BofA SECURITIES

Global Rates Viewpoint

Global rates mid-year: sufficiently resilient

15 June 2023

Rates Research
Global

The Godot recession in action

At the global level the main surprise versus our year ahead views from last year (see Global Rates Year Ahead, 20 November 2022) is the resilience of the US economy. As a result, our US economists revised their forecasts for a later recession, a higher terminal rate and later cuts. At the global level this implies for us an upward revision to near-term rate forecasts, more prolonged curve inversions, and a less pronounced outperformance of USD rates vs EUR for the remainder of the year.

US – surprisingly resilient: higher front end, flatter curve

Our US economists recently pushed out the timing of their recession call, pencilled in more Fed hikes and slightly pushed out timing of rate cuts. We reflect these views in updated rates forecasts and views. The most notable shift: (1) higher fed funds path = higher rate forecasts & a flatter curve; (2) UST cheapening risks with increased supply and softer demand backdrop; and (3) 2Y spread carry longs trade.

Euro Area – defying gravity for a little longer

We maintain a near-term bearish bias on economic momentum not being as weak as suggested by surprise indices, ECB likely remaining hawkish for longer than priced, and meaningful supply pressures in the context of investors having flipped long. Medium term, there is considerable potential for a belly-led rally as markets return to more sensible neutral rate estimates.

UK – maintaining a bearish bias

Investors are short the UK cross market and BoE pricing is more hawkish than our forecasts, but we remain worried about Gilt underperformance. Supply will remain an issue in Q3, macro vulnerabilities remain pronounced, and scope for cuts more limited than elsewhere even towards the end of the forecast horizon.

Australia – behind the curve

Since our last update three months ago, the RBA has delivered two surprise hikes. The RBA's hawkish turn has fuelled a sell-off in rates, and we have upgraded our forecasts for yields over the next few quarters. The outlook for year-end 2024 remains the same but we now see much higher yields in the belly of the curve in H2 23 and forecast a more aggressive rally from Q1 24 as investor concerns shift from inflation to growth.

Japan – in thrall to BoJ policy changes

Despite considerable uncertainty, we expect supply-demand factors to remain the main driver of the JGB market through end-2024, with upward pressure on yields. Our view reflects the uptrend in JGB issuance by the Ministry of Finance (MoF) in line with the Japanese government's loose fiscal policy, and the potential for the Bank of Japan (BoJ) to begin normalizing monetary policy as early as within FY23. Our 10yr JGB yield forecasts are 0.70% at end-2023 and 0.80% at end-2024.

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See Team Page for List of Analysts

See Exhibit 20 for definitions of common abbreviations and terms used in our reports.

For a list of our trade recommendations and those trades closed in the past 12 months please see the latest Global Rates Weekly.

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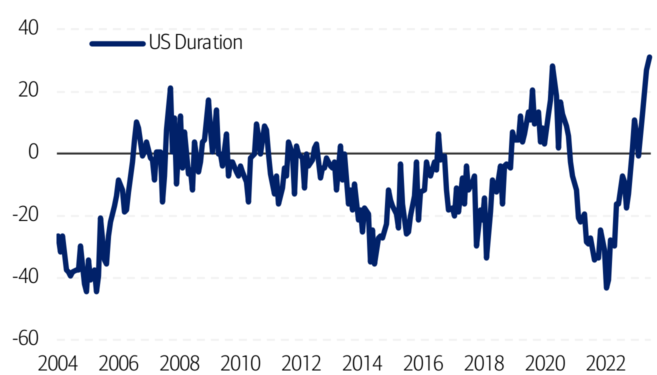
Surprisingly resilient

In our Year Ahead publication we wrote: "macro uncertainty to decline in '23. Lower uncertainty ... because: slower place of Fed hikes / eventual pause, falling though still high inflation, softening labor market, USTs regaining their risk-off hedge value... Rates to move past their peak & decline in '23, vol to drop, real rates to fall, spread curve likely steeper."

We have learned 3 key things since our Year Ahead:

- **US macro resilience**: A strong macroeconomic backdrop has extended uncertainty / volatility. Our economists still hold a mild recession call but have pushed out the timing of it to 1H '24 (see Resilient economy, higher policy rates, 14 June 2023). They now expect two additional Fed rate hikes in July and Sept. A strong economy and Fed hikes will keep nominal and real rates high + curve flat.
- **US banking system fragility**: We expected increased bank competition for funding with Fed QT & higher overnight rates. We did not expect large bank failures and emergency Fed lending. Banking concerns are likely to encourage the Fed to go slower, which reduces hard landing risk. Slower Fed = fewer cuts in '24.
- **UST long positioning is extended**: USTs appear to have already re-gained risk-off hedge value via stretched asset manager longs. We worry that a resilient economy could result in a reduction of these positions and result in soft longer-dated demand. Risk to cheaper USTs if demand is weak amidst growing bill and coupon supply.

Exhibit 1: UST duration overweight now exceed the April 2020 pandemic highs
US duration longs extend further in June versus May for a new post-2004 high



Source: BofA Global Research FX and Rates Sentiment Survey

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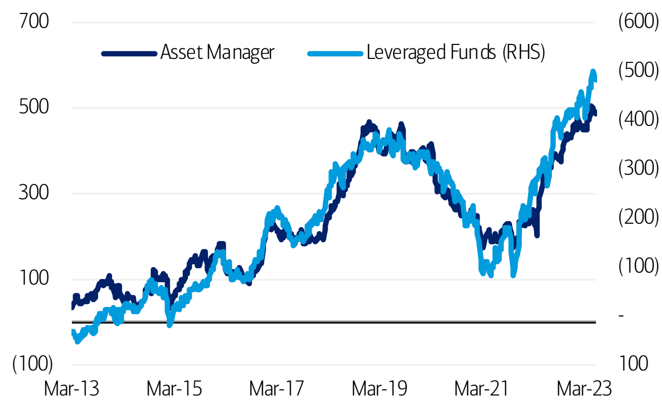
Exhibit 2: Asset manager and leveraged fund positioning (10y equivalent, $bn)
Asset manager longs correspond with leveraged fund shorts



Source: BofA Global Research, Bloomberg

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Key changes: forecast revisions & curve move

The lessons learned above have resulted in the following changes:

- **Forecasts**: We revise our front-end rate forecasts higher with more Fed hikes expected by our economists. We also nudge up our end '23 10Y forecast by 25bps to 3.5%, reflecting a longer period of macro resilience (Exhibit 3).

