# Japan Macro Watch

# BoJ review: No red lines

At its policy meeting on 31 October, the Bank of Japan policy board decided unanimously to maintain its targets for the short-term policy rate, and the long-term interest rate, at -0.1% and "around zero," respectively. However, it voted 8-1 to further increase the flexibility of yield curve control (YCC).

Following its previous YCC adjustment in July 2023, the BoJ had established +0.5% as a "reference" for the level of the 10yr JGB yield, with 1% as the hard line of defense where the central bank promised to intervene with daily, unlimited fixed-rate bond buying operations (see Japan Macro Watch: BoJ flexibilizes yield curve control—quick take, 28 July 2023).

With today's change, 1% becomes the new "reference" for the upper bound of 10yr JGB yields. Just as importantly, it stopped citing a specific level for its defense of YCC, deleting its explicit commitment to conduct unlimited fixed-rate bond buying operations every business day and instead replacing it with a commitment to "continue with large-scale JGB purchases" (Exhibit 1).

In our view, the changes represent another step forward in the BoJ's pivot away from rigid YCC, and opens up the possibility for domestic long-end yields to move higher (including beyond 1%), provided the move is orderly and backed by fundamentals.

**Exhibit 1: Revisions to the BoJ's directive on the "Conduct of Yield Curve Control" - Jul vs. Oct**
The BoJ raised the "reference" for the 10yr JGB yield and increased further its flexibility around YCC

| Old (Jul '23 MPM) | New (Oct '23 MPM) |
|---|---|
| The Bank will continue to allow 10-year JGB yields to fluctuate in the range of around plus and minus 0.5 percentage points from the target level, while it will conduct yield curve control with greater flexibility, regarding the upper and lower bounds of the range as references, not as rigid limits, in its market operations. The Bank will offer to purchase 10-year JGBs at 1.0 percent every business day through fixed-rate purchase operations, unless it is highly likely that no bids will be submitted. In order to encourage the formation of a yield curve that is consistent with the above guideline for market operations, the Bank will continue with large-scale JGB purchases and make nimble responses for each maturity by, for example, increasing the amount of JGB purchases and conducting fixed-rate purchase operations and the Funds-Supplying Operations against Pooled Collateral. | The Bank will regard the upper bound of 1.0 percent for 10-year JGB yields as a reference in its market operations, and in order to encourage the formation of a yield curve that is consistent with the above guideline for market operations, it will continue with large-scale JGB purchases and make nimble responses for each maturity by, for example, increasing the amount of JGB purchases and conducting fixed-rate purchase operations and the Funds-Supplying Operations against Pooled Collateral. |

**Source:** Bank of Japan

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**31 October 2023**

Macro
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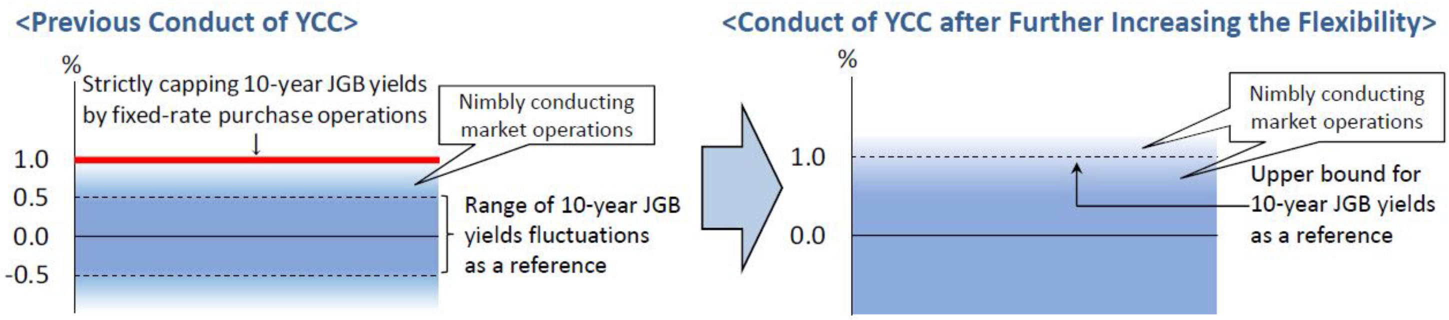
**Exhibit 2: BoJ schematic of the latest adjustments to Yield Curve Control**
From the materials accompanying the 31 October MPM decision




**Source:** Bank of Japan

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The BoJ's new tactics around 10yr YCC are also highlighted in updated reference materials from the central bank that no longer show a red line of defense at the previous 1% ceiling (Exhibit 2).

