Liquid Insight

BoJ preview: Are we there yet?

27 July 2023

Rates and Currencies Research
Global

Key takeaways

- Speculation of YCC changes at the July MPM have lingered. We expect a hold, but the decision may not be unanimous.
- FX/Rates:YCC tweak = not tightening signal, not USD/JPY lower; JPY rates could fall sharply if the BoJ stands pat in July.
- Equity: Risk-reward skewed to the upside following the Jul MPM; market focus will shift to Apr-Jun earnings season.

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

Chart of the day: Major scenarios for July 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	JGB 10yr	JGB 30yr	FX USD/JPY	Equity TOPIX
Jul base case	Unchanged	5bp	35bp	125bp	143 >	Rise up to 1% Value exporters outperform
Risk scenario	Unchanged + vote split	15bp	50bp	135bp	Unchanged	Unchanged
Risk scenario	YCC 10yr ceiling raised to 1%	30bp	70bp	145bp	Fall to 137-139 initially. but quickly recover to 140	Initially dip 1-2%, then quickly recover; Banks and lifers slightly outperform
Risk scenario	YCC target shortened from 10yr to 5yr or 2yr	40bp	75bp	150bp	Fall to 136-138 initially. but quickly recover to 139-140	Initially dip 1-2%, then quickly recover; Banks and lifers slightly outperform
Tail risk	Remove YCC, move to flexible QE	50bp	80bp	155bp	Fall to 132-134 initially, but recover to 134-136 over time	Drop 3-5%; Defensive & financials outperform

Source: BofA Global Research
Spot ref as of July 25: USD/JPY 141.42、 TOPIX 2,282.4、 10yr JGB 0.46)

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A "live" BoJ meeting, but we expect a hold

The BoJ will release its next policy decision this Friday, 28 July. We expect the policy board to maintain its key policy settings, including the 0.0% +/-50bp target for the 10yr yield JGB yield, as detailed in our earlier report (see BoJ Watch: Cautious BoJ to bide more time to tweak YCC, 10 July 2023).

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Based on Bloomberg's July BoJ Survey (conducted 12-18 Jul) and BofA's latest Rates Sentiment Survey (conducted 7-12 July), around 20% of analysts and investors expect the BoJ to tweak YCC this month, making this a "live" meeting. Market expectations for policy change at the July MPM fell, following dovish comments from Governor Ueda at the 28 June ECB Sintra forum (Exhibit 1). However, speculation of policy adjustments were re-kindled following a strong May wage print (see Steady uptrend in macro wages, 7 July 2023) and the 7 July publication of a Nikkei Shimbun Interview with deputy governor Uchida.

Market participants focused on Uchida's comment that, in considering adjustments to Yield Curve Control, the BoJ will "make a balanced decision with an eye on how to effectively maintain monetary easing while being mindful of [the impact on] financial intermediation and market functioning." The timing of the interview, coupled with Uchida's repeated reminder that the BoJ "would not be able to provide a 'definitive' answer for upcoming policy decisions in advance," has led some investors to speculate that his comments were a subtle nod to YCC adjustments at the July policy meeting.

Ueda dowses the fire at the G20 meetings

We are, however, somewhat skeptical of the view that Uchida's comments were intended as a subtle signal for immediate policy changes (i.e. at the July MPM).

First, Uchida's comment on the BoJ's intention to strike the right "balance" between YCC's easing effects and its side effects is largely in line with earlier remarks by Governor Ueda (see Cautious BoJ to bide more time to tweak YCC, 10 July 2023).

Second, Governor Ueda's subsequent remarks at the sidelines of the 17-18 July G20 Finance Ministers and Central Bank Governors meeting suggest that, in the eye's of the BoJ leadership, the "balance" between Japan's economic/inflation fundamentals and YCC side effects has not shifted to the point of requiring immediate policy changes.

Though the Governor did not close the door to potential policy adjustments, re-iterating the fact that the BoJ evaluates its policy settings at every MPM, taking into account new information that comes in from one meeting to the next, he noted that his own assessment of bond market functionality had "not changed significantly since the time of the April and June monetary policy meetings" (Exhibit 1). Meanwhile, on the fundamentals, he continued to cite considerable uncertainty in the outlook for overseas economies even as he acknowledged the on-going resilience in US data.

