Capital Markets Strategy
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MUFG

Policy Note

This Sunday, April 9, Kazuo Ueda will take over from Haruhiko Kuroda as Governor of the Bank of Japan. MUFG's Head of Research, ***Derek Halpenny, highlights this as a significant "changing of the guard" for the BoJ and expects Governor Ueda to remove Japan's yield curve control (YCC) policy in the months ahead.***

Governor Ueda, the first academic to hold the seat, has a challenging task ahead. ***He takes over the BoJ with policy rates still in negative territory and a significant bond buying program in place to cap long-term government borrowing costs.*** MUFG expects Governor Ueda to normalize interest rate policy, unwinding two decades of quantitative easing policy.

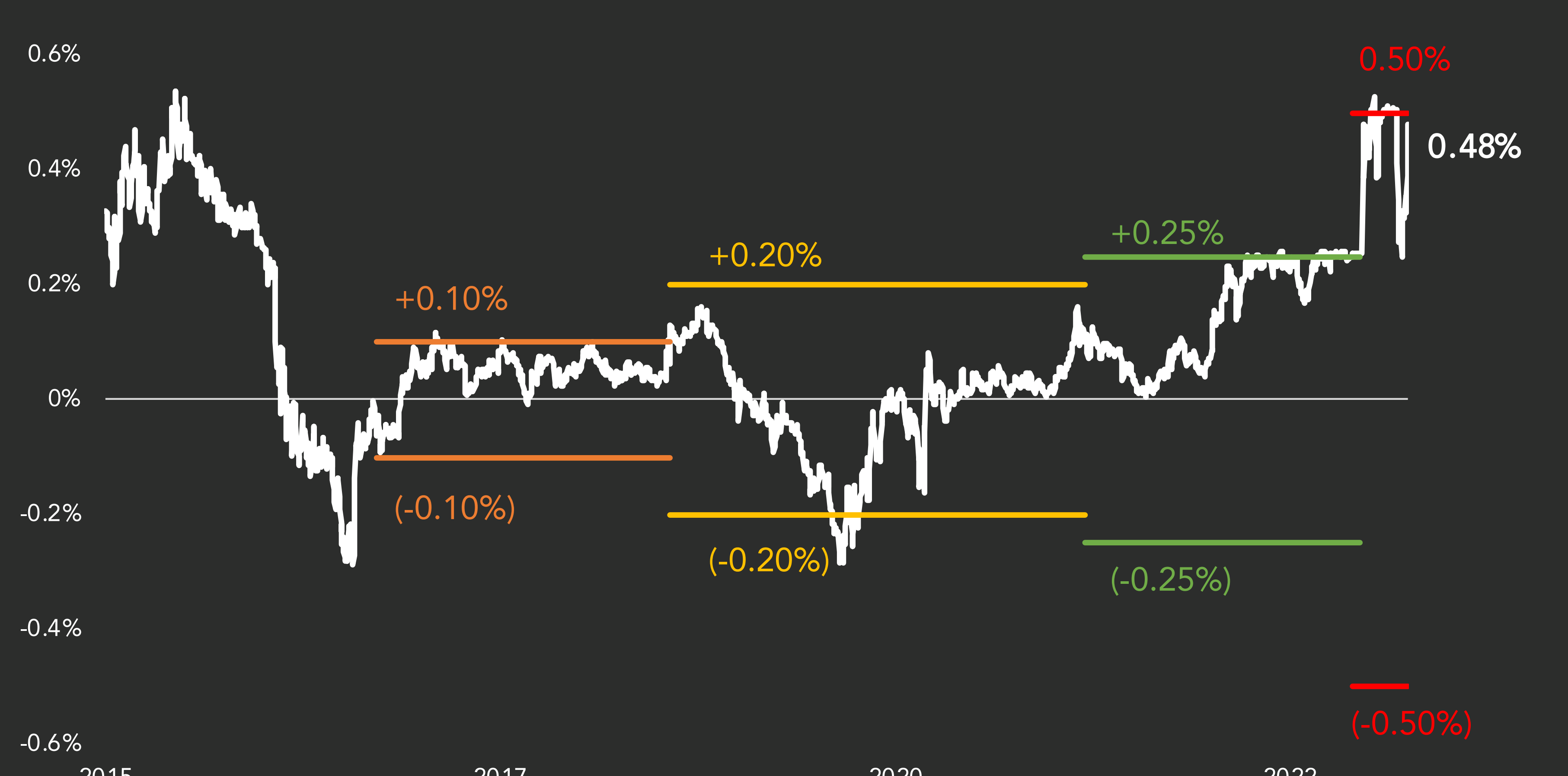
In his recent comments to Parliament, ***Ueda appeared in no rush to end YCC but did signal that the policy was unlikely to survive in its existing form and acknowledged its distorting effects on Japan's rate curve.*** Markets are now left to interpret if that means the policy will be amended to ***widen the policy band from its existing +/- 50 bps, if the policy will target shorter duration yields rather than the current 10-year, or if it will be abandoned altogether.***

