TOPIX
Jun base case	Unchanged	No change	No change	No change	No change	Unchanged
Risk scenario	YCC 10yr ceiling raised to 1%	40bp	75bp	145bp	Fall to 135-137 initially. but quickly recover to 137-138	Initially dip 1-2%, then gradually recover; Lifers and banks slightly outperform
	YCC target shortened from 10yr to 5yr or 2yr	50bp	80bp	150bp	Fall to 135-137 initially. but quickly recover to 137-138	Initially dip 1-2%, then gradually recover; Lifers and banks slightly outperform
Tail risk	Remove YCC, move to flexible QE	55bp	85bp	155bp	Fall to 132-134 initally, but may recover to 134-136 over time	Drop up to 5%; Defensive & financials outperform

Source: BofA Global Research, Spot ref as of June 14: USD/JPY 140.1、TOPIX 2265、10yr JGB 0.426)

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The Bank of Japan (BoJ) meets this Friday, 16 June. Given the strength in underlying inflation pressures, we continue to think that further adjustments to yield curve control (YCC) are a matter of time and certainly would not rule out a move at this meeting. However, given Governor Ueda's cautious approach, and the BoJ's likely lingering concerns around the impact of recent banking system stress on the US economy, we think the BoJ prefers to wait until the 28 July MPM before delivering further YCC adjustments (our base case is a shortening of the long-rate target duration to 5 years). Waiting until the 28 July MPM will also give the BoJ time to assess key data on underlying inflation that will be released over the next month (Exhibit 3).

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Timestamp: 14 June 2023 12:58AM EDT

14 June 2023

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BoJ gradually laying the groundwork for normalization

At its previous meeting on 28 April, the BoJ kept all key policy settings unchanged but delivered some notable tweaks to its forward guidance (see BoJ review: Continuity and difference, 28 April 2023).

On one hand, it deleted its long-standing rates forward guidance that it expects "short- and long-term policy interest rates to remain at their present or lower levels." It also added new language stressing that it would "patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions (emphasis ours)."

On the other, it flagged "extremely high uncertainties surrounding economies and financial markets at home and abroad." It also formalized prior communications stating that the Bank will "aim to achieve the price stability target of 2% in a sustainable and stable manner, accompanied by wage increases."

We think the removal of the rates forward guidance, as well as the commitment to respond "nimbly" to economic and market developments, are signs that the BoJ is laying the groundwork for further flexibilization of YCC. Indeed, we think the BoJ already has the grounds to justify such a move.

Striking the balance between YCC's benefits and side effects

In his latest interview with *Nikkei Shimbun*, published 26 May, Governor Ueda stated that YCC "may be revised in the future if there is a change in the balance between its benefits and side effects." While operational pressures on yield curve control have eased since March, the BoJ's latest bond market survey shows that bond market functioning remains low in absolute terms (though it is "improving" in sequential terms according to this survey).

Meanwhile, the pro-cyclical nature of yield curve control means that policy is getting easier as underlying inflation picks up, a fact that Governor Ueda emphasized in his post-April MPM press conference (see BoJ review: Continuity and difference, 28 April 2023).

As Governor Ueda stated then:

> "Although this may not be included in your question, when underlying inflation is weak, the effect [of YCC] is not very strong. However, as the underlying inflation rate rises a bit, inflation expectations also increase, and by keeping nominal interest rates down, [YCC] has the effect of lowering the real interest rate-nominal interest rates less inflation expectations-and the easing effect is strengthened. However, it could also be said that as we reach such a phase, the side effects of the policy also increase. I think we have been in such a phase since last year. Thus, I think we need to continue to analyze the benefits and side effects [of YCC] and closely monitor the situation."

The above comments support our view that the BoJ will justify further flexibilization of YCC based on the double-pronged argument that 1) underlying inflation, though not yet certain to be sustained at 2%, had risen sufficiently to keep policy easy (i.e. real yields low) despite a rise in long-term yields and that, 2) this was further justified in view of the policy's lingering side effects.