We think the relatively sanguine remarks on YCC's side effects, in particular, were designed to temper speculation of YCC adjustments at the July policy meeting which had resulted from the market's potential misreading of the 7 July Uchida interview.

Exhibit 1: Key comments from the BoJ leadership since end June
Investors' interpretation of recent BoJ communications has been mixed, resulting in market volatility

Date	Speaker	Format	Quote	Source
28-Jun	Gov. Ueda	ECB Sintra Forum Panel Discussion	"We have a forecast or projection of the inflation path that looks like it's going to go down for a while toward the end of this year on a decline in import prices...and from there on, we are forecasting some increase in the rate of inflation into 2024. But we are less confident about the second part. If we become reasonably sure that the second part is about to happen, that could be a good reason for policy change."	BofA transcription of forum recording
7-Jul	Dep. Gov. Uchida	Nikkei Shimbun Interview	"We are currently focused on how to continue easing effectively while being mindful of the impact on financial intermediation and market functioning. If adjustments to Yield Curve Control are followed by a move towards an exit, we might look back and say that was the first step, but this is just hindsight. We will continue with Yield Curve Control in order to maintain monetary easing. As for any adjustments [to YCC], we want to make a balanced decision with an eye on how to effectively maintain monetary easing while being mindful of [the impact on] financial intermediation and market functioning."	BofA translation of Japanese Nikkei Q&A transcript
16-Jul	Gov. Ueda	Comments at sidelines of G20	"Since last year, the US and global economy have begun to slow due to high inflation and central bank's subsequent monetary tightening. However, since the beginning of this year, some would argue that the slowdown hasn't been as significant as expected. Nevertheless, there is a high degree of uncertainty about what will happen in the future." "My assessment of the bond market's functionality has not changed significantly since the time of the April and June monetary policy meetings. Overall, some decline in functionality, such as reduced liquidity, can be observed, but the distortions once seen in the yield curve have eased considerably."	BofA translation of quote cited by NHK*
18-Jul	Gov. Ueda	Comments at sidelines of G20	"First and foremost, our view is that there is still a distance until sustainable and stable 2% inflation is achieved. Based on this understanding, we have been patiently continuing with monetary easing under Yield Curve Control while being mindful of the impact on financial intermediation and market functioning. Of course, we evaluate the premise [that there is a distance to sustained 2% inflation] at every policy meeting, and we will revisit and re-assess our policy stance should our outlook change. However, I would like to state that if our assumption [that sustained achievement of 2% inflation remains distant] is unchanged, our overall narrative on monetary policy remains unchanged."	BofA translation of Japanese BoJ press conference transcript

Source: BofA Global Research, ECB, Nikkei Shimbun, NHK, Bank of Japan; *The BoJ did not provide an official transcript of this press conference so we used the direct quotes cited by national broadcaster NHK.

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Outlook report: Will the FY24 f'casts show 2%+ inflation?

Of course, even if the BoJ did not consider the side effects of YCC to be pressing, it could still justify an adjustment to policy based on improved "fundamentals."

On this point, Bloomberg reported on 24 July that the BoJ policy board's median Japan-style core (CPI ex fresh food) inflation projection for FY23 may be upgraded sharply, to +2.5% YoY in the upcoming Outlook Report, from the April projection of +1.8% (figures are FY averages), citing unnamed BoJ "sources" (Exhibit 2). However, such an upgrade is not surprising considering how stale the BoJ's projections were relative to the dataflow (Apr-Jun '23 average Japan-style core inflation was +3.3%) and our own forecasts (see June CPI: Lower than expected on special factors, but high inflation to persist, 30 June 2023).

Moreover, Governor Ueda has repeatedly said that changes to policy (including adjustments to YCC) hinge on the BoJ's forecasts for, and confidence in, the inflation outlook 6-18 months ahead (see Cautious BoJ to bide more time to tweak YCC, 10 July 2023). Governor Ueda has also said that the BoJ's assessment for the medium-term inflation outlook is based on an assessment of various factors that shape prices, "such as the output gap, inflation expectations, and wage growth, as well as considering anecdotal evidence from firms."

