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Liquid Insight

BoJ preview: Inching closer to normalization

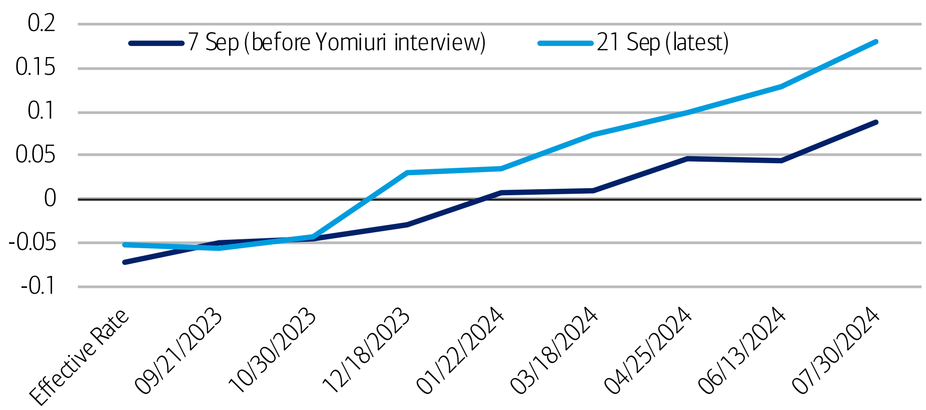
Key takeaways

- We see a hold at the Sep MPM but would watch for hints of further operational tweaks to YCC & shift in BoJ's policy stance.
- FX/Rates:BoJ aligned with MoF to support JPY by letting long-tern yields rise, but impact on FX limited.
- Equity: Risk-reward skewed to the upside following the Sep MPM; rate sensitivity screen.

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

Chart of the day: Japan's implied short-term policy rate based on OIS (%)

Markets have fully priced in the end of NIRP by the January 24 MPM



Source: Bloomberg

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The BoJ policy board will deliver its next policy decision tomorrow, Friday 22 September. Having just tweaked yield curve control (YCC) settings at its previous MPM on 28 July, and given the lack of significant new information on inflation and wages, the analyst consensus is unanimous in expecting a hold.

We also view changes to the BoJ's key policy targets as unlikely. However, given the recent shift in tone in the BoJ's communications, including the signal for an earlier-than-expected end to negative interest rate policy (NIRP), the meeting, and particularly the post-MPM press conference will be "live" as the markets look for further policy hints.

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Liquid Insight Recent Publications

Raising the stakes of the meeting is the Yomiuri Shimbun's exclusive interview of Governor Ueda, published 9 September (note that the interview was conducted earlier, on 6 September).

In the interview, Governor Ueda noted that there was a "non-zero" possibility that the Bank of Japan would have sufficient data/information to judge the sustainability of FY24 wage hikes—and therefore 2% inflation—by the end of this year. He also added that termination of negative interest rate policy (NIRP) was one of the "various options" that the BoJ would consider once it had confidence in the sustainability of 2% inflation (see BoJ Watch: Could the BoJ end NIRP in 2023?, 11 September 2023).

Moreover, the Governor dropped the hint that the BoJ's risk management approach, may be changing: that is, while the BoJ leadership have, up until this point, placed much more emphasis on the downside risks associated with a return to the pre-pandemic zero-inflation regime, Governor Ueda suggested that the BoJ was also growing more mindful of the costs of waiting too long confirm the re-anchoring of inflation and falling behind the curve:

> "There is still some distance to go in achieving the price target and we will patiently continue with aggressive monetary easing for the time being. Given questions around how much room there is for monetary easing, responding to an undershoot of prices is exceptionally challenging. We cannot afford to overlook downside risks. However, this does not mean we are completely disregarding the risk of overshooting, and it is not our intention to actively embrace a policy stance that is 'behind the curve.'"
>
> - *BoJ Governor Kazuo Ueda Yomiuri Shimbun Interview, 9 September 2023*

FX concerns putting pressure on the BoJ

What explains the sharp turn in BoJ communications and the potential shift in the central bank's policy stance over the past month?

We think developments around FX are key. As discussed in our review of the meeting, that meeting already hinted at a shift in the BoJ's reaction function towards 1) greater data dependence, and a more forward-looking approach to policy; and 2) increased focus on upside—and not just downside risks—to the inflation outlook (see Japan Macro Watch: BoJ flexibilizes yield curve control—quick take, 28 July 2023). But it also saw the BoJ admit much more openly that it was concerned about FX, with Governor Ueda admitting in his post-MPM press conference that the YCC adjustments were in part intended to pre-empt a rise in volatility in the foreign exchange markets.