Is the BoJ losing faith in its "transitory inflation" view?

Indeed, recent communications from the BoJ suggests that the central bank is beginning to consider, more seriously, the possibility of a structural shift in inflation dynamics.

Speaking at the Lower House Committee on Financial Affairs on 9 June, Governor Ueda said that "we are starting to see upward changes in corporate pricing behavior."

In a supplement to its April Regional Economic (Sakura) Report, published on the same day (9 June), the BoJ pointed to a structural shift in wage and price hikes dynamics following the pandemic, noting that wage hikes are spreading even to companies (i.e. SMEs) that have much more limited financial flexibility. The Report also pointed to a growing number of price hikes that are motivated by a desire to secure funds for wage increases.

As we discussed in a previous report, the price pass-through of labor costs in Japan has been much more gradual compared to energy and raw material costs (see Japan Watch: Delayed price hikes = Delayed disinflation, 28 February 2023). However, this looks to be changing.

Though lagging macro wage data are yet to reflect the boost to salaries from this year's spring wage negotiations (see Japan Watch: April macro wage data disappoints, but too early to judge the trend, 6 June 2023), the BoJ takes into account inputs from surveys of both households and corporates when assessing the trend for underlying inflation. Together with the strong Shunto results, which is on track to deliver the strongest base pay hikes since 1992[1], we think the BoJ is growing more confident in the prospect of broad-based wage increases in FY2023.

Risk of a non-linear rise in inflation

This has important implications. A working paper[2] published on 22 May by researchers at the BoJ Monetary Affairs Department looked at the possible non-linearity in the pass-through to CPI inflation of increases in firms' input costs. Their conclusions were three-fold:

1) there is nonlinearity in the pass-through to CPI inflation of increases in producer prices, exchange rates, and wages rises once such input cost increases exceed a certain threshold;

2) existing linear models underestimate the degree of the pass-through of an input-cost increase that exceeds the threshold; and

3) the pass-through of wage growth tends to be persistent due to the observed higher inertia in wage growth.

The paper's findings neatly explain why the BoJ policy board, which likely relies on linear models of inflation, failed to forecast the magnitude and duration of the recent CPI pick-up, following the surge in import costs last year (Exhibit 1).

It also challenges the BoJ's still-sanguine view that the current inflation pick-up will prove transitory, with CPI inflation dropping below 2% around the fall ("middle of FY23").[3]

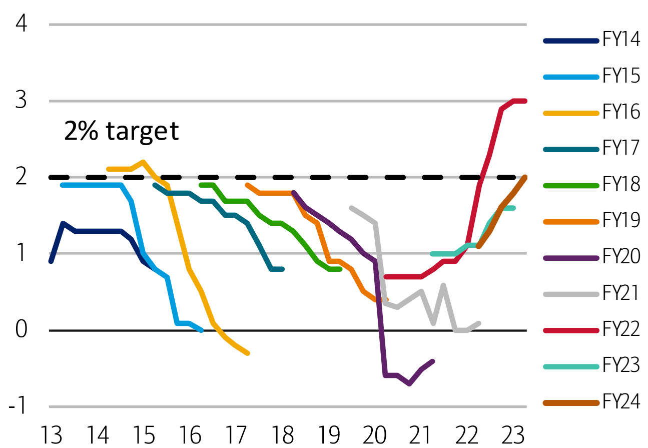
In fact, the expected strong pick-up in wages over the coming months—we continue to expect nominal macro wage growth to jump to around +3.5%YoY by the fall, up from the current ~2.0% pace (based on MHLW's reference series of continuously-surveyed firms)—suggests we will likely get another strong wave of price pressures in 2H FY23.

[1] According to the 6th and second-to-last round of FY23 Shunto responses compiled by the Japanese Trade Union Confederation (Rengo), firms are on track to deliver average base pay hikes of 2.14%, up from 0.63% in FY22.