  In 2H23 our short rates forecasts are modestly above the forwards and above consensus; by early '24 our forecasts across the curve are below the forwards and consensus in line with our US economists' continued call for a mild recession and Fed cuts in '24. QT stops with cuts.

- **Curve**: We have lower conviction on the curve. The 2s10s curve is biased flatter near term with additional rate hikes but should quickly shift steeper with signs of labor moderation. Popular forward starting curve steepeners make positioning vulnerable. Any steepener is less risky in 5s30s vs 2s10s given additional Fed hike risk.

What we got right:

- **Duration**: US rates have largely been in a range during 1H '23. This is especially true for the 10Y between 3.25% and 4%. Clients that traded tactically with a bullish rate bias have likely done reasonably well. We hold this guidance in 2H23. We also recognize it may take longer for the range to shift lower vs our prior expectation.

- **Front end spreads**: We expected short-dated UST cheapening with bill supply wave after debt limit. We were early on this theme in late '22 (see: US front end in '23). Debt limit was resolved slightly earlier than we anticipated in late '22, but the overall supply, spread, and spread curve story was right.

Exhibit 3: US rate forecasts & changes

We revise rates higher, especially at the front end; most UST curves are also flatter vs prior forecast

	New Forecast (%)							Old Forecast (%)					Change				
	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	4Q25	3Q23	4Q23	1Q24	2Q24	4Q24	3Q23	4Q23	1Q24	2Q24	4Q24
2y Govt	4.50	4.25	3.85	3.50	3.25	3.00	3.00	3.75	3.50	3.25	3.00	2.75	0.75	0.75	0.60	0.50	0.25
5y Govt	4.00	3.90	3.65	3.45	3.25	3.15	3.15	3.45	3.40	3.25	3.10	3.00	0.55	0.50	0.40	0.35	0.15
10y Govt	3.60	3.50	3.40	3.35	3.30	3.25	3.25	3.35	3.25	3.25	3.25	3.25	0.25	0.25	0.15	0.10	0.00
30y Govt	3.80	3.75	3.70	3.70	3.70	3.70	3.70	3.55	3.40	3.40	3.45	3.50	0.25	0.35	0.30	0.25	0.20
2s10s	-0.90	-0.75	-0.45	-0.15	0.05	0.25	0.25	-0.40	-0.25	0.00	0.25	0.50	-0.50	-0.50	-0.45	-0.40	-0.25
5s30s	-0.20	-0.15	0.05	0.25	0.45	0.55	0.55	0.10	0.00	0.15	0.35	0.50	-0.30	-0.15	-0.10	-0.10	0.05
10s30s	0.20	0.25	0.30	0.35	0.40	0.45	0.45	0.20	0.15	0.15	0.20	0.25	0.00	0.10	0.15	0.15	0.20

Source: BofA Global Research

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Bottom line: US macro resilience, roll forward of recession timing, and more Fed hikes result in higher rates and a flatter curve path. We revise forecasts at the front end and only modestly at the back end. To trade, tactical duration longs are easier than curve at this stage of cycle. We prefer front-end underweights, long 10Y at or above 4%, 2Y spread carry, and vol normalization. UST supply / demand imbalance is a risk for cheaper USTs.

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EUR rates: defying gravity for a little longer

We raise our near-term euro rates forecasts and lower our long(er) term forecasts (Exhibit 4). We see 10Y German bonds at 2.25% in end-2023 and 1.90% in end-2024 (vs 2.20% previously on both dates). We also set the forecast at 1.60% for end-2025. The upward revisions to our near-term forecasts reflect risks of a higher terminal rate than what is priced in by the market and a later start to the cutting cycle. The downward revisions reflect our economists' inflation forecast falling below the European Central Bank's (ECB's) target in 2025. Renewed concerns regarding a de-anchoring of inflation to the downside may prompt a downward reassessment of neutral rates and long-term inflation expectations in the euro area, providing scope for further decline in rates.

Near term (next 2-3 months): bearish bias

For the next few months, we maintain a bearish bias, especially at the front-end, expect bear flattening pressures, and a cheapening of German bonds vs swaps due to:

- **Data.** Our economists showed hard economic data have been resilient even as soft data, such as manufacturing PMIs, signalled a serious contraction (Exhibit 5, and Europe Economics Weekly, 9-Jun-23). This means risks on economic activity are skewed to the upside, with consensus being too optimistic only for 2H24 onwards.
- **Inflation and ECB reaction function.** Near term, we think inflation will be sticky, with core prints still above 5% by the July meeting. Inflation is also expected to be above the ECB's inflation target at least through 2024. This may challenge the market's pricing of a 25bp rate cut by the ECB by April 2024.
- **Supply.** We forecast core supply to be elevated in 3Q 2023: net German supply will exceed €50bn, equivalent to one-third of Germany's annual net supply (Global Rates Weekly 26-May-23). This may be a challenge for the market to absorb as positioning is already long (FX & Rates Sentiment Survey, 9-Jun-23), while growth in the euro area and US remains firm and central banks including the Fed continue hiking.