Over the past few months, there has seemingly been closer coordination between FX and monetary policy, with growing pressure on the BoJ to keep the depreciation of the yen in check (or at the very least not add to depreciation pressures). In addition to laying the communications groundwork for an eventual end to NIRP/front-end hikes, we think the interview was intended as a form of verbal intervention to keep the pace of yen depreciation in check, and demonstrate the BoJ's alignment with the MoF/government with respect to FX concerns.

Sep MPM: An important litmus test for the BoJ

Against this backdrop, this week's policy meeting will be an important litmus test to confirm the potential changes in the BoJ's reaction function and the distance to the central bank's next policy move, which we think will involve an exit from NIRP and removal (or further softening of) yield curve control.

We do not yet expect major changes to the policy statement. But we will be paying close attention to Governor Ueda's press conference remarks. In particular, we think questions at the press conference will be aimed at:

1) Seeking clarification on Governor Ueda's comments in the 9 September Yomiuri interview: namely, has the BoJ's Ueda's risk management approach shifted to one that is more neutral? How much weight is the BoJ now putting on the costs of an inflation overshoot?

2) Getting more color on the type of data that the Bank of Japan will be looking at to judge progress toward the achievement of sustained 2% inflation, if it is to be able to make this assessment before the results of the Spring Wage Shunto negotiations firm up next spring.

3) Getting further color on the sequence of the BoJ's policy exit: that is the order between NIRP removal, YCC removal, and balance sheet reduction. There have been conflicting signals on this from recent BoJ speakers, pointing to a lack of consensus; we would expect Governor Ueda to avoid giving details at this point.

4) The BoJ's current thinking on long-end yield curve control, and to what extent it was satisfied with the recent movements in interest rates.

With USDJPY back to 148 as of this writing, we think it is unlikely that Governor would try to "walk back" his comments in the Yomiuri Interview. At minimum, we expect Governor Ueda to sound more hawkish in his post-MPM press conference than he did in July, acknowledging continued progress with inflation, and reiterate the stance from his Yomiuri interview that the BoJ is also paying attention to the risk of overshooting, and not just downside risks to the inflation outlook. He is likely to stress that future BoJ policy adjustments will be data dependent, leaving the door open to an early NIRP exit (before the spring). This may sustain the market's expectations for a more notable shift in communications at the October MPM, which will coincide with a fresh Outlook Report.

BoJ eyeing further operational tweaks to YCC?

Meanwhile on 4) we see the risks of further operational tweaks to the BoJ's management of long-end YCC.

In a "preview" of the 21-22 September MPM published on 17 September, Yomiuri Shimbun reported that the BoJ would "review recent movements in interest rates." The article noted that the BoJ is expected to maintain the policy targets under YCC, as well as the reference band for the 10yr yield at "around" +/-50bp points from the zero % target, while allowing the 10yr yield to trade up to 1%.

However, the article also hinted at the possibility that the BoJ may be looking for further flexibility in the conduct of yield curve control, citing resilience in corporate profits and capex, and the fact that inflation expectations were firming among corporates and consumers on the back of price rises since last spring. The article noted that the 10yr yield had risen to 0.7% as a result of these developments, and that the BoJ is seeking to transition to an environment where interest rate levels are determined "more" autonomously via transactions among market participants.

The tone of these statements mirrors a comment that Governor Ueda made earlier in his 9 September Yomiuri interview, where he stated that the BoJ is "not contemplating strict control of interest rates within the range of 0.5% - 1%."

Reading between the lines of the Yomiuri article and Governor Ueda's 9 September interview comments, we suspect that the BoJ is hoping to reduce its degree of bond market intervention further. Specifically, we think the BoJ is seeking to reduce its monthly bond purchases, which have remained high despite July's adjustment to YCC settings.

We would therefore be watching for hints on possible changes to the BoJ's stance to bond purchase operations in the post-MPM press conference. And though it is not our base case for the September MPM, we would not rule out the risk that the BoJ deletes the reference to the "around" +/-50bp benchmark for the 10yr permissible trading band, given that is seemingly acting as an impediment to a reduction in the BoJ's bond purchase (rinban) operations.

Pulling up our baseline scenario for NIRP+YCC exit

Looking a bit further ahead we recently revised our baseline scenario for the timing of NIRP + YCC exit (see BoJ Watch: Inching closer to normalization, 21 September 2023). We now see an earlier window for the likely timing of policy adjustments to Dec '23 – Apr '24, from mid-'24 previously, and bring forward our new baseline forecast for NIRP + YCC removal to the January '24 MPM.