[2] See T. Sasaki, H. Yamamoto & J. Nakajima, "Nonlinear Input Cost Pass-through to Consumer Prices: A Threshold Approach," Bank of Japan Working Paper Series, 22 May 2023.

[3] See, for example, the view outlined by BoJ Governor Ueda in his 19 May speech. "Basic Thinking on Monetary Policy and the Outlook for Economic Activity and Prices -- Speech at a Meeting Held by the Naigai Josei Chosa Kai (Research Institute of Japan)," 19 May 2023.

Exhibit 1: Evolution of BoJ policy board's core CPI forecasts (%YoY)
From over-estimating to under-estimating inflation



Source: BofA Global Research, Bank of Japan
Note: Forecasts show the median value of the majority of policy board members (highest and lowest projections are discarded from the calculation of the median)
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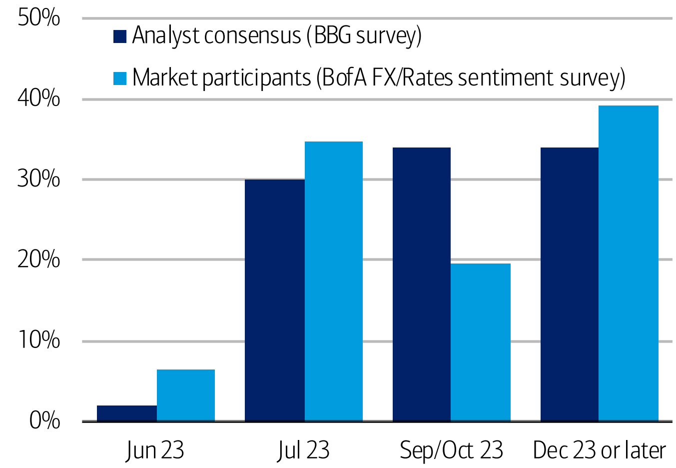
Exhibit 2: Expected timing of BoJ policy/YCC changes
Expectations of June policy changes have faded while July remains popular



Source: BofA Global Research, Bloomberg
Note: Bloomberg BoJ analyst survey was conducted between 1 - 6 Jun (n=46). BofA FX/Rates sentiment survey was conducted 2 - 7 Jun (n=81)
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The clock is ticking

Given the dynamics above, we do not think the BoJ has the scope to leisurely wait for the results of the FY24 spring wage negotiations before beginning policy adjustments. We believe that the BoJ should at least loosen its still-rigid YCC settings before the fall, when the inflation/wage data will likely challenge the central bank's view of a significant slowdown in inflation—thus inviting another round of potential challenges to yield curve control.

Note that, given the BoJ's total control of the Japanese government bond markets, these challenges may be reflected in further yen depreciation, rather than a rise in cash JGB yields. We do not think the current level of the yen is a big concern for policymakers, but it is likely to be a headache—particularly for the government—if the undervaluation becomes extreme (USD/JPY > 150), or the move becomes more volatile, as was the case last year (for more, see Japan Viewpint: Yen weakness in '22 = headache for MoF; Yen weakness in '23 = tailwind for BoJ, 7 June 2023).

We continue to see YCC adjustments at the 28 July MPM

Predicting the exact timing of the BoJ's next move is difficult. Given the nature of YCC, any hint of adjustments/exits results in enormous pressure on the 10-yr long-rate ceiling. Hence the changes will likely be delivered without a clear warning, a fact that both Governor Ueda and deputy governor Uchida have acknowledged. We thus think all upcoming meetings, including this Friday's MPM, are "live."

However, our base case is that the BoJ will wait until the 28 July MPM before announcing further YCC changes (our main scenario is a shortening of the duration of the long rate target, to 5yrs, though other configurations are possible).

Why not move this week?