However, we would disagree with the characterization of today's move as abandonment of YCC, as the BoJ retains the option to intervene, as needed, depending on economic/market conditions. As was the case in July, we think the aim of the BoJ's latest move is to expand the flexibility around YCC amidst the on-going improvement in underlying inflation and continued risk of spillovers from overseas rates volatility.

Today's decision defied analyst consensus of no change but was largely in line with our expectations (see Japan Watch: BoJ Preview: Trick or tweak?, 25 October 2023). Our sense is that domestic market participants' expectation was 50-50 in favor of another YCC tweak before rising significantly following Nikkei Shimbun's overnight scoop (published 30 Oct 23:00 JST) that anticipated the adjustments.

Elsewhere in the statement, all elements of the Bank of Japan's forward guidance were unchanged, including the 2% inflation "overshooting commitment" for the monetary base (Exhibit 9). Moreover, despite another set of significant revisions to its FY23 and FY24 core CPI projections (Exhibit 3), the BoJ largely left intact its assessment that the current pick-up in inflation is largely imported (what Governor Ueda described as the "first force" in his 25 September speech in Osaka[1]).

It re-iterated that it will "patiently" continue with monetary easing under the current QQME+YCC framework, until it gains further confidence in the sustainability of wage growth, and therefore the achievement of its 2% price stability target.

[1] See Kazuo Ueda, "Japan's Economy and Monetary Policy: Speech at a Meeting with Business Leaders in Osaka," 25 September 2023.

**Exhibit 3: BoJ Policy Board median CPI projections vs. consensus**

The BoJ delivered another significant upgrade, especially to its FY23 and FY24 projections

| | CPI ex fresh food | | | | CPI ex FF & energy | | | |
|---|---|---|---|---|---|---|---|---|
| CY | BoJ (Jul) | BoJ (Oct) | BBG (11 Oct) | BofA (29 Sep) | BoJ (Jul) | BoJ (Oct) | BBG (11 Oct) | BofA (29 Sep) |
| 23 | -- | -- | 3.0 | 3.1 | -- | -- | 3.9 | 3.9 |
| 24 | -- | -- | 2.0 | 3.2 | -- | -- | 2.1 | 2.6 |
| 25 | -- | -- | 1.4 | 1.8 | -- | -- | 1.6 | 2.1 |
| FY | | | | | | | | |
| 23 | 2.5 | 2.8 | 2.7 | 3.0 | 3.2 | 3.8 | 3.8 | 3.9 |
| 24 | 1.9 | 2.8 | 1.9 | 2.8 | 1.7 | 1.9 | 1.8 | 2.3 |
| 25 | 1.6 | 1.7 | 1.4 | 1.7 | 1.8 | 1.9 | 1.7 | 2.0 |

**Source:** Bank of Japan

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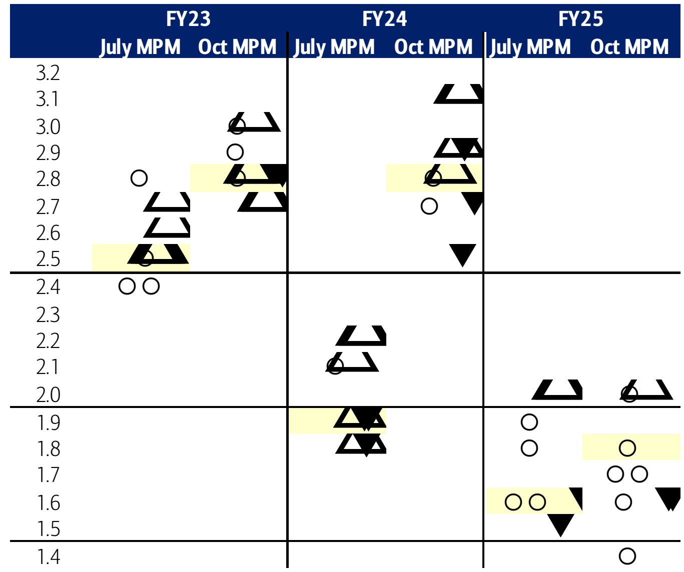
**Exhibit 4: BoJ CPI ex Fresh Food forecasts (Oct vs. July)**

