HSBC Global Research

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The Major bond letter

#46. Big in Japan

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Fixed Income - Rates

Global

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Whether the Bank of Japan (BoJ) decides to hike rates a smidgeon is not what matters at the March or April meetings. It will be the totality of the announced policy shift that we will focus on, along with what it does to expectations for more of the same. Something big in Japan is about to happen.

There's widespread anticipation of action at the upcoming BoJ meetings. The two main decisions on the table will be the removal of negative interest rates and yield curve control (YCC). The bond market has been demanding a lot more yield since the end of 2022; this was when the first steps were taken to exit YCC.

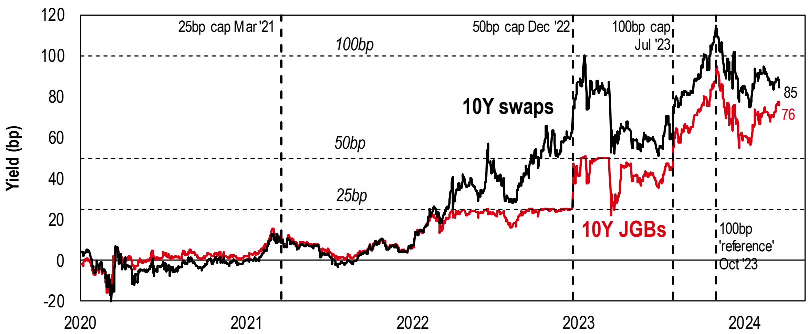
Given the last hike was in 2007, many market participants will be too young to remember the last time the BoJ did this. As for those of us who ***are*** old enough, well, we might not recollect either. It's a big deal because both global and domestic investors will be watching to see whether Japanese government bond (JGB) yields can go still higher or whether they've completed the journey to fair value.

Markets can have a mind of their own. We regularly experience moves in the various asset classes that have not been immediately validated by the latest economic data releases. This is because interconnectivity between markets means what happens in one part of the world can have immediate implications for elsewhere. Initial and relative values matter: if there's not already enough factored into valuations there could be a big move, and vice versa.

Our chart shows 10-year bond and swap yields, with the latter often taking the lead, moving a lot higher to reflect the increased premium investors require to hold Japanese debt. With each iterative shift in YCC over the last 15 months, bonds have been adjusting to expectations of the change in direction to monetary policy.

The overall trend in yields has been upwards because the market believed there was always something bigger in the offing.

Policy normalisation and JGB yields



Source: Bloomberg, HSBC

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We think the BoJ's decisions over the next two months will matter to global bonds for the following reasons.

First, Japan has the world's second biggest bond market, representing almost one-fifth of the global sovereign bond index[1]. Some global investors may have been underweight Japanese bonds, in anticipation of yields going still higher, and only when the rise in JGB yields is sufficient will they return en masse.

Related to this is the impact on the currency. Overseas investors in Japanese bonds would have been best served by hedging currency risk, but this could change if the aggregate effect of the policy shifts means the yen starts to strengthen versus other currencies. It's not only tourists to Japan who notice the shift in affordability. Unhedged or partially hedged positions in bonds will start to be an option for some investors.

Second, a successful lift-off will presumably mean no disruption to bond, currency and equity markets, because anything else would make it difficult for further normalisation steps to take place. It's about much more than the policy rate. Money market forwards anticipate a small lift in the policy rate within the next two months, but other unconventional monetary policies will likely be retired, including YCC. Also, the more controversial aspects of quantitative easing could be halted, including purchases of equities via exchange traded funds (ETFs), especially now the stock market doesn't need the BoJ's helping hand.

Third, just looking at the chart, JGB yields have been increasingly testing the BoJ bond intervention levels. There was almost two years between the imposition of the 25bp (March 2021) and 50bp caps (December 2022), but the changes have since been coming at shorter intervals. It took only seven months for the cap to double again to 100bp (July 2023), and then another three months for this to become a "reference" rate. Extrapolating the trend implies these controls will soon be gone and JGBs will have to find their own level.

Ultimately, the level that JGB yields reach will depend on both what happens to the BoJ's bond purchases ***and*** how far the policy rate rises from its current level of minus 10bp. There have been occasions where swap yields have surged ahead of JGBs because they were not constrained, and we note that in the 30-year segment, where there is no intervention, JGBs yield more than swaps.

"Big in Japan" was 40 years ago[2]. The German pop band Alphaville sang about being successful in another world. Indeed, JGB yields were in a range of 2.5-7.0% through the 1980s, and another barometer, the Nikkei stock market index, reached a peak of 38,916 on 29 December 1989, a more than fivefold increase over the decade.

We've gotten used to Japanese interest rates being grounded and it has taken 35 years for the Nikkei to return to its previous high. As the BoJ gets ready to increase rates for the first time in 17 years, we are mindful that the rate hikes that began in May 1989 were just prior to the peak in stocks. No wonder today's BoJ is cautious about policy normalisation.

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1 JGBs make up 18.8% of the global sovereigns index (LGTRTRUU Index)
2 "Big in Japan" was the debut single of the German synth-pop band Alphaville from their 1984 album Forever Young.

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