We see two main reasons for the BoJ may want to wait until July to make its move: first, the Fed is expected to "skip" a rate rise this week to gain more clarity on the impact of the past year's cumulative rate increases on the economy, as well as the impact of tighter bank lending following the recent regional banking stress. Given that the BoJ was concerned about "extremely high uncertainties" surrounding overseas economies at its April MPM, it would seem natural for the central bank to adopt the Fed's wait-and-see stance.

We also think the BoJ wants a bit more time to assess domestic data on wages, inflation, and expectations, to build its case that underlying inflation and spending momentum are likely to remain sufficiently strong. Dataflow from end-June to early July, including the June Tokyo preliminary CPI print, July BoJ Tankan, May wages, and the latest BoJ Household Opinion Survey, will be particularly important to watch (Exhibit 3).

Given the focus on the July MPM among the analyst consensus and market participants, the risk is that these data releases stoke another round of YCC attacks ahead of next month's policy meeting (Exhibit 2). However, just as it did in December 2022-March 2023, we think the "patient" BoJ will be willing to pay the price of defending against these attacks with aggressive bond-buying intervention if it means building a stronger case for policy adjustments.

Exhibit 3: Calendar of key BoJ-related data releases and events

30 June - 12 July data will be key ahead of the 28 July BoJ policy meeting

Date	Event
06 Jun	Apr Labor cash earnings (wages)
08 Jun	1Q GDP (revised)
15 Jun	Jun FOMC decision (14 Jun local time)
16 Jun	BoJ Jun MPM
17-23 Jun	Japanese Emperor visit to Indonesia (return 23 Jun)
21 Jun	Scheduled end of Diet Session
23 Jun	May Nationwide CPI
26 Jun	BoJ Jun MPM Summary of Opinions
30 Jun	Jun Tokyo preliminary CPI
03 Jul	July BoJ Tankan
07 Jul	May Labor cash earnings (wages)
12 Jul	BoJ Household Opinion Survey (conducted 11 May - 6 Jun)
21 Jul	Jun Nationwide CPI
27 Jul	Jul FOMC decision (26 Jul local time)
28 Jul	Jul Tokyo preliminary CPI
28 Jul	BoJ Jul MPM & Outlook Report
02 Aug	BoJ Jun MPM Minutes
07 Aug	BoJ Jul MPM Summary of Opinions
08 Aug	Jun Labor cash earnings (wages)
15 Aug	2Q GDP (preliminary)
18 Aug	Jul Nationwide CPI
25 Aug	Aug Tokyo preliminary CPI
01 Sep	BoJ Bond Market Survey
08 Sep	Jul Labor cash earnings (wages) & 2Q GDP (revised)
21 Sep	Jul FOMC decision (20 Sep local time)
22 Sep	BoJ Sep MPM
27 Sep	BoJ Jul MPM Minutes

Source: BofA Global Research, Bank of Japan, MIAC

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- Izumi Devalier & Takayasu Kudo, Economists

Rates: No change expected in the BoJ's operations

As noted above, we expect the BoJ to leave its monetary policy unchanged at the MPM on 15-16 June. We also do not expect the BoJ's Financial Markets Department to make any changes to its bond purchase operations. According to the department's bond market survey conducted from 1 to 10 May, the bond market functioning DI remains low but has improved from a record-low level seen in the February survey. The BoJ, therefore, may have concluded that it no longer needs to implement additional tweaks to its bond purchase operations in response to the deterioration in market functioning.

Considering the recent steepening of the 7-10yr curve and the consensus view that this week's MPM will not include any policy changes, 7s10s JGB flattener may be an attractive investment. That said, as the BoJ's Deputy Governor Uchida previously noted, it is difficult for the central bank to give the financial markets advance notice of a change in YCC, which leaves open the possibility of YCC revision at the June MPM, despite our and the consensus expectations for the BoJ to stand pat. In the event that the BoJ does make a change, yen rates would likely rise in response, but the yen bond market reaction should differ slightly depending on the content of the YCC revision.