Exhibit 4: BofA EUR rates forecast profile
We raise our near-term forecasts and lower our long(er) term forecasts

	Q3 23	Q4 23	Q1 24	Q2 24	YE 24	YE 25
3m Euribor	3.80	**3.90**	**3.80**	**3.60**	**3.20**	**2.20**
2y BKO	2.90	**2.65**	2.45	2.30	**1.90**	**1.40**
5y OBL	2.45	**2.15**	2.05	2.00	**1.75**	**1.50**
10y DBR	**2.40**	**2.25**	**2.15**	**2.10**	**1.90**	**1.60**
30y DBR	2.40	**2.40**	2.40	2.40	**2.25**	**2.00**
2y Euribor swap	3.60	**3.35**	**3.10**	**2.90**	**2.40**	**1.80**
5y Euribor swap	3.10	**2.80**	**2.65**	**2.50**	**2.15**	**1.80**
10y Euribor swap	**3.00**	**2.80**	**2.65**	**2.55**	**2.30**	**1.90**

Source: BofA Global Research

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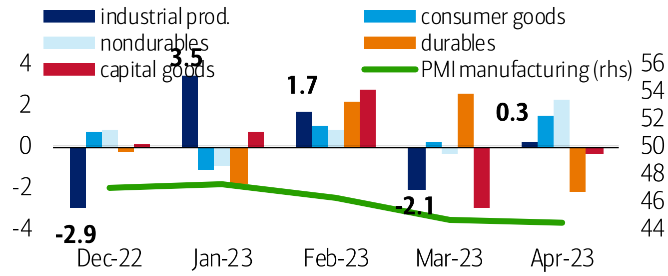
Exhibit 5: Germany: industrial production and PMI
Production is more resilient that tanking PMIs would suggest



Source: Destatis, S&P, BofA Global Research

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Medium term (4Q23 to 4Q24): evolving rally

We expect rates to rally after the terminal rates are reached. The pricing of cuts and slow grind lower in the market's view of neutral can put bull flattening pressures on the curve initially. As we approach delivery of the rate cut, the dynamics of the curve is expected to evolve to bull steepening, first in 2s10s and then in 2s5s. Our economists expect the first cut to be delivered only in Jun-24, and this, in part, explains why our forecast implies less steepening than what the market is pricing in 1y ahead (Exhibit 6).

We also expect 5y5y Euribor swaps to rally but by a lesser extent, reflecting inflation in that period still expected to be above target and growing term premia in the curve against the backdrop of ongoing quantitative tightening (QT). The availability of bond supply, supported by QT, also leaves us with a bias for further asset swap tightening.

For the periphery, very high demand from retail investors (see report: Retail flows into EGBs accelerating, but headwinds may appear 24 May 2023) vs limited net government bond supply (relative to core) can help justify the benign market reaction to the growth deceleration and tightening of monetary conditions. Expectations of a soft landing have also helped the periphery, like other risk assets. As inflation drops faster than policy rates in 2024, the narrative about a hard landing or a policy mistake may gather steam, weighing on risk sentiment, potentially pushing periphery spreads wider. Support from retail demand will also hinge on the outright yields.

Long term (2025): back to pre-COVID?

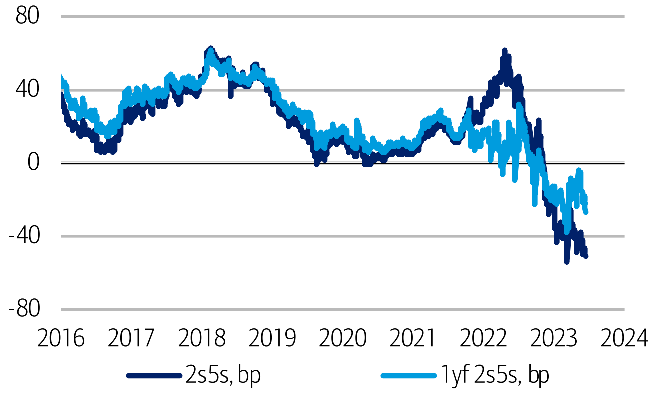
Our economists forecast inflation to fall to 1.5% in 2025, clearly below the ECB's target. In our view, this may prompt the 5y5y Euribor swap rate to fall towards 2%. In this environment, the market may also reassess the neutral rate for the euro area from the 2% that the ECB has been guiding us toward and to a lower level of between 1.25% and 1.75%. This may provide scope for further declines in rates, and is reflected in our 2y, 5y, and 10y swap forecasts for end-2025 being c. 100bp below the forwards.
There are two-way risks to our long-term view:

- Downside: A de-anchoring of inflation to the downside and repricing of neutral rates towards what was expected pre-COVID could drive the market to price cuts below 1% and take 5y5y Euribor swaps to 1.5% (Exhibit 7). 10y swaps would decline sub 1.5%. An even lower rate may be tested if the ECB considers restarting QE.

- Upside: Persistent inflation, with the ECB ready to tolerate it around 2.5%, could cause the trough in rates to be above 2% and 5y5y Euribor swaps stay above 2.5%. 10y swaps would stay above 2.5%, where they are when the ECB starts cutting.