The BoJ's next meeting, to be held on April 27-28, will be a particular focal point for markets as it will be the only G4 central bank meeting this month (Fed, BoE and ECB all meet next in May). With the BoJ signaling policy change, ***MUFG's Derek Halpenny believes markets should view each upcoming BoJ policy meeting as "live" with the YCC policy framework engineered by Kuroda to be removed relatively quickly.***

Implications for global bond markets could be significant. ***Japanese investors have more than $3 trillion invested overseas in stocks and bonds, more than half of that in the US.***

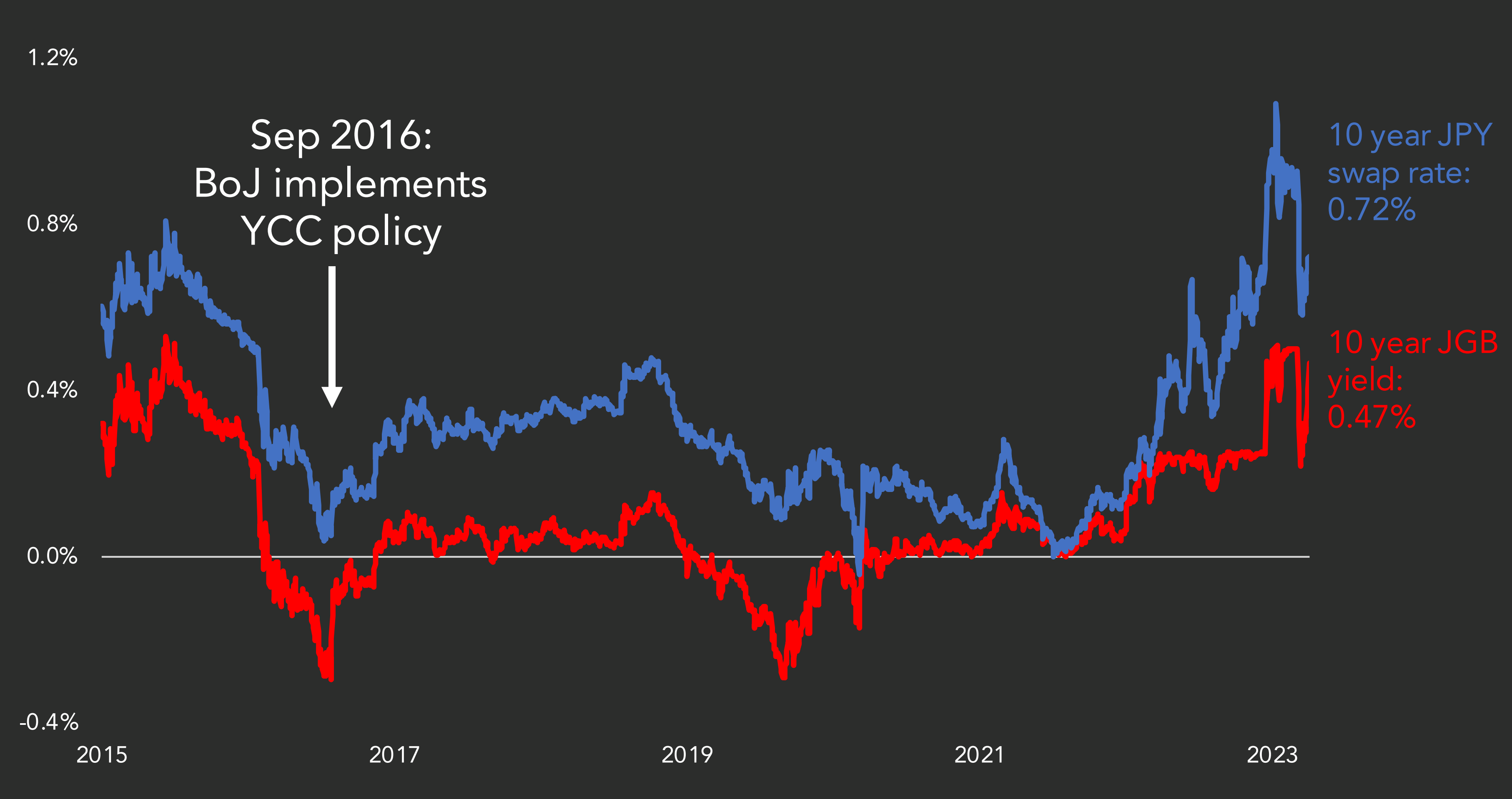
In December, the BoJ surprised markets by expanding its YCC operations range from +/- 25 bps to +/- 50 bps. MUFG's Derek Halpenny views each upcoming BoJ meeting this year as "live" for potentially significant changes to Japan's YCC policy.