- *Tomonobu Yamashita, Rates Strategist*

FX: BoJ surprise unlikely to boost JPY sustainably

Heading into the BoJ's June MPM, the FX market's expectations for the BoJ's policy shift remain minimal as the near-dated vol lower than longer-dated (Exhibit 7). Our investor survey also shows near-zero expectation (only 2%) for a YCC change in the June MPM while investors expect 30% expect the BoJ to move in July and 34% in the fall (Exhibit 5).

Timing-wise, the BoJ's move in the June MPM is unlikely if we assume the BoJ does not want to surprise the market as it seeks to improve communication with the market. However, Governor Ueda has said YCC changes are difficult to signal and surprises may not be completely avoided given the nature of YCC. Then, the June MPM appears the perfect timing with limited expectations. In fact, the BoJ's YCC rate hike in December had preceded minimal market expectations though we note the Dec MPM was under the previous governor (Exhibit 7).

USD/JPY scenarios – dip possible but short-lived in most cases

How would a market react in case of the BoJ's surprise policy change? Still a half of investors see short yen duration (26%) or short USD/JPY (25%) as the best Japan trade for 2023, outnumbering long Japan equities (13%) – see Exhibit 6. We disagree with the short USD/JPY trade because (1) our US team thinks the Fed will not cut rate at least until next spring and (2) the BoJ's YCC tweak, if not accompanied by a hawkish shift on the front end, would not cause sustainable JPY strength (and it could eventually be negative for JPY by reducing policy uncertainty and market volatility; see: Patient BoJ = greenlight for yen-carry trade 01 May 2023). But the market would likely trade the BoJ's surprise policy tweak on YCC in the June MPM by shorting yen rates and USD/JPY initially as positioning appears light.

Exhibit 4 summarizes our expectations for near-term market reactions to various scenarios in the June MPM. If the BoJ tweaks YCC, USD/JPY could dip to 135-137 but we would buy the dip as USD/JPY's 6% carry is likely to continue in coming months. In case of a YCC removal, USD/JPY would fall sharper and the rebound may be weaker although we still do not expect USD/JPY to enter a bear-market, assuming the BoJ maintains its dovish guidance on the front end.

Relative to shorting yen rates and buying financial shares, shorting USD/JPY's risk reward is not favorable (see the rates and equity section). Instead, we wait for USD/JPY's dip to buy.

Exhibit 4: Major scenarios for June BoJ MPM and expected market reactions
BoJ's YCC changes to raise yen interest rates but may not boost JPY

Scenarios	Policy	JGB			FX	Equity
	YCC / long-rate target	5yr	10yr	30yr	USD/JPY	TOPIX
Jun base case	Unchanged	No change	No change	No change	No change	Unchanged
Risk scenario	YCC 10yr ceiling raised to 1%	40bp	75bp	145bp	Fall to 135-137 initially. but quickly recover to 137-138	Initially dip 1-2%, then gradually recover; Lifers and banks slightly outperform
	YCC target shortened from 10yr to 5yr or 2yr	50bp	80bp	150bp	Fall to 135-137 initially. but quickly recover to 137-138	Initially dip 1-2%, then gradually recover; Lifers and banks slightly outperform
Tail risk	Remove YCC, move to flexible QE	55bp	85bp	155bp	Fall to 132-134 initally, but may recover to 134-136 over time	Drop up to 5%; Defensive & financials outperform

Exhibit 4: Major scenarios for June BoJ MPM and expected market reactions
BoJ's YCC changes to raise yen interest rates but may not boost JPY

Scenarios	Policy	JGB	FX	Equity

Source: BofA Global Research, Spot ref as of June 14: USD/JPY 140.1、TOPIX 2265、10yr JGB 0.426)