Exhibit 6: 2s5s Euribor and 1yf 2s5s Euribor

Our forecasts imply 2s5s at -40bp by mid '24, i.e., steeper than spot but less so than what forwards point to



Source: BofA Global Research, Bloomberg

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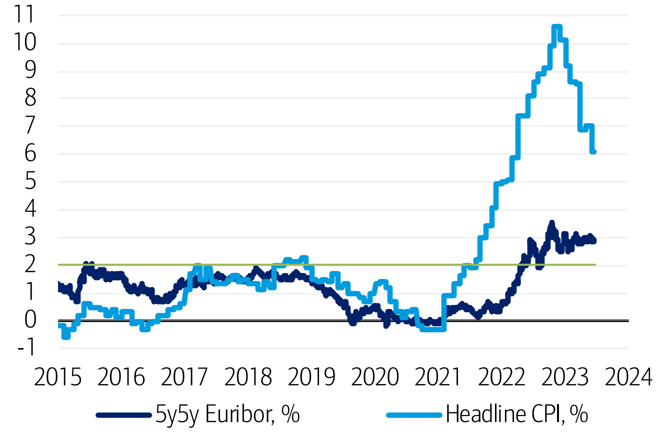
Exhibit 7: Headline CPI and 5y5y Euribor

Neutral rate may be reassessed downwards if inflation is below target again



Source: BofA Global Research, Bloomberg

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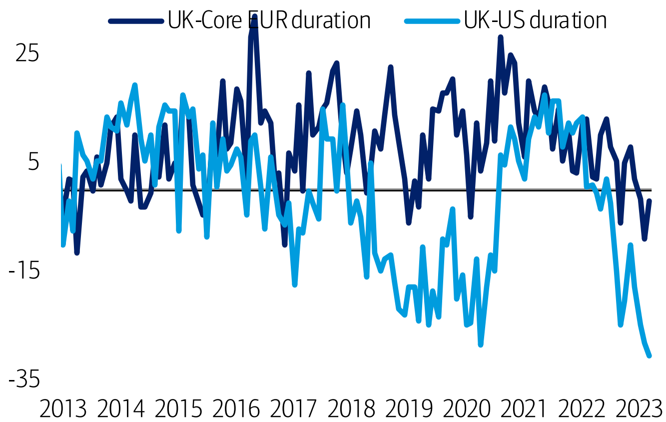
Maintaining a bearish bias

In our Year Ahead publication, we outlined our bearish bias in UK rates, relative to the forwards and other markets, emphasizing: (1) the increasing dependency on the kindness of strangers (the need for overseas investors to buy even more Gilts than they have been buying); (2) the negative feedback loop between an increasing shortfall in the Bank of England (BoE) Gilt portfolio and the deficit increasing losses crystalized on sales; and (3) what was then a burgeoning current account deficit with a deteriorating International Investment Position (IIP).

In Q1, UK rates fluctuated in a range and mostly in line with moves in the US. Q2 saw our expectations play out above and beyond, with 10y yield Gilts almost 1% higher outright and 65bp higher relative to 10y USTs since the end of March. We have revised our forecasts upwards several times since in light of these sharper-than-expected market moves. Investors appear to be short the UK cross market into Q3 (Exhibit 8) and BoE pricing is more hawkish than our forecasts (Exhibit 9), but we remain worried about Gilt underperformance. Near term, supply will remain an issue into Q3. Macro vulnerabilities will remain pronounced in both the near-and medium-term. And scope for Bank rate cuts to our forecast horizon seems more limited in the UK than elsewhere.

Exhibit 8: UK-Core Europe/US Duration Exposure
UK vs Core EUR, US Bull-Bear rates exposure spread



Source: BofA Global Research FX and Rates Sentiment Survey

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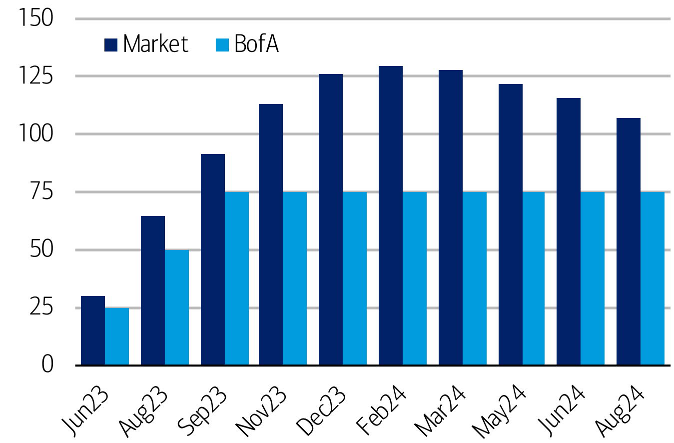
Exhibit 9: MPC-dated Sonia Bank Rate hike exp. vs. BofA f'casts, bp
Market pricing more than our own expectation



Source: Bloomberg, BofA Global Research

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10y Sonia at 4.5% in Q4 2023 and 4.25% in Q4 2024

As we approach H2 2023, our concerns remain the same and we maintain a bearish bias on UK rates. Our 10y Sonia yield forecasts of 4.5% for Q4 2023 and 4.25% for Q4 2024 are 20-30bp above the forwards (Exhibit 10 and Exhibit 11). A 25bp 10y Sonia rally that we have in our forecasts implies small underperformance vs. what we expect for the US.

2y Sonia at 5% for Q4 2023 and 4% for Q4 2024 is some 5-10bp below the forwards on average over the forecast horizon, reflecting our BoE base case scenario. Our Chief UK Economist, Rob Wood, expects three more 25bp Bank rate hikes by September and Bank rate remaining at that level until late 2024. We expect once per quarter easing in 2025.

In the near-term, monthly Gilt issuance will reach a peak in July, which is a material risk to Gilt yields during the quieter summer months. More long end supply in Q3 means more risk to be supplied relative to the previous quarter and limited scope for short-dated Gilt underperformance in the near term, although we pencil in some in late 2023 (we see it as likely that the Autumn Statement adds to the skew shorter in Gilt sales) and towards the end of the new fiscal year. Fiscal risks are high for 2024/25, we think.