Policy Board Members' Forecasts and Risk Assessments




**Source:** Bank of Japan, BofA Global Research; Note: The locations of ○, △, and ▼ in the charts indicate the figures for each Policy Board member's forecasts to which they attach the highest probability. The risk balance assessed by each Policy Board member is shown by the following shapes: ○ indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside." The yellow-shaded figure refers to the median of the Policy Board members' forecasts.

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## Governor Ueda press conference

Meanwhile, questions at Governor Ueda's post-MPM press conference focused on teasing out the BoJ's thinking on the following topics: 1) motivations behind the latest yield curve control adjustments; 2) if and where the BoJ sees the "new" limit for 10yr JGB yields; 3) the BoJ's assessment of the strength of underlying inflation, and whether it had changed since its last Outlook Report in July; and, by extension, 4) the distance to the BoJ's next policy move, which many market participants assume is the removal of negative interest rate policy (NIRP).

1) On the motivations for the latest YCC adjustment, Governor Ueda effectively used the same rationale that he did in July, stating that the decision was made by weighing the potential side effects of rigid yield curve control vs. its easing effects. As was the case in July, Governor Ueda acknowledged that such side effects included a deterioration in market functioning but also "volatility in the FX markets."

2) As for if and where the BoJ sees the "new" limit for the 10yr JGB yield: Governor Ueda began by explaining that, like the July move, the intention is not to actively push yields higher but to secure greater flexibility for YCC before upward pressures on nominal yields built up further. He stated that while the BoJ no longer sets an explicit limit for the upper bound for the 10yr yield, it did not think that "it would greatly exceed 1%." He stressed that the BoJ would "use its bond market operations flexibly to respond to speculative yield rises" while tolerating yield increases "if backed by fundamentals."

3) Meanwhile, as discussed earlier, the BoJ's latest CPI forecasts reflected across-the-board upgrades to FY23-FY25 inflation (Exhibit 3). However, Governor Ueda continued to characterize the pick-up as still largely driven by the extended passthrough of exogenous shocks, such as the past rise in import prices as well as the recent rise in crude oil prices. In its outlook report, the BoJ also added that the large jump in projected FY24 Japan-style core (CPI ex fresh food) inflation partly reflected payback for the assumed fading of government subsidies for energy.

The BoJ and Governor therefore implied that the central bank's assessment of underlying inflation had not changed significantly since the last Outlook Report in July. That said, Governor Ueda did express optimism that "there are signs of changes in inflation norms," and that "the probability of achieving the BoJ's target of sustained and stable 2% inflation is rising a bit."

4) Finally, in relation to the above, Governor Ueda stressed that for the BoJ to conclude that its 2% price stability target had been achieved (and therefore end NIRP), it needed confidence that inflation was being driven endogenously, and not just from prolonged pressure from imported costs. He then stated that confidence in the outlook for wages was a critical piece of the puzzle for the BoJ. On this point, He acknowledged that next year's *Shunto* spring wage negotiations were a key event. But as he had stressed in his 9 September Yomiuri Shimbun interview, he suggested that the BoJ would not be relying solely on the *Shunto*, nor necessarily wait until their results are announced, in making a judgment on wages (see BoJ Watch: Could the BoJ end NIRP in 2023?, 11 September 2023).

Finally, he added that, in addition to confidence in the sustainability of wage growth, the BoJ would also need assurance that corporates would continue reflecting the increased wage costs in the form of price hikes.