At that stage, we expect the BoJ to upgrade its FY24/25 inflation forecasts and argue that sustainable and stable achievement of the 2% has "come into sight," and that allowing both short-term and long-term rates to move higher was designed to prevent policy settings from becoming overly stimulative.

That said, in order to mitigate the risk of a disorderly rise in long-end rates, we think that the BoJ is likely to maintain a very soft form of YCC, for example by retaining the commitment to conduct fixed-rate bond purchases for 10yr JGBs at a certain level.

Currently, the level of this "backstop" for yields is set at 1%. But given the further rise in inflation expectations that is likely by the time the BoJ removes NIRP, we envisage that the level will be raised further, i.e. to 1.5%. We do not forecast additional rate hikes in 2024 at the moment, but intend on discussing the risks in a separate report. *d*

- *Izumi Devalier & Takayasu Kudo, Japan Economists*

Rates: Focus on JGB purchase reductions

As noted above, we expect the BoJ to leave its monetary policy unchanged at the MPM to be held from 21 to 22 September. In my view, however, the risk for JGB yields is skewed to the upside. The Bond Market Survey, conducted by the BoJ from 1 to 7 August indicated that the degree of bond market functioning was -40, slightly better than -46 in the May survey. However, it is still deeply negative. We think the BoJ's excessive bond buying operations have been exacerbating the JGB market functioning. BoJ Governor Ueda might mention the future reduction in JGB purchases at the press conference (for details, see Japan Rates Watch: Ueda's comments raise possibility of reducing bond-buying operations 2023-09-12).

- *Tomonobu Yamashita, Rates Strategist*

FX: difficult to talk down USD/JPY

The BoJ is in a difficult position. With low FX volatility, the government is unlikely to able to intervene to the FX market, which should primarily be used to contain volatility. Monetary policy is one of few tools available to a broader government to contain the yen weakness and the BoJ has aligned with the MoF since around the Jul MPM in attempting to slow the yen's weakness. However, the scope and the speed of potential monetary tightening may be limited given structural issues such as Japan's high public debt (see: Liquid Insight: Short JGB, not USD/JPY 12 September 2023).

The BoJ may attempt to sound hawkish at the Sep MPM and could let the long-term JGB yields rise through operational tweaks, but these would not be a fundamental solution to the yen weakness. As the FX rate now appears to be in the BoJ's reaction function, the market may be incentivized to short the yen and yen duration to test the BoJ. If USD/JPY shrugs off the BoJ's potential verbal intervention and rallies through 150, the risk of FX intervention by the MoF may start to increase. Until the Fed's rate cuts become more imminent and certain, the yen weakness is likely to keep pressuring the BoJ, leading to higher long-end yields.

- *Shusuke Yamada, FX/Rates Strategist*

Equity: Risk-reward skewed to the upside; rate sensitivity screen

We believe the risk-reward balance with regard to equities following the BoJ's September MPM could be skewed to the upside.

- The price action in equity markets seems to have overcome the hawkish comments of Governor Ueda in an interview published on 9 September (Japan Economics 11 September 2023), with TOPIX surpassing 2,400, likely reflecting the ongoing yen depreciation and PM Kishida's cabinet reshuffle. Looking forward, potential earnings upgrades, coupled with domestic inflation and fading concerns about higher US rates and slowing China economy, should help fuel market rally in the October-December quarter, in our view (Japan Equity Strategy 15 September 2023).

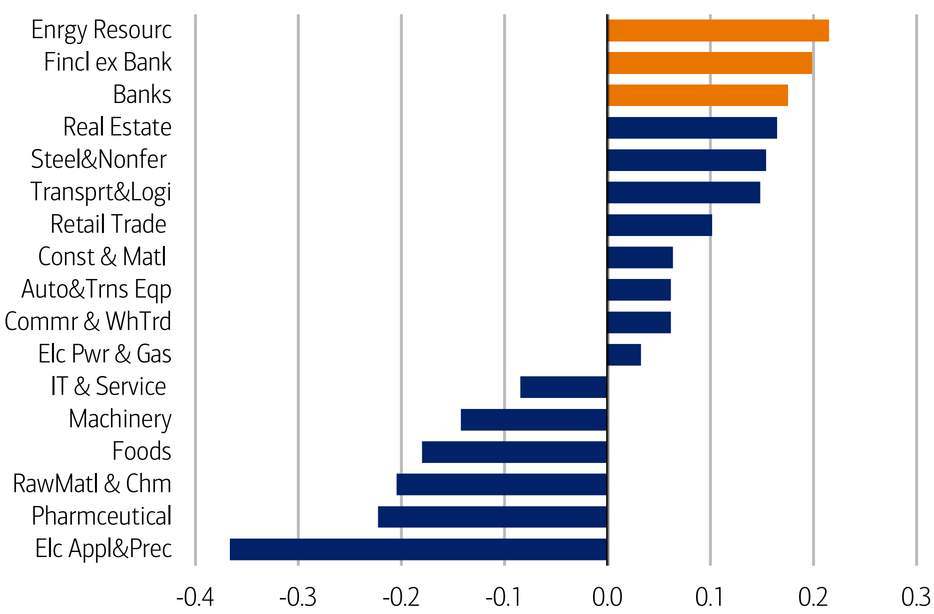
- Sector-wise, our expectation of a higher 10-yr JGB yield (see Liquid Insight 12 September 2023) prompts us to maintain a selective stance on sectors. We believe energy-related sectors and financials might look relatively attractive among TOPIX-17 sectors, based on the sensitivity analysis to 10-yr swap rate (Exhibit 1).