Exhibit 10: BofA Gilt yield forecasts, %
10y Gilt to end 2024 at 4.5%

	Gilts		
	Q4 2023	Q4 2024	Q4 2025
Bank rate	5.25	5.00	4.00
2y	4.75	4.00	3.00
5y	4.25	3.75	3.25
10y	4.75	4.50	4.50
30y	5.25	5.00	5.00

Source: BofA Global Research

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Exhibit 11: BofA Sonia yield forecasts, %
10y Sonia to end 2024 at 4.25%

	Sonia		
	Q4 2023	Q4 2024	Q4 2025
3m Sonia	5.25	4.75	3.75
2y	5.00	4.00	3.00
5y	4.25	3.75	3.25
10y	4.50	4.25	4.25
30y	4.50	4.25	4.25

Source: BofA Global Research

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The case for retail 'discovering' Gilts is getting stronger

We approach the summer light on trade ideas, having just closed 1y forward 1s3s Sonia curve flattener at target (1y forward 1s3s Sonia flattener reaches target, 13 June). We closed a 2s20s ASW curve steepener a short while ago as Gilt supply will turn longer in Q3 (Rates – UK section of Hop, skip & a supply jump, 2 June). We see ASW flattening resuming later in the year.

In November, we noted that the tax efficiency of low coupon Gilts should attract retail interest, driving an RV wedge between neighbouring Gilts with different coupons. This was and remains accentuated in a post-QE environment of superabundant liquidity, where banks do not feel compelled to compete aggressively for retail term deposits. Note, we do not give tax advice and we do not give any investment advice for retail investors, and nothing in this note should be construed as such. Since we wrote in November, Gilt yields have risen substantially. The tax advantage goes up as yields rise, so we think it's worth reiterating:

- Sell UKT 4.125% 2027 Gilt vs. UKT 0.125% 2028 (Will retail discover Gilts? A little bit complicated maybe, but not too taxing 10 November 2022). Entry: 1.8bp (ois z-spread basis). Current: -13bp. Target: -25bp. Stop: +12bp. Risk to the trade is that the new Gilt accrues a strong benchmark premium.

Playing for inflation persistence

It has become a consensus view that the UK has an inflation problem that is distinctly worse than its developed market peers. That is apparent in the inflation numbers themselves, which have repeatedly surprised to the upside, and in wage data (with private sector regular pay accelerating to 7.9% in April), resulting from a tight labour market.

Our preference to be long breakevens is now restricted to the ultra-long end of the curve. Here, we see additional value in the convexity contribution, and from the fact that although net issuance is very large in Gilts overall, this fiscal year, this is not the case for linkers (with a large redemption late in the year).

Our bigger play on inflation persistence as a problem is in real yields. A lot of the inflation is priced in the inflation curve, but not the required tightness in monetary policy (prospective real policy rates) to tackle it, we would argue. We therefore argue for paying forward real rates beyond a four- to five-year horizon.

Australia

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Behind the curve

Since our last update to the forecast three months ago, the RBA has delivered two surprise hikes. The central bank's hawkish turn has fuelled a sell-off in rates and we have upgraded our forecasts for yields over the next few quarters. We also now forecast a more aggressive rally from the first quarter of 2024 as growth concerns mount and the RBA moves to cut policy rates by year-end (Exhibit 12).

The outlook for year-end 2024 remains the same, but we now see much higher yields in the belly of the curve in H2 23 but forecast a more aggressive rally from Q1 24 as investor concerns shift from inflation to growth.

Exhibit 12: New forecasts – cheaper rates in 2023, sharper rally in 2024
Hard landing looks more likely as terminal cash rates reprice higher

	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q4 25
2y	4.3	4.1	3.3	2.8	2.5	2.25	2.5
5y	3.9	3.8	3.4	3.0	2.75	2.50	2.25
10y	3.7	3.6	3.5	3.2	3.0	2.75	2.5
30y	3.8	3.7	3.6	3.5	3.4	3.25	3.0

Exhibit 12: New forecasts – cheaper rates in 2023, sharper rally in 2024
Hard landing looks more likely as terminal cash rates reprice higher

	Q3 23	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q4 25

Source: BofA Global Research, Bloomberg

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Fade the soft landing in 2023, buy duration for 2024

The risk of a hard landing is growing, and we like long duration trades at these levels. 2y ACGBs have cheapened more than 100bps in two months and our macro framework suggests the belly of the curve should rally from here (see Global Rates Weekly: Commonwealth Surprise 09 June 2023, p11). Yet the RBA's slower pace of hikes in 2022/23 has meant that cash rates are still more than 100bps lower than in the US and NZ, and more than 50bps below the UK and Canada.

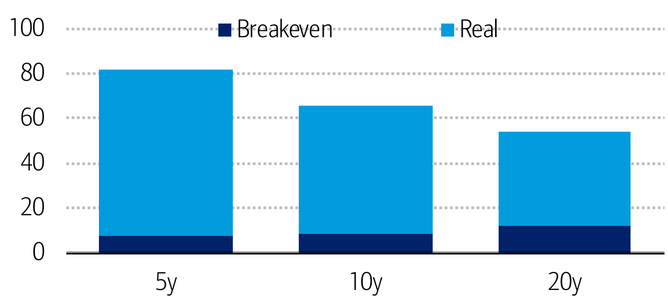
We see further cheapening in the belly of the curve as likely in the near term given that the RBA has shifted its focus from preserving gains in the labour market to tackling inflation expectations and preventing a premature easing of financial conditions. On the flipside, breakevens have remained well contained during this rally, leaving real rates to lead the cheapening of nominal bonds over the past 90 days (Exhibit 13).