As we discussed in our earlier report, all of these indicators are generally moving in the right direction but do not provide a slam-dunk case for a July YCC move based on the fundamentals. We thus think that the BoJ's FY24 Japan-style core inflation projection will be largely unchanged from its April projection of 2.0%, if not slightly downgraded due to the unfavorable base effects established by its higher FY23 forecasts. The lack of conviction in the sustainability of 2% inflation in FY24 would be consistent with Governor Ueda's Sintra remarks.

Exhibit 2: BoJ Policy Board median CPI projections vs. consensus
The BoJ is almost certain to upgrade its FY23 CPI projection sharply, but FY24 outlook more important

	CPI ex fresh food			CPI ex FF & energy		
CY	BoJ (4/28)	BBG (7/12)	BofA (5/27)	BoJ (4/28)	BBG (7/12)	BofA (5/27)
2023	--	3.0	3.1	--	3.6	3.6
2024	--	1.7	2.7	--	1.7	2.0
2025	--	1.5	1.6	--	1.6	1.8
FY						
2023	1.8	2.6	3.0	2.5	3.3	3.5
2024	2.0	1.6	2.2	1.7	1.5	1.8
2025	1.6	1.5	1.6	1.8	1.6	1.8

Source: Bank of Japan

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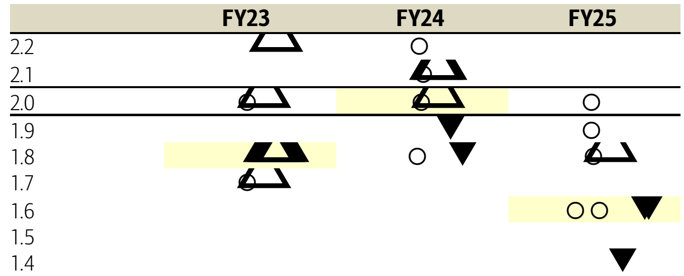
Exhibit 3: BoJ April '23 CPI ex Fresh Food forecasts
Policy Board Members' Forecasts and Risk Assessments



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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What to watch: Will Friday's vote be unanimous?

If the BoJ keeps YCC unchanged this week, as we expect, there are still a few things to keep an eye on.

First, in addition to the pinpoint forecasts for FY23-25 GDP and inflation, we will be paying attention to the policy board's assessment of risks around these projections.

Since the beginning of the year, the BoJ has cited "uncertainties" around the growth and inflation outlook as a reason to maintain its aggressive easing stance. As Governor Ueda explained in his post-June MPM press conference, some of the ways in which the BoJ communicates its assessment of uncertainties around the outlook include 1) its chart showing the risks around each policy board members' projections; and 2) its examination of upside risks and downside risks related to the economy and prices in the Outlook Report. A potential easing in the board's assessment of downside risks, particularly around FY24 inflation, would signal that the BoJ is moving closer to policy adjustment.

Hawkish dissent could keep speculation of near-term YCC adjustments alive

Perhaps of greater importance for markets will be the margin of Friday's vote.

Since the departure of former policy board members Takehiro Sato and Takahide Kiuchi, in July 2017, there has been no hawkish dissent on the vote for policy rate settings. Though not our base case, we would not be surprised if Friday's decision saw at least one member of the 9-person BoJ policy board voting against maintaining the status quo on Yield Curve Control.

The April Outlook Report showed that one board member already sees Japan-style core inflation averaging 2% or higher throughout the entirety of the BoJ's forecast horizon from FY23-25 (Exhibit 3). Meanwhile, the Summary of Opinions for the 16 June MPM showed one board member stating that "a revision to the treatment of yield curve control should be discussed at an early stage," citing its deteriorating cost-benefit trade-offs.

Asked about the increasing "uniformity" of BoJ decisions by a lawmaker in his 27 February Upper House confirmation hearings, Governor Ueda stated: "I believe it is essential to allocate ample time for discussions among policy board members and facilitate a vigorous exchange of opinions."