Japan 10 year government bond yield



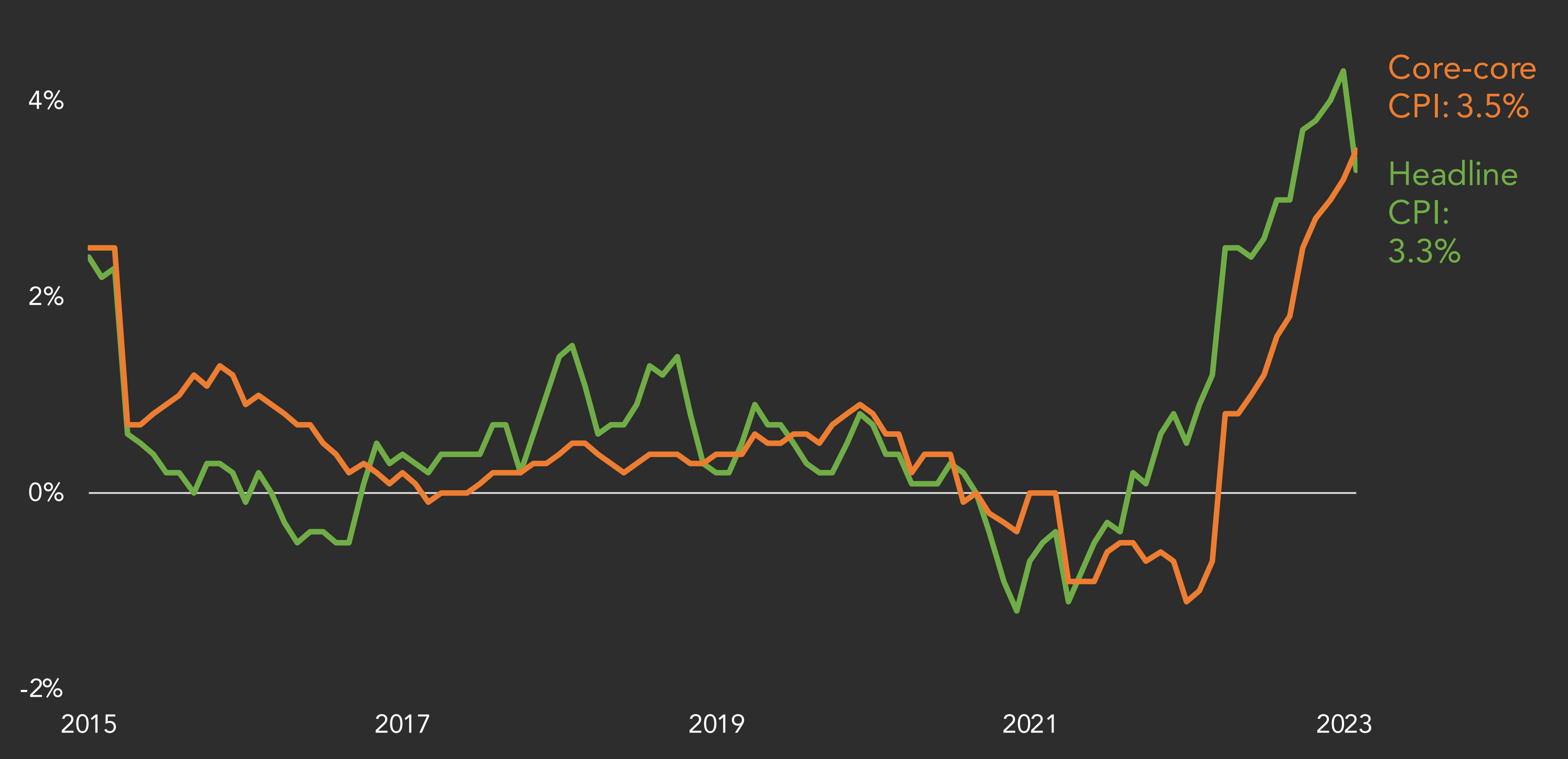
While global market turmoil fueled by banking concerns has eased upward pressures on 10yr JGBs, 10 yr JPY swap rate pricing suggest the fair value of JGBs sit well above the 0.5% yield cap

