MARKET COMMENTARY

BoJ soft-exits yield curve control policy

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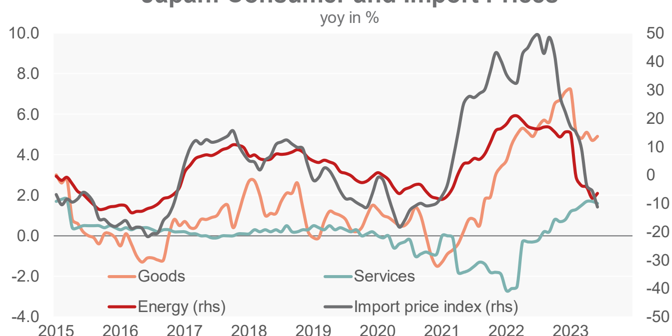
- **Despite recent press reports of no action, the Bank of Japan (BoJ) announced today a "soft-exit" of its yield curve control (YCC) policy. The move looks rather complicated, prompting the BoJ to publish an explaining slide here.**
- **The BoJ will maintain its official 10-year JGB yield target of 0% and a tolerable band of around ±0.5 pp (as before) but will not enforce the upper bound anymore. Instead, it will offer fixed-rate purchases only at 1.0%. Thus de facto, the upper bound of the band has widened to 1%.**
- **Moreover, the BoJ will make "nimble responses for each maturity" to encourage the formation of a consistent yield curve, which would allow for a steeper curve. At the same time, the BoJ judges that a stable achievement of it 2% inflation target "has not yet come in sight". This suggests that the process to give up the YCC policy completely will remain slow.**
- **The 10-year JGB yield rose to 0.57% following the BoJ announcement (the highest level in almost nine years), up from 0.44% the day before. Nevertheless, a possibly further steepening of the JGB curve could make Western bonds relatively less attractive to Japanese investors (on a hedged basis). As our views are skewed towards lower yields, the US economic resilience and today's BoJ soft exit are headwinds. We see the yen geared towards moderate further strength as the US/Japan yield gap is set to narrow.**

In its two-day meeting ending today, the BOJ decided to adjust its yield curve control (YCC) policy and to "*conduct current YCC framework with greater flexibility*". The move is rather complicated and may also signal a compromise within the Governing Council. Officially, the central bank maintained the 10-year JGB yield target at 0% incl. the band of around ±0.5 pp. However, it will conduct fixed-rate purchase operations now at 1.0%, de-facto widening the band. The BoJ may have chosen this complicated structure to avoid giving the impression of a start of a tightening cycle. Moreover, the bank argued that strictly capping long-term interest rates could affect the functioning of the bond markets. The argument comes a bit surprising as the yield curve was strongly distorted before (esp. 9y yields) but smoothed out much of late. Another rationale is in line with remarks from Deputy Governor Uchida who stated that the BoJ sees signs that inflation expectations esp. of firms to have moved up and thus may change corporate wage and price-setting. By adding a chart in the accompanying slide, the BoJ shows its vigilance. However, overall the BoJ judged that a stable achievement of it 2% inflation target "*has not yet come in sight*".

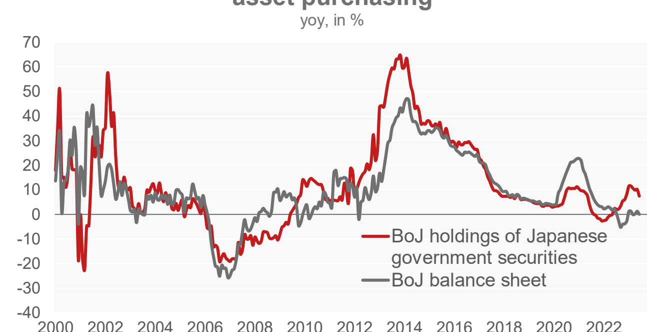
The BoJ also revised its inflation outlook in the quarterly Outlook Report. It adjusted markedly up the inflation outlook (core CPI ex fresh food) for FY2023 to 2.5% yoy (from +1.8% yoy before) but lowered its outlook for FY2024 marginally to 1.9% yoy (from +2.0% yoy) and maintained 1.6% yoy for FY2025. Implicitly, the BoJ confirms again its scepticism regarding wage growth to stay high enough to sustain inflation at 2%.

Given this appraisal, the BoJ will likely act rather calm as before. In fact, the further development of wage growth will become clear only next spring. The BoJ has brought itself today in the position to possibly wait for these data. This was underlined by Ueda's remark in the press conference that today's move was pre-emptive to handle future risks.

Regarding markets, we agree with the BoJ expectation of falling inflation rates (with similar forecasts). Thus for the time being, the likelihood to fall back into deflation after the energy price push will have moved through the economy has receded (but is not zero). For now, a possibly steepening of the JGB curve could make Western bonds relatively less attractive to Japanese investors (on a hedged basis). As our views are skewed towards lower yields, the US economic resilience and today's BoJ soft exit are headwinds. We see the yen geared towards moderate further strength as the US/Japanese yield gap is set to narrow.



Source: Datastream, GIAM calculations



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