**Implications and outlook for monetary policy:**
With the BoJ now gaining considerable flexibility over its management of long-end yield curve control, we think the central bank's next move is the removal of NIRP and YCC (though we think the central bank will continue to maintain a backstop for yields). Given our optimism on the outlook for inflation and wage growth, we have been expecting December '23 – April '24 as the window for such a move. The BoJ's latest communications point to a reduced likelihood of a move in December. But we remain comfortable with our base case of a move at the 17-18 January MPM, and April '24 at the latest (please see Exhibit 7 and Exhibit 8 for schedule of BoJ policy meetings).

*- Izumi Devalier & Takayasu Kudo, Japan Economists*

## Rates: Reducing rinban ops depend on Nov JGB auctions

At its Monetary Policy Meeting (MPM) held on 30-31 October, the BoJ tweaked its yield curve control (YCC) policy, changing the previous 1.0% upper limit on the 10yr JGB yield to a reference "target" level and indicated that it would not necessarily conduct consecutive-day fixed-rate purchase operations even if the yield rose to that level. Any fixed-rate purchase operations for consecutive days will be announced in advance, with the BoJ providing information about the issues to be purchased, the schedule of the purchases, purchase size, and the fixed rate applied on the BoJ home page.

An article leaking news about the BoJ's YCC revision that appeared at 11pm on 30 October (JST) triggered a selloff of JGB futures and JGBs in the morning session. After the announcement of the MPM results, JGB futures briefly rose and JGB yields fell. However, JGB futures fell again, and JGB yields rose once more in the afternoon session. The market considered the October MPM to indicate a more hawkish BoJ.

The BoJ also clarified that future fixed-rate purchase operations would not be limited to 10yr JGBs but could also include purchases of 2yr, 5yr, 20yr, 30yr, and 40yr bonds as deemed necessary. However, the BoJ announcement is not an expansion of its bond-purchasing operations, as its Market Operations in Fiscal 2016 stated that fixed-rate operations were not limited to bonds with maturities of 10 years. Indeed, the BoJ conducted fixed-rate purchases of 2yr, 5yr, and 20yr JGBs last December and in January this year. The BoJ restating that its fixed-rate purchase operations are not necessarily limited to 10yr JGBs may be an effort to stimulate investor demand for JGBs. Recently weak JGB auction results have increased the BoJ's JGB purchases, which could trigger further deterioration in the bond market functioning and exacerbate JPY depreciation. Even if the BoJ curtails its Rinban operations, it could be aiming to use fixed-rate operations as a backstop to prevent a sharp rise in JGB yields and help stabilize the JGB market.

The BoJ's schedule for purchase of JGBs, released along with the post-MPM statement, does not include any changes in the size to be offered each time or the number of offers. However, on 6 November, the next business day after the 10yr JGB auction on 2 November, the Bank is scheduled to purchase JGBs of all maturities except those under one year and JGBi, further evidence that the BoJ aims to alleviate investors' concerns about JGB auctions.

Investors' focus is now likely to shift to the offer amounts for Rinban operations and triggers for the fixed-rate purchase operations. While the BoJ's decisions at the October MPM suggests its plan to reduce JGB purchases in the future, the Bank has maintained its basic policy of expanding the monetary base, and any reduction in JGB purchases is likely to be conducted at a gradual pace. In addition, any move toward curtailing purchasing operations will depend on investor demand at JGB auctions to be held in November. Weak result is likely to increase the probability of the BoJ conducting its fixed-rate purchases. Even in that case, the BoJ is likely to focus on slowing the rise in yields rather than an all-out effort to defend the yield level at which it conducted fixed-rate operations.

*- Tomonobu Yamashita, Rates Strategist*

## FX: US rates in USD/JPY's driving seat

The BoJ tweaked YCC and made it less rigid. Ueda admitted the rise in the US rates since July has exceeded his expectation and was a factor behind the YCC tweak. As we had argued, a YCC tweak or even a YCC removal would not be sustainably positive for JPY:

We recently estimated the fair value of the 10yr JGB yield around 1.2% as the stock effect of the BoJ's JGB holdings (80bp) is subtracted from the fair value without the stock effect (2%) (Liquid Insight: Japan's policy challenge – defend JPY or JGB? 05 October 2023). Even if the rise in the JGB yield from here is driven entirely by the real yield, the 10yr real yield would still not be positive if our fair value estimate is right and until the BoJ starts QT.