Even though we see the curve as likely to flatten further over the coming months, it is difficult to say with certainty when investors will start pricing in the end of the cycle by adding curve steepeners, so the risk/reward of the trade is less asymmetric than we would like. Given that the 3s10s curve has flattened significantly and steeper forwards align with our forecast for a more aggressive rally in 2024, we prefer adding duration as a way to position for a higher probability of a hard landing in 2024 (Exhibit 14).

Overshooting neutral

The neutral rate is the cash rate at which RBA policy is neither accommodative nor tight. As Assistant RBA Governor Luci Ellis notes, short-run and long-run neutral rates can diverge (see The Neutral Rate: The Pole-star Casts Faint Light, 12 October 2022). We estimate neutral cash rates by using global term premia and local bond yields to solve for 5y5y forward rates. While this approach results in a more volatile estimate of neutral rates, it is useful at the end of a cycle when the RBA is attempting to engineer sufficiently restrictive policy. This method suggests the neutral cash rate is around 4%, which means the RBA has now entered restrictive territory (Exhibit 15).

Exhibit 13: Real rates have led cheapening of nominals over past 90d
Lower real rates in 2024 likely to lead to richer duration, in our view



Source: BofA Global Research, Bloomberg

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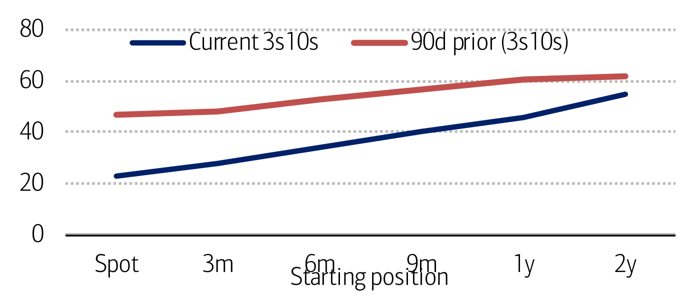
Exhibit 14: Market now pricing a more aggressive steepening
3s10s likely to steepen as cycle matures



Source: BofA Global Research, Bloomberg

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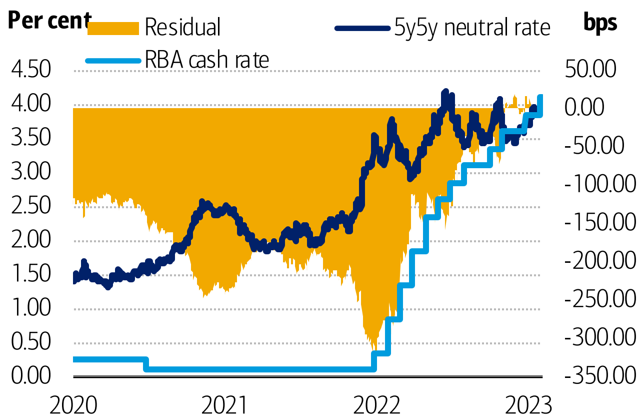
The RBA has been roughly in line with neutral rates in 2023 but hiking cycles usually do not conclude until the RBA has meaningfully overshot neutral. At the end of the hiking cycle in 2011, the cash rate overshot 5y5y neutral rates by as much as 77bps, with an average of around 30bps for the period that the RBA was on hold (Exhibit 16). In 2002-08, the overshoot was closer to 100bps.

We see the speed of this cycle as a reason to expect a lower overshoot. Our economists see at least one more hike before the end of the cycle with the next rate increase pencilled in for July. OIS markets are also pricing a terminal of around 4.5%, suggesting an overshoot roughly in line with the 2011 cycle. Given that terminal rates are not too far from current levels, adding duration looks attractive at these levels.

Exhibit 15: Neutral cash rate around 4%
RBA is slightly above neutral but probably needs to overshoot



Source: BofA Global Research, Bloomberg

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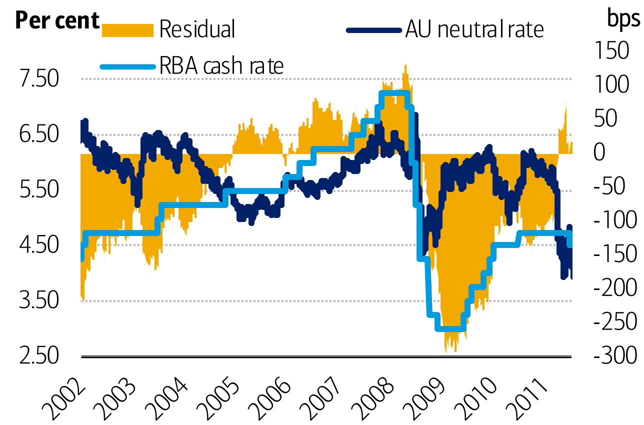
Exhibit 16: Overshooting of c. 30-80bps required in previous cycles
RBA usually adopts a restrictive policy at the end of the cycle



Source: BofA Global Research, Bloomberg

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QT risk unlikely to lead 10y yields significantly higher

A potential active quantitative tightening (QT) program, which we forecast to begin in October, is likely to weigh on long-duration bonds and presents a risk to our forecast for richer 10y bonds (see Australia Rates Viewpoint: Ready to receive: receive 10y swap EFP as RBA mulls bond sales 17 May 2023). The exact impact of active QT (bond sales) on yields is difficult to estimate, especially given that the RBA's pandemic-era bond purchases were more concentrated in shorter tenors than comparable central banks. However, a Bank for International Settlements paper published last week suggests USD 215bn of QT should increase long-term yields by 10bps. The RBA only holds around USD 180bn (AUD 270bn) of ACGBs and they will not dispose of them all at once, which suggests a QT program is unlikely to be significant driver of price action.