10yr JPY Rate Swap vs. 10yr JGB yield



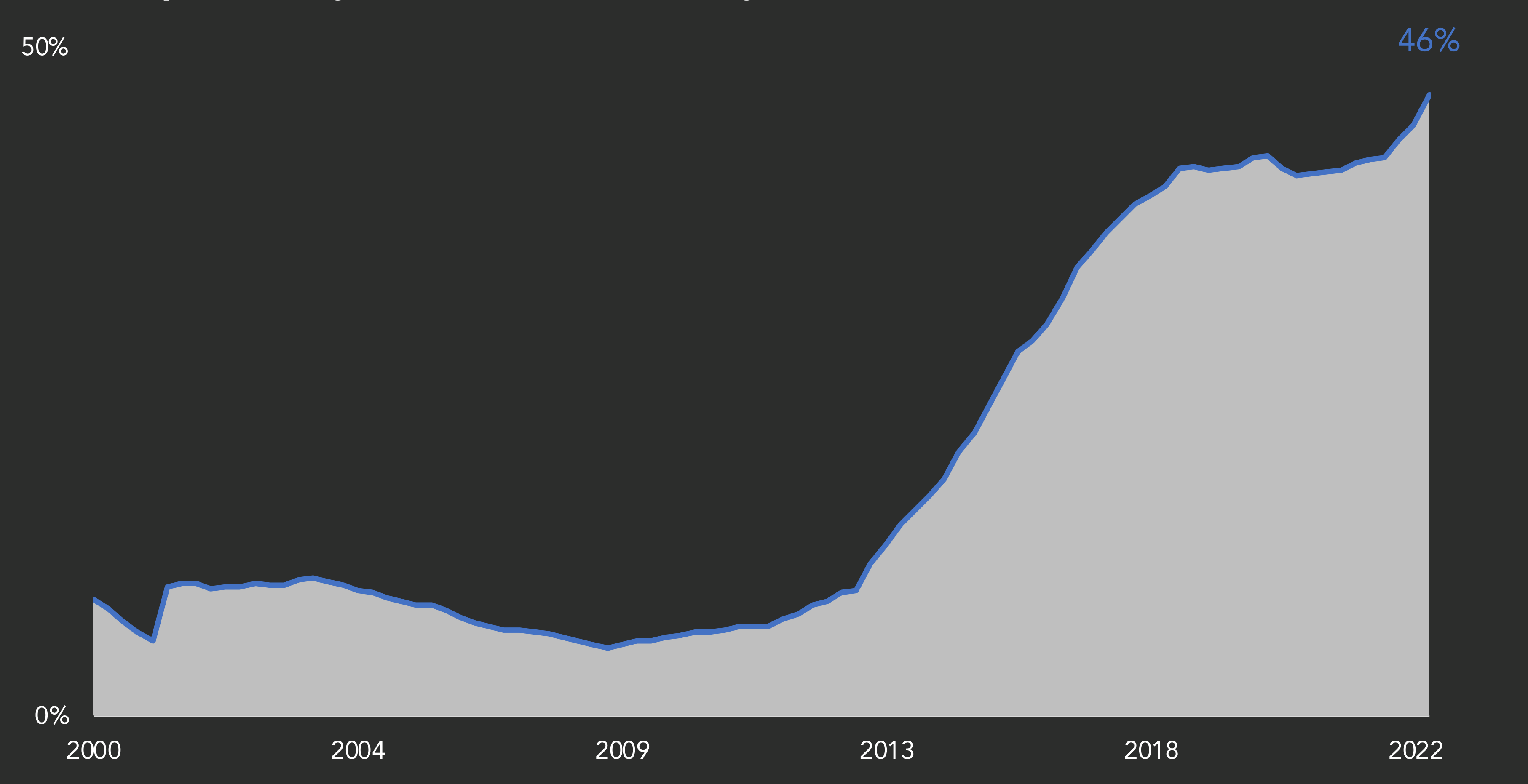
In February, Japan's headline CPI surpassed the BOJ's target level for the 10th consecutive month while core-core inflation (ex energy and fresh food) accelerated from 3.2% to 3.5%, its highest level since January 1982. Further, wage negotiations with Japan's trade union confederation concluded with a base pay raise of 2.3%, up from 0.5% a year ago. While Japan has historically struggled with deflation, the recent rise in inflation has put upward pressure on Japanese rates.