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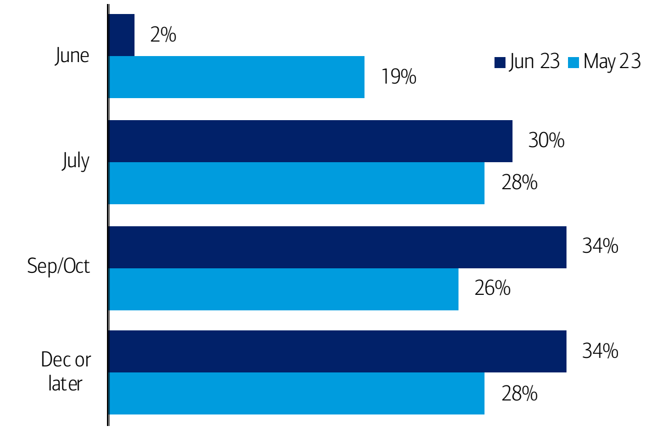
Exhibit 5: When do you think BoJ will tweak or remove YCC? (from June BofA FX and Rates Sentiment Survey)
Base case has shifted to September or later



Source: BofA Global Research FX and Rates Sentiment Survey

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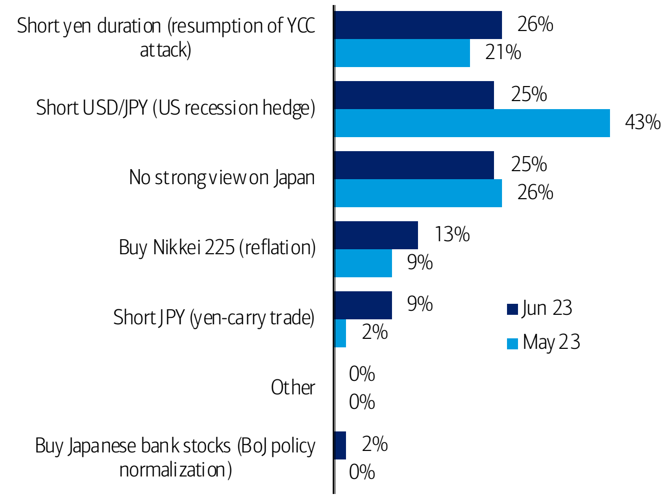
Exhibit 6: What is the best Japan trade for 2023? (from June BofA FX and Rates Sentiment Survey)
Short yen duration and short USD/JPY remain a consensus trade



Source: BofA Global Research FX and Rates Sentiment Survey

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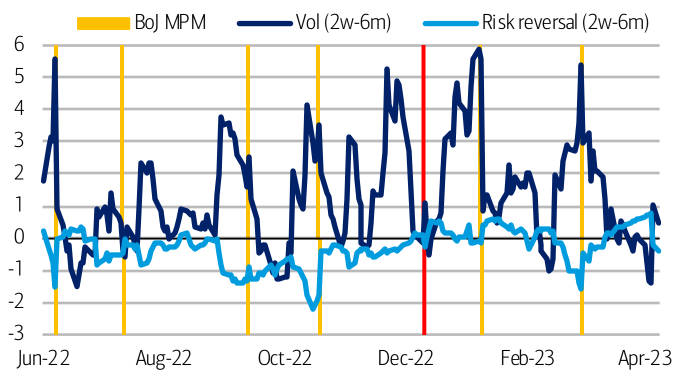
Exhibit 7: USD/JPY 2w-6m vol and risk reversal spread
Market expectations for Jun MPM minimal



Source: BofA Global Research, Bloomberg

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- Shusuke Yamada, FX/Rates Strategist