While the NIRP removal may be a matter of time with the Jan MPM as our economists' base case, any subsequent hikes may be gradual, considering its impact on the economy, the BoJ's finance, and the public debt sustainability (see our economists' analysis: Japan Watch: Impact of potential BoJ rate hikes (part 3): Effect on BoJ finances 10 October 2023).

Japan is still running deficit in the basic balance of payments (see: FX Watch: Japan BoP: deficit expanding again 10 October 2023).

In coming sessions, the JGB yields are likely to rise. The BoJ's policy intervention or the lack thereof can impact the FX market, but we would not expect higher JGB yields to drive USD/JPY's direction yet. Instead the US rates would be in the driving seat. As our US team expects the Fed to start cutting rate in June 2024, we expect USD/JPY to peak out only in 1Q24 at around 155. In the meantime, the MoF may manage volatility in the FX market by FX intervention.

*- Shusuke Yamada, FX/Rates Strategist*

## Equity: Limited overall impact; value preference intact

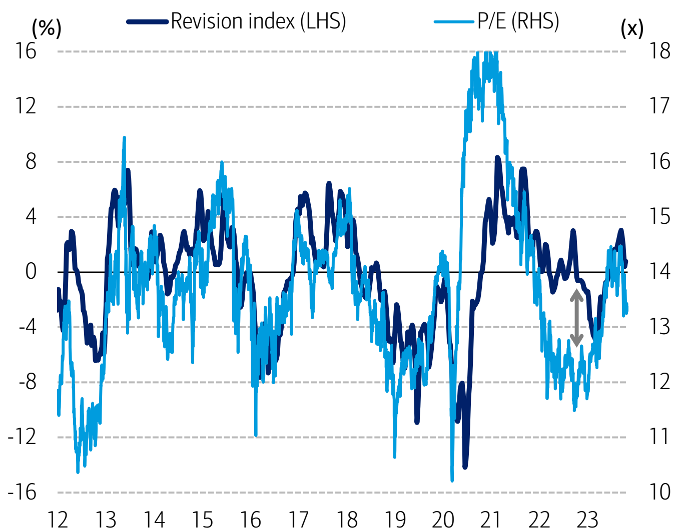
The BoJ decided to increase flexibility in its yield curve control (YCC) policy. Overall, we do not see this change in policy as negative for value stocks in the sense that interest rates will be allowed to move more flexibly along with economic conditions. Particularly, the BoJ's outlook for the core core CPI (all items less fresh food and energy) is 3.8% (3.2%) for FY23, 1.9% (1.7%) for FY24 and 1.9% (1.8%) for FY25 (figures in parentheses indicate its outlook, as of July), settling around 2%. This outlook suggests the time may be near for the BoJ to lift negative interest rates, with more news in store for value stocks.

We believe the overall impact on Japanese equity will be light. Firstly, in the bank and insurance sector, which has a 10.2% weighting in TOPIX, the BoJ's policy change will likely provide tailwinds to value stocks, which form the bulk of Japanese equity. Secondly, the yen is unlikely to rapidly appreciate because the large gap in interest rates between the US and Japan is likely to remain, as mentioned above in the FX session. There is still room for 10-year JGB yields to move closer to the upper bound, and if interest rates were to suddenly increase, the BoJ would probably intervene. Thirdly, TOPIX P/E has already fallen to 13.4x. A P/E lower than its long-term median value of 14x implies that earnings estimate revisions are about to worsen from positive to negative territory, but there is no clear sign of earnings deterioration in this cycle now.

The fact that Japan's inflation and the BoJ's policy normalization are one step behind that of other countries has underpinned the outperformance of value names in Japan, but if US interest rates reach a peak, stock selection is likely to become a mixed bag. In this scenario, we would consider cyclical growth stocks as long candidates in light of the strengthening signs of a bottom in the manufacturing cycle. However, as long as the term premium is increasing in the US and monetary policy is tight, we look for low-volatility stocks to be at an advantage, at least in the near term (see our 31 October 2023 Japan Insight: BofA Strategy Monthly report).

