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The Major bond letter

#28. Japan's curveball

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Fixed Income - Rates

Global

Strange things can happen in markets during December. Perhaps it's the party mood, less liquid trading conditions, or some combination of the two. We suspect the Bank of Japan's "technical" shift in yield curve control (YCC) represents more of a curveball than a fundamental change in direction.

The current tendency to fear the worst for bond markets may be traceable to the Fed's hawkish turn a year earlier. Given the completely different context faced by Japan, we think it would be dangerous to infer too much from the modest policy shift on 20 December 2022. It was defined as a surprise because none of the 47 economists polled by Bloomberg had forecast anything from the BoJ – but, to be fair, whilst it was nobody's base case, most would have recognised the possibility of a change at some point in 2023.

This is what we know from the BoJ announcement. The range within which the central bank will buy JGBs was widened from 25bp to 50bp either side of zero, and, in an attempt to reinforce the message that nothing has fundamentally changed, the monthly volume of bond purchases was increased to JPY9trn from JPY7.3trn.

Beyond the practical challenge of running both yield and quantity targets at the same time, we think it's the wider context and read-across that really matters here. Japan is no longer in deflation, with core consumer prices running at 3.7% (y-o-y) and recent BoJ minutes noting a rise in inflation expectations. What's more, Governor Kuroda has for a long time been expected to retire in April 2023, having been at the helm of the BoJ for the last decade, perhaps setting the stage for a more hawkish policy once his successor is in position.

Then there's the prevailing mood of hawkishness, which seems to put more weight on sticky inflation than on the increasing risk of recession. The US precedent for a hawkish view comes from December 2021, when the freshly reappointed Fed Chair, Jerome Powell, announced a faster taper for quantitative easing (QE).

And then, in the statement from that December FOMC, the Fed gave markets a further hawkish surprise by removing the "expected to be transitory" reference to inflation. This brought forward market expectations on the timing for the policy rate increase, with the December 2021 "dot plot" projecting three 25bp rate hikes in 2022, followed by three more in 2023.

But this hawkish tilt turned out to be something much bigger. By the end of 2022, the upper bound of the Fed funds rate had reached 4.50%, some 350bp more than projected at the end of 2021. Roll forward to December 2022, and the dot plot was projecting rates in 2023 more than 400bp higher than a year before.

So, what's wrong with the hawkish interpretation? Why doesn't Japan follow the US with some disruptive monetary tightening of its own?

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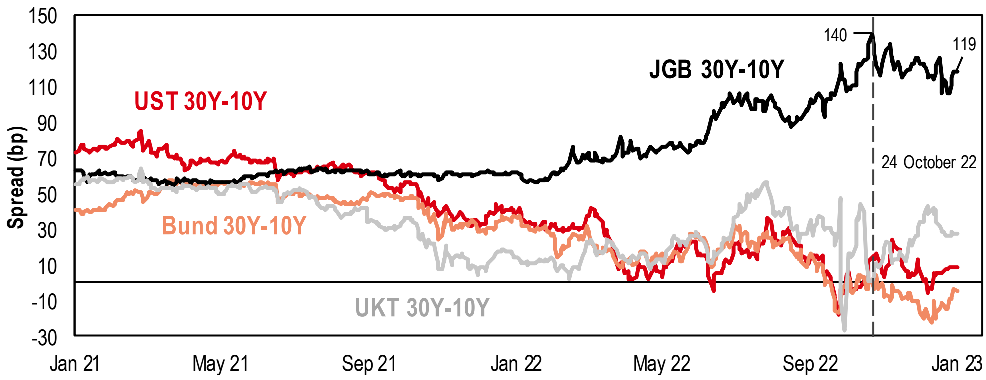
First, there's the shift in short rates. The money market spread between the rest of the world and Japan is much wider today than it was one year ago – so, presumably, higher Japanese rates will be less disruptive. Because BoJ policy rates are still below zero, US rates are about 500bp higher than Japanese equivalents, which means hedging costs into overseas bonds are prohibitive for Japanese investors. By definition, it must be more attractive for foreign investors to invest, on a hedged basis, into Japan's bonds.

Second, much of the global economy is already in recession or experiencing anaemic growth, and it is not altogether clear that Japan can sustain a recovery if monetary policy is to be tightened too dramatically. After fighting deflation for the last few decades, presumably policy normalisation, if and when it comes, will move cautiously.

Third, there are indications that markets have been positioning for a more hawkish BoJ over the last three months. Examples are the 13% rally in the yen versus the US dollar, from around JPY150 on 20 October 2022 to JPY130 today, and the flattening of the 30-10-year segment of the JGB curve.

Figure 1. Japan's curve divergence peaked with dollar/yen in October



Source: Bloomberg, HSBC

Our chart compares G4 yield curves beyond the 10-year point targeted by the BoJ. We do this to get a truer comparison with Europe and the US in a segment of the curve that is free to move. The 30-10 year JGB curve reached a peak on 24 October, around the same time as the yen had reached close to 150 versus the dollar. This was when intervention in the foreign exchange markets by the Japanese authorities revealed what was an unacceptably weak level for them.

We recognise that any slight change in direction from the most dovish of central banks is likely to attract attention. After all, it was the BoJ that gave the world QE more than 20 years ago. But markets have been moving ahead of policymakers for some three months already, with the yen and the yield curve recognising that an iterative shift in policy was becoming unavoidable.

Years of experience have taught us to be careful taking fresh views at the start of the calendar year. Only time will tell whether the BoJ's "technical" shift turns out to be a fundamental change of direction or another of those December curveballs.

Previous editions of 'The Major bond letter'

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