Japan CPI inflation and Japan core-core inflation



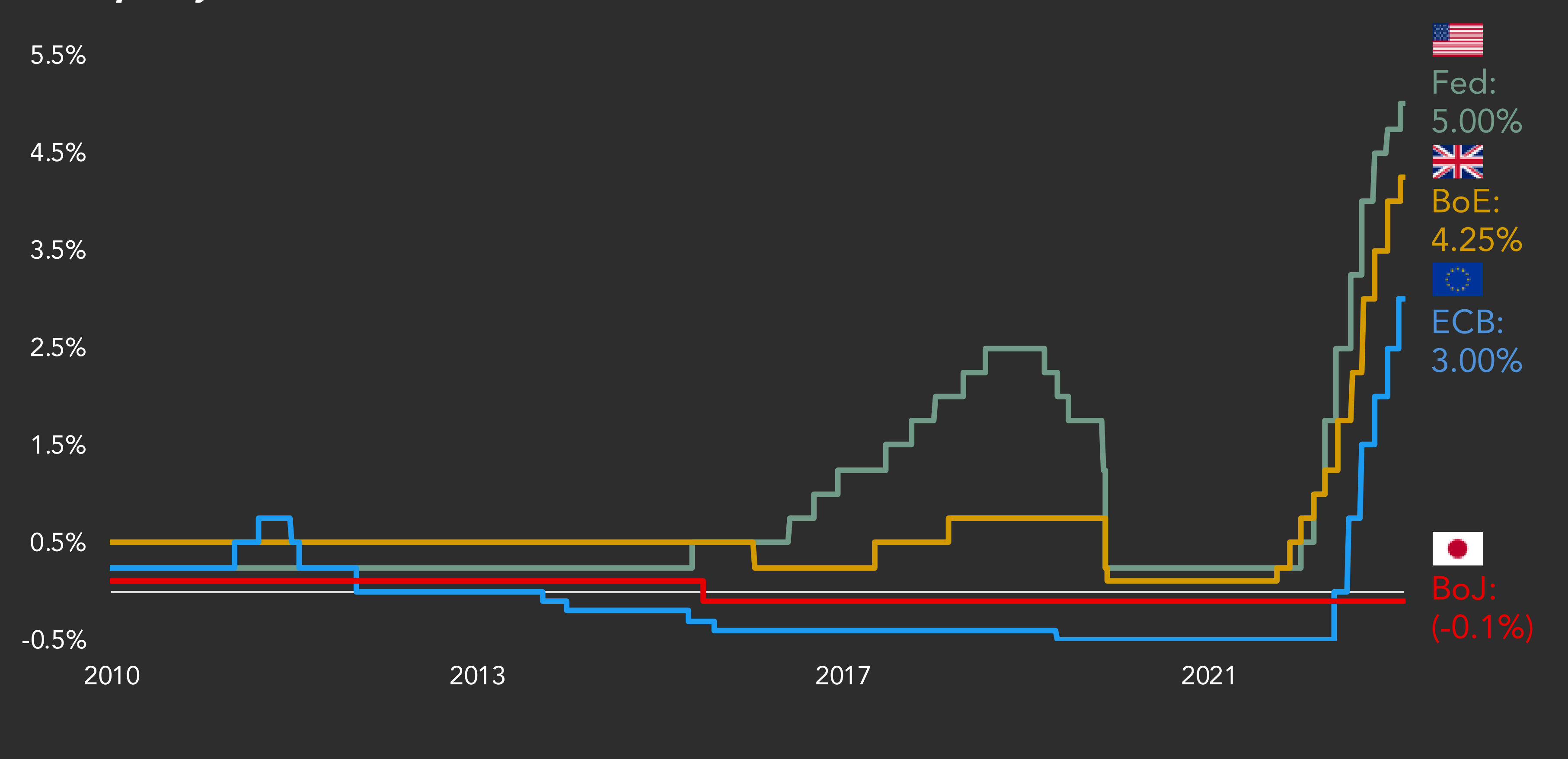
Upward pressure in the JGB market has made defending the YCC target more difficult. In December and January alone, the BoJ spent $300 bn buying government bonds to defend the target. They also expanded a program of loans to banks to ease pressure in the bond market. Today, the BoJ owns nearly 50% of the JGB market.