**Exhibit 5: TOPIX revision index and 12-month forward P/E**

TOPIX P/E will not drop below 14x substantially unless earnings revision turns into negative territory




**Source:** BofA Global Research, Refinitiv

The revision index (4 weeks moving average), P/E is based on I/B/E/S consensus estimate for 12-month forward EPS.

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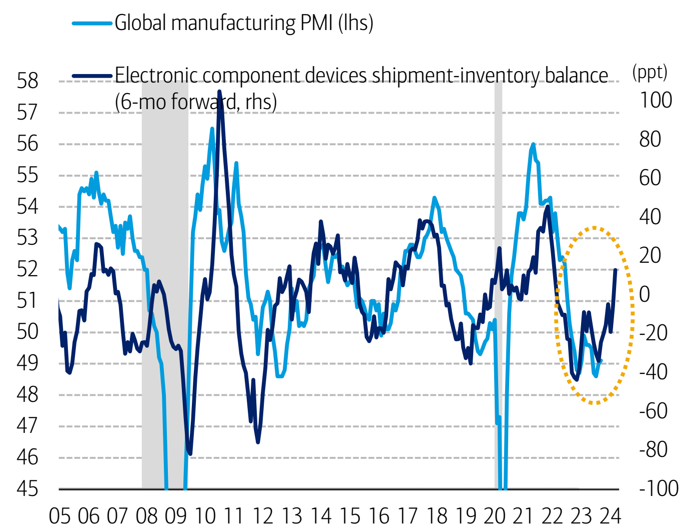
**Exhibit 6: Global manufacturing PMI and the shipment-inventory balance of electronic components**

Manufacturing cycle could be bottoming vs. history




**Source:** BofA Global Research, Refinitiv, S&P500 Global

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*- Masashi Akutsu, Chief Japan Equity Strategist and Tony Lin, Equity Strategist*

# Appendix

**Exhibit 7: Schedule of BoJ monetary policy meetings and key releases in 2023-2024**
2023-2024

| Date of MPM | | Outlook Report | Summary of opinions | MPM Minutes |
|---|---|---|---|---|
| 21 Sep (Thu) | 22 Sep (Fri) | - | 2 Oct (Mon) | 6 Nov (Mon) |
| 30 Oct (Mon) | 31 Oct (Tue) | 31 Oct (Tue) | 9 Nov (Thu) | 22 Dec (Fri) |
| 18 Dec (Mon) | 19 Dec (Tue) | - | 27 Dec (Wed) | 26 Jan '24 (Fri) |
| 22 Jan (Mon) | 23 Jan (Tue) | 23 Jan (Tue) | 31 Jan (Wed) | 25 Mar (Mon) |
| 18 Mar (Mon) | 19 Mar (Tue) | - | 28 Mar (Wed) | 2 May (Thu) |
| 25 Apr (Thu) | 26 Apr (Fri) | 26 Apr (Fri) | 9 May (Thu) | 19 Jun (Wed) |
| 13 Jun (Thu) | 14 Jun (Fri) | - | 24 Jun (Mon) | 5 Aug (Mon) |
| 30 Jul (Tue) | 31 Jul (Wed) | 31 Jul (Wed) | 8 Aug (Thu) | 26 Sep (Thu) |
| 19 Sep (Thu) | 20 Sep (Fri) | - | 1 Oct (Tue) | 6 Nov (Wed) |
| 30 Oct (Wed) | 31 Oct (Thu) | 31 Oct (Thu) | 11 Nov (Mon) | 24 Dec (Tue) |
| 18 Dec (Wed) | 19 Dec (Thu) | - | 27 Dec (Fri) | TBD |

**Source:** BofA Global Research, Bank of Japan

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**Exhibit 8: G3 central bank decision calendar**
2023

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **BoJ** | **18** (Wed) | | **10** (Fri) | **28** (Fri) | | **16** (Fri) | **28** (Fri) | | **22** (Fri) | **31** (Tue) | | **19** (Tue) |
| **Fed** | | **01** (Wed) [T+1] | **22** (Wed) [T+1] | | **03** (Wed) [T+1] | **14** (Wed) [T+1] | **26** (Wed) [T+1] | | **20** (Wed) [T+1] | | **01** (Wed) [T+1] | **13** (Wed) [T+1] |
| **ECB** | | **02** (Thu) | **16** (Thu) | **05** (Wed) | | **15** (Thu) | **27** (Thu) | | **14** (Thu) | **26** (Thu) | | **14** (Thu) |

**Source:** BofA Global Research, Bloomberg Note: Blue shaded dates represent decisions associated with Summary of Economic Projections (SEP) for the FOMC, Staff projections for the ECB, and Outlook Report for the BoJ.

