MACRO INTELLIGENCE 2 PARTNERS

BoJ: One Green Bottle

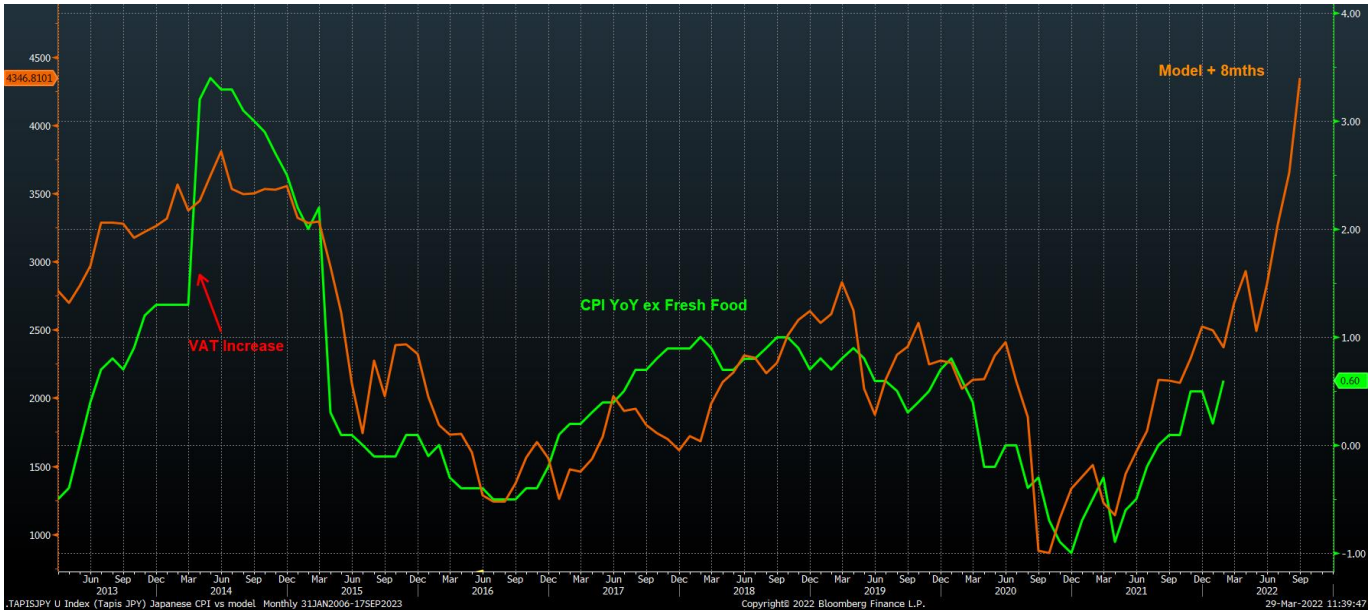
29th March 2022

Summary

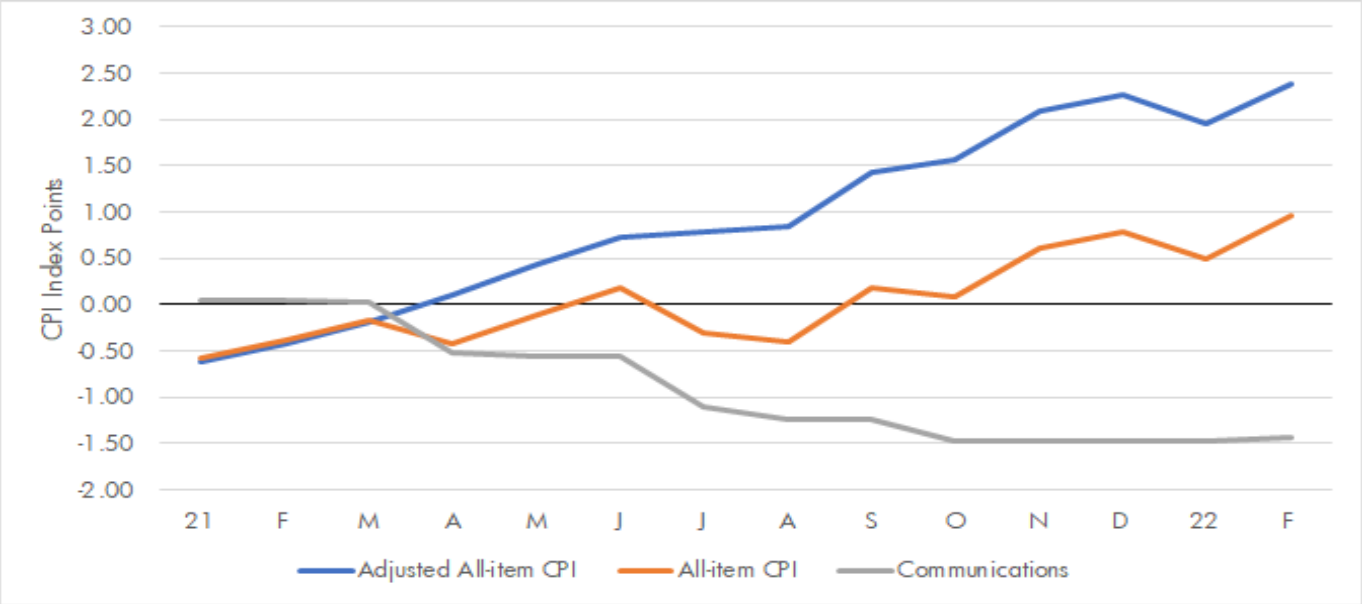
- Inflation pressures have pushed JGBs to the top of the YCC peg, forcing BoJ intervention
- Yet their reluctance to raise rates is now spilling into Yen weakness
- Unfortunately, Yen weakness no longer helps Japan and is arguably detrimental
- Lifting the JGB peg slightly would be a logical response and has precedents

For those not familiar with the nursery rhyme, it starts with ten green bottles hanging on the wall and counts down until there is one and