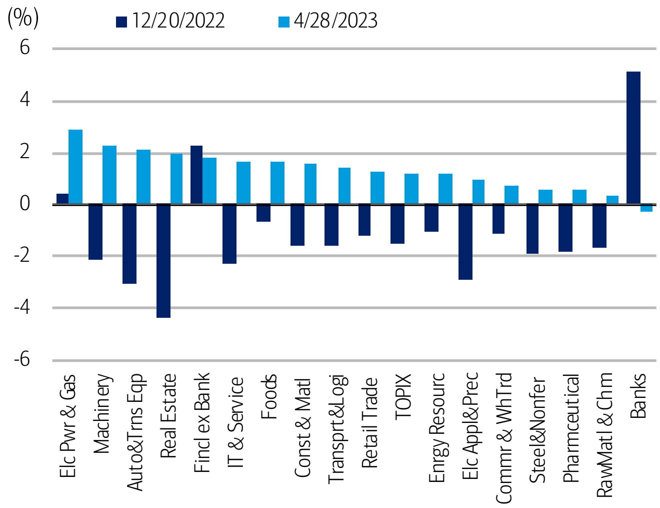
Equity: extending the dovishness; potential SME outperformance

We believe our base case for the BoJ's status quo stance on monetary policies would be neutral to the market, with the focus likely shifting to overseas macro dynamics. In a risk scenario of YCC adjustment (note this is our base case in July), we think the near-term knee-jerk market selloff (down 1-2% for TOPIX) should be bought over the medium-term (see Exhibit 4 for scenario table). Sector-wise, Exhibit 8 shows the potential playbook for no YCC adjustment (Apr 23) vs. YCC twist (Dec 22), if history is any guide.

We note that TOPIX's cyclical adjusted P/E (CAPE) has recovered to 13.9x, close to the average of last decade (14.1x), likely reflecting the robust inflows by overseas investors since Apr (Exhibit 9). While we maintain a positive stance on equities for the rest of the year, potential macro-driven reversal of overseas future inflows could pose near-term risks to the market, likely favoring small & medium cap companies (see Concerns about Japanese stocks' 33-year high; stock selection outlook 12 June 2023).

- Tony Lin, Equity Strategist

Exhibit 8: Share price performance by sector
Potential playbook for no YCC adjustment (Apr 23) vs. YCC twist (Dec 22)



Source: BofA Global Research, Bloomberg
Note: based on daily sector performance on Apr 28, 2023 and Dec 20, 2022.
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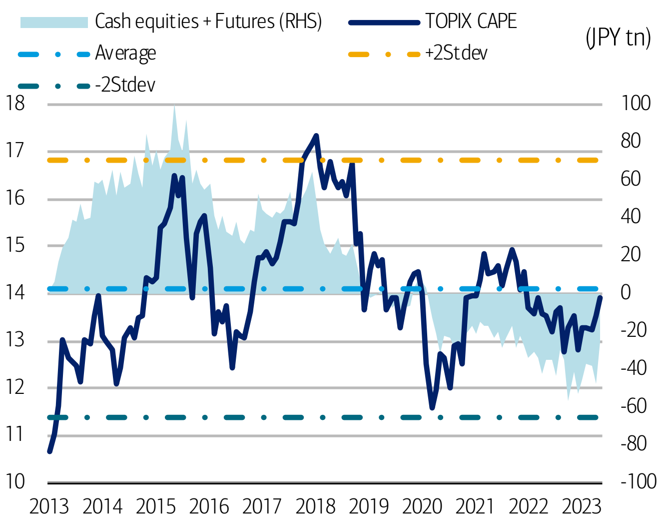
Exhibit 9: TOPIX's CAPE vs. cumulative overseas investors' net investment flows
TOPIX traded near the long-term average CAPE since 2013, echoing the robust inflows by overseas investors



Source: BofA Global Research, Astra Manager
Note: CAPE measures the inflation-adjusted last 10 years of earnings on the market versus the current TOPIX price.
We aggregate futures of Nikkei 225, Nikkei 225 mini, TOPIX, TOPIX mini and JPX Nikkei 400.
Monthly basis, as of May, 2023.
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- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
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- Commonwealth Surprise **Global Rates Weekly**, 09 June 2023
- USD breather, **Liquid Cross Border Flows**, 05 June 2023

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For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: High(er) rates for (much) longer 09 June 2023

Global Rates Weekly: Commonwealth Surprise 09 June 2023

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