Japan

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In thrall to BoJ policy changes

Despite considerable uncertainty, we expect supply-demand factors to remain the main driver of the JGB market through end-2024, with upward pressure on yields. Our view reflects the uptrend in JGB issuance by the Ministry of Finance (MoF) in line with the Japanese government's loose fiscal policy, and the potential for the Bank of Japan (BoJ) to begin normalizing monetary policy as early as within FY23. Our 10yr JGB yield forecasts are 0.70% at end-2023 and 0.80% at end-2024 (Exhibit 17).

Exhibit 17: BofA JGB yield forecasts
Forecast 0.70% at end-2023, 0.80% at end-2024

(%, EOP)	23Q3	23Q4	24Q1	24Q2	24Q3	24Q4	25Q4
2y Govt.	0.05	0.00	-0.05	-0.05	0.20	0.20	0.30

Exhibit 17: BofA JGB yield forecasts
Forecast 0.70% at end-2023, 0.80% at end-2024

(%, EOP)	23Q3	23Q4	24Q1	24Q2	24Q3	24Q4	25Q4
5y Govt.	0.40	0.35	0.25	0.25	0.50	0.50	0.60
10y Govt.	0.80	0.70	0.60	0.60	0.80	0.80	0.90
20y Govt.	1.25	1.10	1.00	1.00	1.15	1.15	1.25
30y Govt.	1.50	1.35	1.20	1.20	1.35	1.35	1.40
40y Govt.	1.65	1.50	1.35	1.35	1.50	1.50	1.55
2y Swap	0.20	0.15	0.05	0.05	0.30	0.30	0.35
5y Swap	0.45	0.40	0.30	0.30	0.60	0.60	0.65
10y Swap	0.85	0.80	0.65	0.65	0.90	0.90	0.95

Source: BofA Global Research

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Monetary policy: Expect YCC/NIRP exit in mid-2024

Our Japan economists expect the BoJ to shorten the target maturity for YCC (yield curve control) from ten years to five at its July 2023 monetary policy meeting (MPM), and do not expect it to exit YCC or NIRP (negative interest rate policy) until mid-2024 (for details, see Japan Watch: BoJ review: Continuity and difference 28 April 2023). As we discuss below, MOF's JGB issuance is increasing, and a change in BoJ policy would likely drive higher JGB yields.

Two-step process: YCC changes, followed by exit

If the BoJ adjusts and then discontinues YCC in line with our forecasts, we would expect yields to rise mainly for the 10yr and shorter maturities that make up a relatively high percentage of the BoJ's holdings. However, as we discuss below, the BoJ's forward guidance includes a policy of expanding the monetary base, and we would not expect it to drastically reduce JGB purchases even if it adjusts or abandons YCC as per our forecasts. Past statements by former Governor Haruhiko Kuroda and the BoJ's Financial System Report suggest that the BoJ may favor a steep curve, and we expect purchases of 10yr and shorter maturities to remain relatively high even after it adjusts YCC (although there is considerable uncertainty about this).

No rate-hiking cycle

We expect the BoJ to return its target for financial market operations to a short-term interest rate of 0-0.1% in mid-2024, in other words ending its negative interest rate policy in summer 2024. However, Japan's relatively low inflation makes a string of rate hikes by the BoJ unlikely at this point, in contrast to other major countries and regions, and we would not expect excessive bear-flattening of the JGB curve.

JGB purchases depend on changes to forward guidance

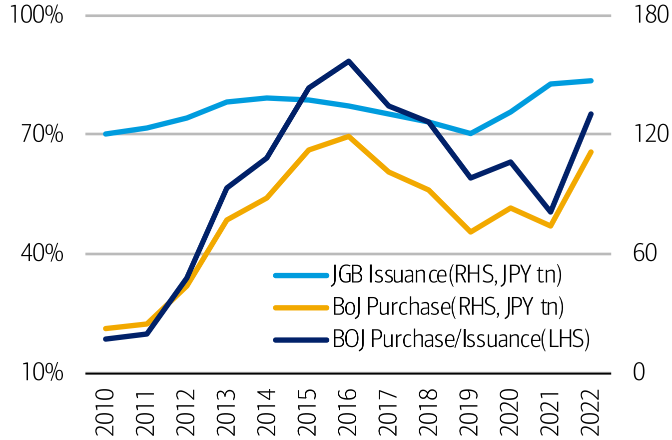
We expect the BoJ to maintain a milder form of QE over the longer term even after it exits YCC and NIRP, and view forward guidance as the key point in gauging its future JGB purchases. The BoJ maintained forward guidance indicating its policy of expanding the monetary base in its April MPM statement[1]. Roughly ¥6.5tn in JGBs held by the BoJ are scheduled for redemption each month from July through end-March 2024, and ¥5.4tn from April 2024 through end-March 2025 (Exhibit 19). It will therefore need to continue purchasing around ¥6-7tn per month unless it revises its forward guidance[2] (for details, see Japan Rates Watch: Expect only limited reduction in BoJ purchases after YCC adjustment 11 May 2023).

The BoJ announced at its April 2023 MPM that it will conduct a broad-perspective review of its monetary policy over the next 12-18 months (to be completed in Apr-Oct

[1] *"The Bank commits to continuing to expand the monetary base until the year-on-year rate of increase in the observed CPI exceeds 2 percent and stays above the target in a stable manner."*
[2] The BoJ bought ¥8.0tn in April and ¥7.4tn in May.

2024). While this could lead it to revise or discontinue its current forward guidance, visibility remains poor.