eventually none—a fitting analogy for the BoJ, the last major central bank still resisting the current inflationary impulse. Yet, as markets have rediscovered, leaning too hard on the platitudes of policymakers, from the Fed to the BoE, ECB or RBA, is a dangerous game. They are the epitome of the unreliable boyfriend, which raises the question, could the BoJ buckle too and abandon YCC?

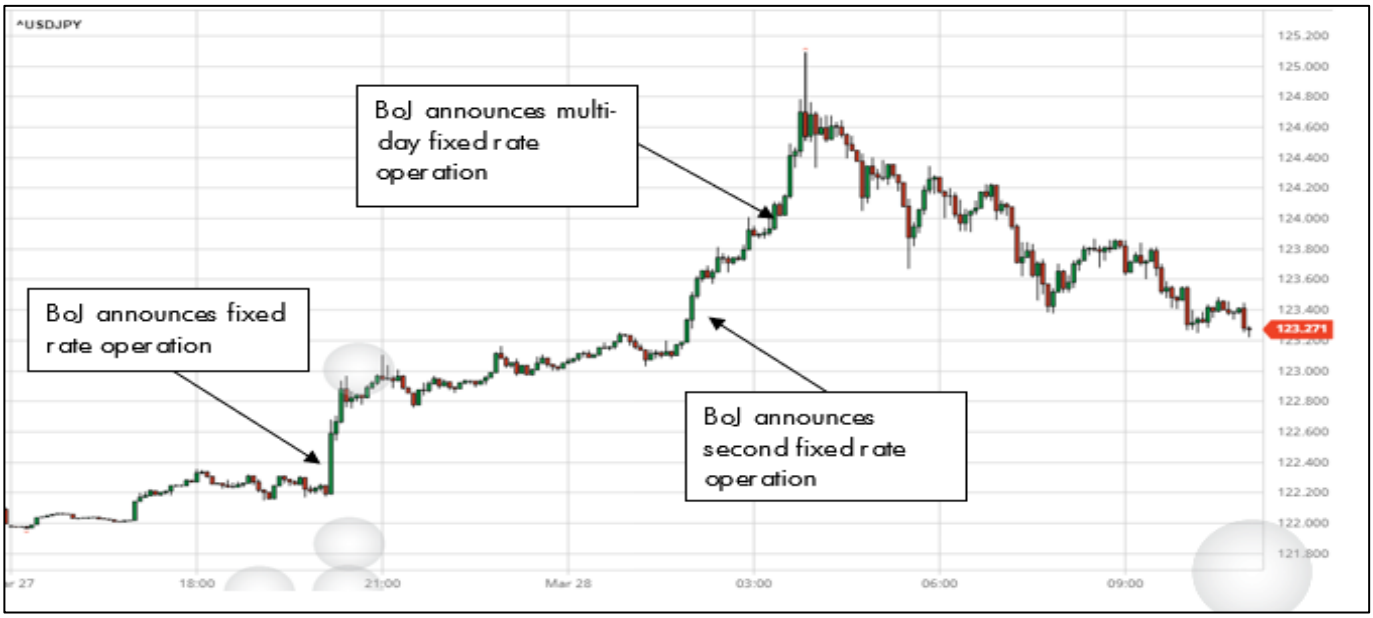
The starting point of any discussion has to be inflation, and while not as extreme as the rest of the G7, we believe that core CPI is set to overshoot the BoJ's stated 2% objective materially.