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**Exhibit 9: Summary of BoJ monetary policy statement (October 2023)**
Key changes from September '23 MPM in red

| | 31 October MPM |
|---|---|
| **Overall assessment of Japan's economy** | Has recovered moderately |
| Exports | Have been affected by the developments in overseas and more or less flat, supported by a waning of the effects of supply-side constraints |
| Business investment | Has increased moderately |
| Private consumption | Has increased steadily at a moderate pace, despite being affected by price rises |
| Housing investment | Has been relatively weak |
| Public investment | Has increased moderately |
| Industrial production | Have been affected by the developments in overseas and more or less flat, supported by a waning of the effects of supply-side constraints |
| Labor market | Has improved moderately |
| Financial conditions | Have been accommodative |
| Consumer prices | Year-on-year rate of increase in the CPI (all items less fresh food) is slower than a while ago, mainly due to the effects of pushing down energy prices from the government's economic measures, but it has been in the range of 2.5-3.0 ~~at around 3~~ percent recently owing to the effects of a pass-through to consumer prices of cost increases led by a rise in import prices. |
| Inflation expectations | have risen moderately ~~shown some upward movements again~~ |
| **Outlook for the Japanese economy** | Japan's economy is likely to continue recovering moderately, supported by factors such as the materialization of pent-up demand, although it is expected to be under downward pressure stemming from a slowdown in the pace of recovery in overseas economies. Thereafter, as a virtuous cycle from income to spending gradually intensifies, Japan's economy is projected to continue growing at a pace above its potential growth rate. |
| Consumer prices | The year-on-year rate of increase in the CPI (all items less fresh food) is likely to be above 2% through fiscal 2024, mainly due to the remaining effects of a pass-through to consumer prices of cost increases led by the past rise in import prices and the effects |

**Exhibit 9: Summary of BoJ monetary policy statement (October 2023)**
Key changes from September '23 MPM in red

| | 31 October MPM |
|---|---|
| | of the recent rise in crude oil prices. As for fiscal 2025, the rate of increase in the CPI is projected to decelerate owing to dissipation of these effects. ~~decelerate, with a waning of the effects of a pass-through to consumer prices of cost increases led by a rise in import prices~~. Meanwhile, toward the end of the projection period, underlying CPI inflation is likely to increase gradually toward achieving the price stability target, ~~Thereafter, the rate of increase is projected to accelerate again moderately~~ as the output gap turns positive ~~improves~~ and as medium- to long-term inflation expectations and wage growth rise~~, accompanied by changes in factors such as firms' wage- and price-setting behavior~~. |
| **Risks to the outlook** | Concerning risks to the outlook, there remain extremely high uncertainties for Japan's economy, including developments in overseas economic activity and prices; developments in commodity prices, and domestic firms' wage- and price-setting behavior. In this situation, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices. |
| **Conduct of monetary policy** | With extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. By doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases. The Bank will continue with QQE with Yield Curve Control, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. |
| Overshoot commitment | It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner |
| Future conduct of monetary policy and forward guidance for rates | For the time being, the Bank will not hesitate to take additional easing measures if necessary, |

**Source:** Bank of Japan, BofA Global Research

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# Disclosures

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| Investment rating | Total return expectation (within 12-month period of date of initial rating) | Ratings dispersion guidelines for coverage cluster[R1] |
|---|---|---|
| Buy | ≥ 10% | ≤ 70% |
| Neutral | ≥ 0% | ≤ 30% |
| Underperform | N/A | ≥ 20% |

[R1] Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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