Exhibit 18: JGB issuance and BoJ purchases
Recent rise in BoJ buying as percentage of issuance



Source: Ministry of Finance, Bank of Japan, BofA Global Research

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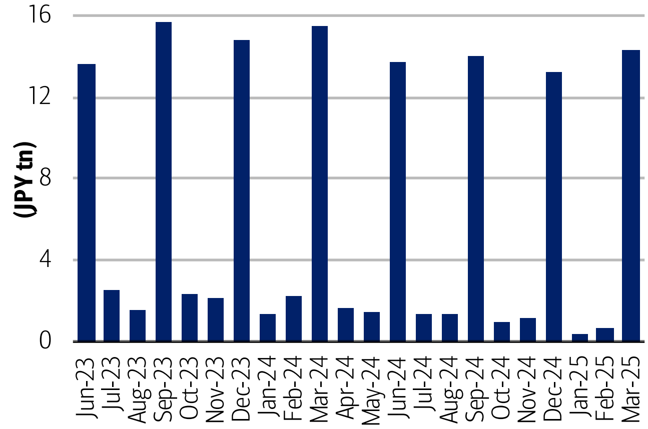
Exhibit 19: Scheduled redemptions of JGBs held by BoJ
Roughly ¥6.5tn in monthly redemptions planned for FY23



Source: Bank of Japan, Bloomberg, BofA Global Research

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JGB issuance: Government to maintain loose fiscal policy

MoF's JGB issuance has trended upward since the start of the pandemic, setting new records of ¥145.7tn in 2021 and ¥147.3tn in 2022 (Exhibit 18). The government's 2021 Basic Policy targeted a primary balance surplus for both the central and local governments in FY25, although this was an unrealistic goal. The 2022 Basic Policy referred to efforts to achieve fiscal consolidation, but dropped any mention of the specific timing. We expect the Japanese government to maintain its loose fiscal policy, and think a move by the BoJ to normalize monetary policy would drive up JGB yields.

Appendix: Common acronyms

Exhibit 20: Common acronyms/abbreviations
This list is subject to change

Acronym/Abbreviation	Definition	Acronym/Abbreviation	Definition
1H	First Half	Jan	January
2H	Second Half	Jul	July
1Q / Q1	First Quarter	Jun	June
2Q / Q2	Second Quarter	lhs	left-hand side
3Q / Q3	Third Quarter	m	month
4Q / Q4	Fourth Quarter	MA	Moving Average
ann	annualized	Mar	March
APP	Asset Purchase Programme	MACD	Moving average convergence/divergence

Exhibit 20: Common acronyms/abbreviations

This list is subject to change

Acronym/Abbreviation	Definition	Acronym/Abbreviation	Definition
Apr	April	MBM	Meeting-by-meeting
AS	Austria	mom	month-on-month
Aug	August	Mon	Monday
BdF	Banque de France (Bank of France)	MPC	Monetary Policy Committee
BE	Belgium	MWh	Megawatt-hour
BEA	Bureau of Economic Analysis	NGEU	NextGenerationEU
BLS	Bank Lending Survey	NE	Netherlands
BoE	Bank of England	Nov	November
BofA	Bank of America	NRRP	National Recovery and Resilience Plan
BoI	Banca d'Italia (Bank of Italy)	NSA	Non-seasonally Adjusted
BoJ	Bank of Japan	OAT	Obligations assimilables du Trésor
BoS	Banco de España (Bank of Spain)	OBR	Office for Budget Responsibility
bp	basis point	Oct	October
BTP	Buoni Poliennali del Tesoro	OECD	Organisation for Economic Co-operation and Development
Buba	Bundesbank	ONS	Office for National Statistics
c	circa	p	preliminary/flash print
CA	Current Account	PBoC	People's Bank of China
CPI	Consumer Price Index	PEPP	Pandemic Emergency Purchase Programme
CSPP	Corporate Sector Purchase Programme	PMI	Purchasing Managers' Index
d	day	PSPP	Public Sector Purchase Programme
GE	Germany	PT	Portugal
Dec	December	QE	Quantitative Easing
DS	Debt sustainability	qoq	quarter-on-quarter
DXY	US Dollar Index	QT	Quantitative Tightening
EA	Euro area	RBA	Reserve Bank of Australia
EC	European Commission	RBNZ	Reserve Bank of New Zealand
ECB	European Central Bank	rhs	right-hand side
ECJ	European Court of Justice	RPI	Retail Price Index
EFSF	European Financial Stability Facility	RRF	Recovery and Resilience Facility
EGB	European Government Bond	RSI	Relative Strength Index
EIB	European Investment Bank	SA	Seasonally Adjusted
EMOT	Economic Mood Tracker	SAFE	Survey on the access to finance of enterprises
EP	European Parliament	Sat	Saturday
SP	Spain	Sep	September
ESI	Economic Sentiment Indicator	SMA	Survey of Monetary Analysts / Simple moving average
ESM	European Stability Mechanism	SNB	Swiss National Bank
EU	European Union	SPF	Survey of Professional Forecasters
f	final print	Sun	Sunday
Feb	February	SURE	Support to mitigate Unemployment Risks in an Emergency
Fed	Federal Reserve	S&P	Standard & Poor's
FR	France	Thu	Thursday
Fri	Friday	TLTRO	Targeted Longer-term Refinancing Operations
GC	Governing Council	TPI	Transmission Protection Instrument
GDP	Gross Domestic Product	TTF	Title Transfer Facility
GNI	Gross National Income	Tue	Tuesday
GR	Greece	UK	United Kingdom
HICP	Harmonised Index of Consumer Prices	US	United States
HMT	His Majesty's Treasury	UST	US Treasury yield
IMF	International Monetary Fund	WDA	Work-day Adjusted
INSEE	National Institute of Statistics and Economic Studies	Wed	Wednesday
IP	Industrial Production	y	year
IR	Ireland	yoy	year-on-year
PCA	Principal Component Analysis	ytd	year-to-date
IG	Investment Grade	DV01	Dollar value of a one basis point change in yield
IT	Italy	WAM	Weighted Average Maturity

Source: BofA Global Research

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