With recent inflation data sparking a healthy debate at the BoJ over the outlook for policy, relatively "hawkish" members of the BoJ board, such as former mega bank executive Naoki Tamura, may begin registering their dissent.

Further evidence of a split on the BoJ board over YCC could keep speculation of future policy adjustments alive and could potentially prevent the strong JGB rally that the BofA rates strategy team expects on a unanimous no change decision, especially in the short-term (see Chart of the day for potential July MPM scenarios and our strategists' expectations for the market reaction).

- Izumi Devalier & Takayasu Kudo, Economists

Rates: Possible strong JGB rally if BoJ stands pat

As noted above, the BoJ is expected to maintain its current monetary policy at its 27-28 July MPM. As our most recent FX and Rates Sentiment Survey indicates that global investors' JPY rate positions remain skewed toward short durations (see FX and Rates Sentiment Survey: Getting a long isn't easy 2023-07-14), there probably is considerable need for short-covering. In addition, since the next Outlook Report will not be released at the September MPM, investors likely assume that any policy revisions are more likely to be made at the October MPM than at this month's meeting. Accordingly, if the BoJ maintains its current policy, as our economists expect, the post-MPM fallback in JPY rates could be greater than after recent meetings while a vote split may prevent the potential strong JGB rally after the July MPM.

However, we still cannot rule out the possibility of a surprise YCC revision. While such a revision at the July MPM is not the consensus view, any surprise hawkish tweaks in the BoJ's monetary policy at the July meeting would likely put some strong upward pressure on JPY rates. That said, considering the BoJ's policy of expanding the monetary base and the need to curtail attacks on its YCC, we think it is unlikely to reduce its bond purchasing operation and expect the JGB purchase schedule to be announced at 5pm on 28 July to look the same as the previous schedule.

- Tomonobu Yamashita, Rates Strategist

FX: YCC teak = not tightening signal, not USD/JPY lower

One of the most frequent questions we have been asked is the impact of the BoJ's potential YCC tweak or removal on JPY. Our view has been that it would not be a game changer as a YCC tweak is unlikely to signal a proper tightening cycle (see: BoJ's one-off policy tweaks may unleash yen-carry trade 27 February 2023). Looking at the pricing in the yen rates market, this view appears to be consensus by now.

As the JGB market softly tested YCC's 10yr ceiling at 0.5% around mid-Jul, we made two observations (Exhibit 4): (1) the 10yr swap rate only touched 0.7% vs 1% in Jan and (2) the reaction in the front-end was muted. We think this is due to a combination of:

- The Fed getting closer to the final hike (less upward momentum in global rates)
- Pent-up demand for JGBs by domestic institutions for FY23
- The BoJ governor Kazuo Ueda's patient stance

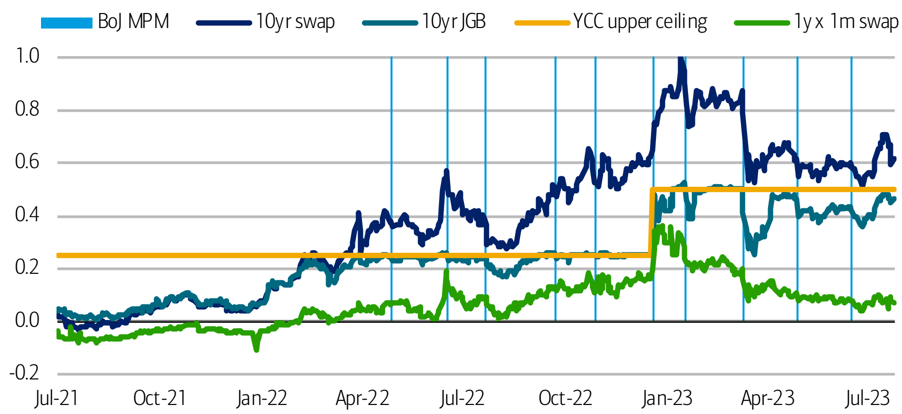
While this time may be different for Japanese inflation, the BoJ can still be credibly dovish on the front-end as the market appears to understand Ueda's patient stance and his lack of strong conviction for sustainable inflation. We think any JPY rally after the BoJ's potential YCC tweak would be short-lived as the BoJ would likely strike a dovish guidance on the front-end and policy uncertainty could even decline as there is not much the BoJ can do in the short-term.