Bank of Japan holdings of total JGBs outstanding



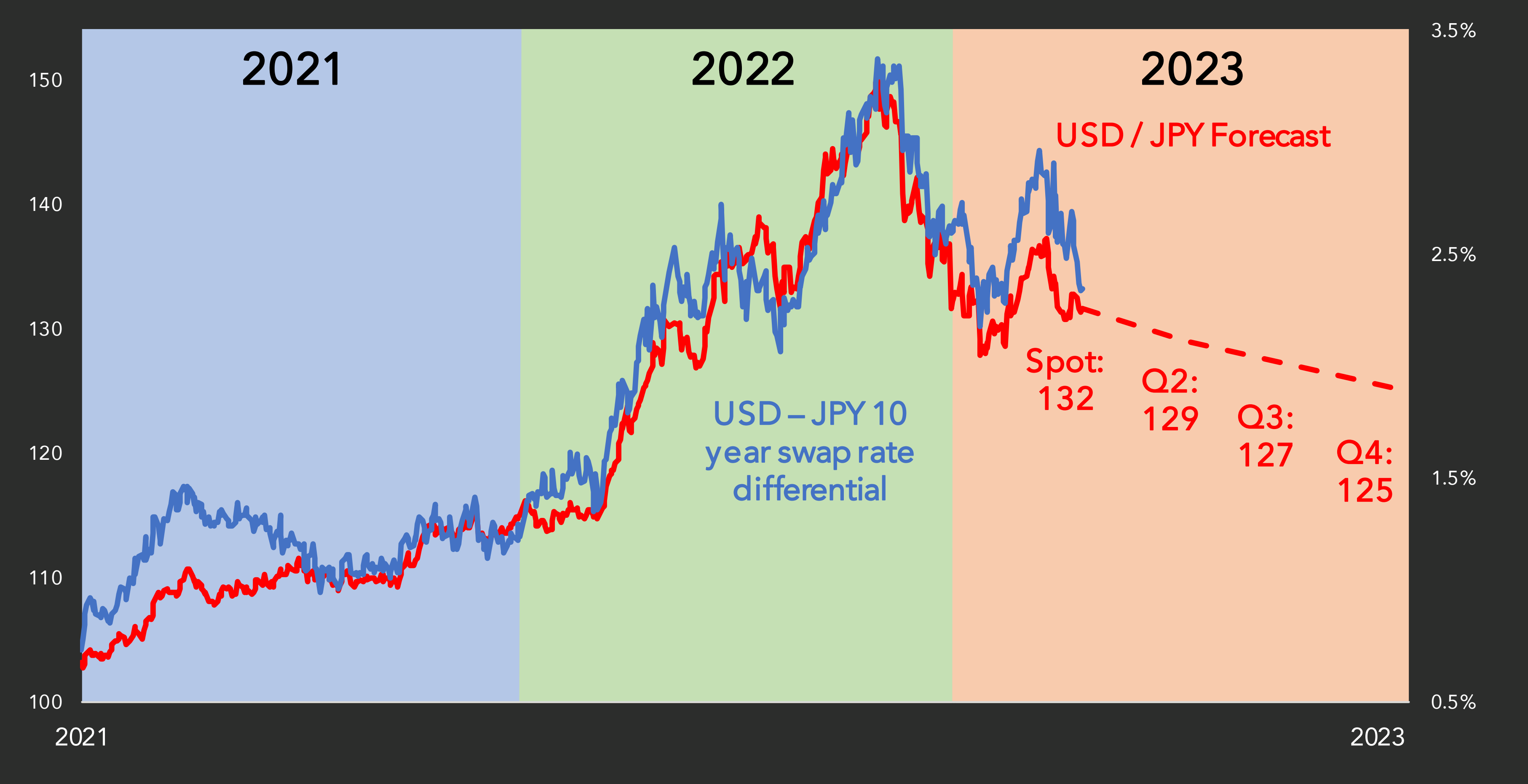
The Bank of Japan is the only G4 central bank that still has a negative policy rate. With benchmark policy rates not expected to increase this year, the rate differential with Fed and other central banks globally continues to widen.

Global policy rates



Rate differentials have been the main driver of USD / JPY. MUFG's Head of Research, Derek Halpenny, expects Yen strengthening over the next 12 months as the Fed nears the end of its tightening cycle, US recession risk rises and as the BoJ loosens its grip on the Japanese bond market.

USD / JPY and USD-JPY 10y swap rate differential



Source: (1-6) Bloomberg. Data as of April 6, 2023. JPY 10 year swap rate is JPY OIS 10Y. USD 10 year swap rate is USD OIS 10Y. MUFG FX Monthly (Derek Halpenny).

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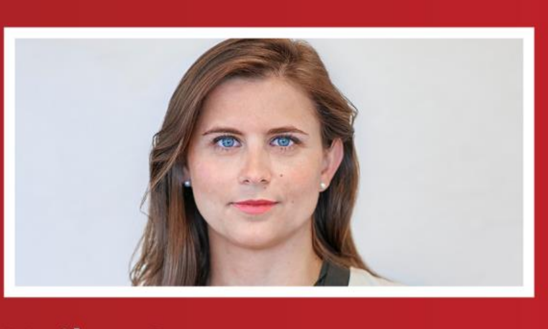

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