A lot of this is obviously higher energy, together with Yen weakness. But for a country with few resources of its own, dismissing the destructive economic impact of these factors is a mistake. Furthermore, it is worth noting that absent last year's massive government-mandated price cuts in the telecoms sector that will drop out in the April data, headline inflation would already be above 2%.



At first glance, this suggests that some tweak to the BoJ's policy is justifiable. However, thus far, they have stuck to their guns and seem determined to defend 10yr yields at 25bps, the long-term metric of YCC (overnight rates are fixed at -0.1%). This has manifested itself this week via a series of fixed-rate operations at the upper end of the band. The intervention amounts weren't vast (JPY 64.5bln Monday, JPY 528.6bln on Tuesday). Nevertheless, they felt compelled to pre-announce operations for the remainder of the month/quarter/financial year, which the Yen took badly. This is an annoying move because our sense is that courtesy of Ukraine and the legacy belief in the Yen as a risk-on/off currency, people had held back playing the break of 116. As we discussed, this move broke a 35-year trendline ("MI2 Chart Point: Interesting Bond Charts" 29th March).



Anyway, back to the peg. It is clear that despite the BoJ's operations, the market remains sceptical of their willingness to hold the line. To illustrate the point and without getting too bond wonky, the quickest way to dump Dv01 or duration risk is by selling the ultra-long end, and that's what investors appear to be doing. Hence, the 10s30s spread is as high as it has ever been during the YCC era. 10s are fixed, while 30s free float. Similar pressure can be seen in things like the 5s10s30s butterfly.

So, is the market, right? As discussed in yesterday's Japan Update, the 6-year history of YCC has been marred by confusion and blunders. A classic example occurred in July 2018, when the trading band on 10yr JGBs was 10bps around the peg of "about zero percent." At the time, selling pressure reared its head and then, as now, the BoJ intervened continuously into the 30th of the month. The trouble is on the 31st, they released a cryptic statement, which changed the trading band to 20bps, and the market gapped. They further increased the bands by another 5bps in March 2021.

Bottom line, despite Kuroda's apparent refusal to accept that inflation is a problem, history suggests the BoJ is as unreliable a boyfriend as their peers. Furthermore, as we have discussed in the Japan Update, the economy is radically different from the 1980s when a weak Yen was desirable. Therefore, we rank the risk of a 10bps recalibration in the peg at the start of the new financial year as comparatively high, and if not then, within a couple of months. From the BoJ, we assume the hope is that it would alleviate the pressure from the bond market and reverse the Yen's runaway weakness.