Trading BoJ MPM with high hurdle for FX intervention

We previously noted that the government's tolerance level for the weak yen may be higher this year than in 2022 as the weak yen may be accompanying more benefits (see: Japan Viewpoint: Yen weakness in '22 = headache for MoF; Yen weakness in '23 = tailwind for BoJ 07 June 2023). But this may also be true that it will be equally more difficult to justify and explain FX intervention to the international community when the economy and equity market are doing so well. We think the right tactical approach to USD/JPY into the BoJ MPM is to trade 138-142 range (more broadly 135-145). In our base case, the BoJ would hold in the Jul MPM and carry will push JPY weaker and we expect USD/JPY to rise to 147 by Sep.

Also, see: JPY – key themes before BoJ MPM and for summer 24 July 2023

Exhibit 4: YCC tweak may be a non-event for JPY
10yr swap rate increase limited and expectations for front-end largely unchanged



Source: BofA Global Research, Bloomberg

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- Shusuke Yamada, FX/Rates Strategist

Equity: Risk-reward skewed to the upside; focus shifting to Apr-Jun earnings

We believe the risk-reward balance regarding equities following the Jul BoJ MPM could be skewed to the upside. In our base case, reconfirming Governor Ueda's patient/ dovish stance could signal a green light for investors' risk appetite, with focus likely shifting to Apr-Jun earnings. In a risk scenario involving YCC adjustment (note this is our base case in October), we believe the near-term knee-jerk market selloff (down 1-2% for TOPIX) could provide dip-buying opportunities (also see T-minus bubble 20 July 2023).

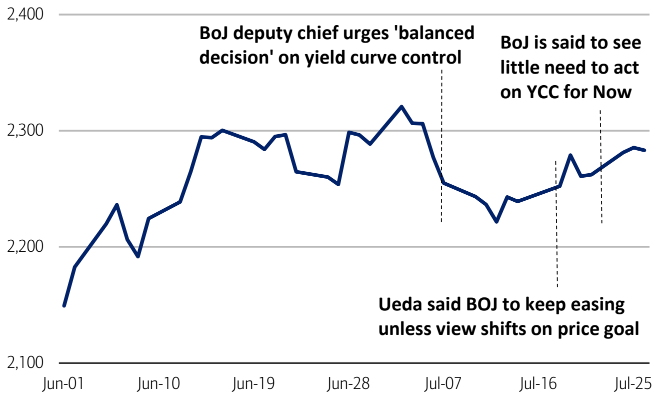
Meanwhile, the initial market selloff partially triggered by Deputy Gov. Uchida's "balanced decision" on YCC seems to have largely recovered, following Gov. Ueda's dovish comments on 18 July (Exhibit 5). This means further hedging/ speculative positioning unwinding owing to the passage of event might be limited as well.

We believe Apr-Jun earnings should provide more near-term catalysts in the coming weeks (Exhibit 6). Note our investment recommendation remains a combination of exporters with value attributes and large-cap quality cyclicals amidst a weaker yen environment (see US disinflation and post-BoJ investment strategy 25 July 2023). Also, the June BoJ Tankan survey might shed light on sector selection heading into the earnings season, in our view. Specifically, services for individuals, accommodations, eating & drinking services, pulp & paper, ceramics, stone & clay and processed metals might look relatively attractive, with both FY2023 forecast DI and revision vs. March Tankan above 5% (ppt, Exhibit 7).

Please refer to our note for a more detailed earnings calendar: Earnings Calendar: 24th July – 4th August announcements 21 July 2023.

Exhibit 5: TOPIX and BoJ Governors' comments in July

Gov. Ueda's dovish reiteration may have at least partially pushed back market speculation on YCC tweak



Source: BofA Global Research, Nikkei Asia, Bloomberg
Note: as of 26 Jul, 2023.