- Similarly, (Exhibit 2) shows our screen on rate sensitivity and historical price action, leveraging our analysts' ratings. We think the current macro backdrop could provide tailwinds to these names, assuming all else remains equal.

In a tail risk scenario involving NIRP removal at this week's MPM (note that our economists' base case for NIRP removal is in January 2024, as discussed above), we believe the near-term knee-jerk market selloff (down 1-3% for TOPIX) could provide dip-buying opportunities over the medium term. Sector-wise, financial sectors could shine vs. other TOPIX sectors, thanks to the normalizing rate dynamics (see Banks in the late stage of the rate cycle: enjoy it while you can 18 September 2023).

Exhibit 1: Relative P/B sensitivity vs. 10-yr swap rate by sector

Diverging sensitivity vs. swap rate suggests a selective stance



Source: BofA Global Research, Bloomberg

Note: Relative P/B (vs. TOPIX) sensitivity is defined as % relative P/B changes given 1bps change in 10-yr swap rate (similar definition for the screen below). Quarterly basis, since 2020.

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Exhibit 2: Stocks with negative sensitivity to 10-yr JGB future

Buy or "Neutral" rated stocks outperformed TOPIX on 11 Sep 2023, following Governor Ueda's interview

TSE	Name	Rating	MKT CAP (tn JPY)	Price sensitivity to 10-yr JGB future	% RP revision (last 3 months, FY)	Relative return (%, Sep 11, 2023)	YTD performance (%)
8306	MUFG	BUY	16.8	-0.7	4.7	4.2	49.0
8316	SMFG	BUY	10.2	-0.5	1.6	5.3	43.5
6501	Hitachi	BUY	9.3	-2.4	2.4	1.4	48.7
8411	Mizuho FG	BUY	6.8	-1.5	1.8	4.4	44.6
8015	Toyota Tsusho	BUY	3.3	-2.7	9.1	0.2	88.0
6701	NEC	BUY	2.3	-0.3	4.0	0.3	81.2
8795	T&D Holdings	BUY	1.5	-0.6	0.7	3.2	36.4
5713	SMM	BUY	1.4	-3.8	8.1	0.4	1.6
4204	Sekisui Chemical	BUY	1.0	-0.0	2.4	1.0	23.1
8331	Chiba Bank	BUY	0.9	-0.9	4.4	5.9	20.0
5334	Niterra	NEUTRAL	0.7	-1.6	8.8	0.1	47.1
5711	Mitsubishi Materials	BUY	0.3	-1.1	4.0	0.2	26.3
5706	Mitsui Mining	NEUTRAL	0.2	-0.7	13.1	0.4	31.9
4819	Digital Garage	BUY	0.2	-2.1	54.4	4.6	-18.1
6135	Makino Milling	BUY	0.2	-0.6	15.3	1.0	60.7

Source: BofA Global Research, Astra Manager, Bloomberg

Screening criteria: 1) BofA coverage names with "Buy" or "Neutral" ratings; 2) Mkt cap above 100bn JPY; 3) Negative price sensitivity to 10-yr JGB futures over the last 5 years (weekly basis); 4) Positive 3 months earnings revision (RP, FY1, QUICK consensus); 5) Positive relative return on Sep 11, 2023 (vs TOPIX). Ranked by mkt cap in descendent order. As of Sep 19, 2023.

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\- *Tony Lin, Equity Strategist*

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The art of pausing **Global FX Weekly**, 15 Sep 2023
- **Little Dipper, Global Rates Weekly**, 15 Sep 2023
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Global FX weekly: The art of pausing 15 September 2023

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