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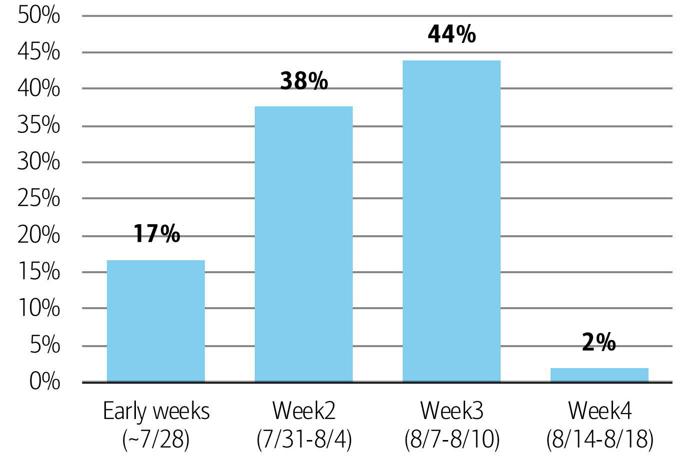
Exhibit 6: TOPIX Apr-Jun earnings reporting by weeks

Earnings releases are concentrated in the 2nd and 3rd weeks



Source: BofA Global Research, Astra Manager
Note: based on TOPIX companies with fiscal year ending in March.

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Exhibit 7: June BoJ Tankan: current profits growth projections (annually) of large enterprises

Tankan survey warrants a near-term bias towards domestic demand-oriented sectors, while further yen depreciation may provide tailwinds in some value exporters, such as Autos

Sector	FY2023 forecast DI (%)	Revision (ppt, vs. Mar Tankan)	Sector	FY2023 forecast DI (%)	Revision (ppt, vs. Mar Tankan)
All industries	-6.2	4.7	Manufacturing	-7.0	1.2
Nonmanufacturing	-5.3	9.0	Textiles	-27.8	-18.6
Construction	0.3	4.6	Lumber & Wood products	5.5	1.6
Real estate, Goods rental & Leasing	-3.1	0.1	**Pulp & Paper**	**98.8**	**84.9**
Real estate	-3.3	0.1	Chemicals	-9.4	-7.4
Goods rental & Leasing	-2.1	0.0	Petroleum & Coal products	-9.2	-71.7
Wholesaling & Retailing	-1.5	16.8	**Ceramics, Stone & Clay**	**13.9**	**9.6**
Wholesaling	-3.3	0.1	Iron & Steel	-5.3	-16.1
Retailing	2.1	3.2	Nonferrous metals	-33.3	-32.8
Transport & Postal activities	-34.5	-10.2	Food & Beverages	4.7	2.9
Information communication	-4.5	2.1	**Processed metals**	**10.3**	**9.0**
Communications	-5.2	-2.9	General-purpose, Production & Business oriented machinery	-15.5	2.5
Information services	-1.1	10.8	General-purpose machinery	-17.4	-9.0
Other information communication	-11.6	0.2	Production machinery	-15.9	5.6
Electric & Gas utilities	NA	NA	Business oriented machinery	-13.0	9.6
Services for businesses	4.3	1.2	Electrical machinery	-5.7	-9.2
Services for individuals	**6.2**	**13.2**	Transportation machinery	-0.3	34.5
Accommodations, Eating & Drinking services	**26.6**	**15.6**	Shipbuilding, Heavy machinery & Other transportation machinery	-6.6	-13.0
Mining & Quarrying of stone and gravel	-77.6	-15.3	Motor vehicles	0.0	37.8
			Other manufacturing	-18.0	-8.6
			Basic materials	-8.7	-12.6
			Processing	-6.4	7.5

Source: BofA Global Research, BoJ Tankan
Note: we highlight sectors with both FY2023 forecast DI and revision vs. March Tankan above 5% or 5ppt.

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- Strong USD selling, **Liquid Cross Border Flows**, 17 July 2023

Rates, FX & EM trades for 2023

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: From monthly narratives to weekly narratives 21 July 2023

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