BoJ needs more time before further policy normalization

Japanese economy

Authors: Daiju Aoki, Regional CIO Japan, UBS SuMi TRUST Wealth Management Co., Ltd.; Hiromu Uezato, Strategist; Toru Ibayashi, Analyst, UBS Switzerland AG; Chisa Kobayashi, Analyst, UBS SuMi TRUST Wealth Management Co., Ltd.

- The Bank of Japan kept its yield-curve controls (YCC) unchanged, possibly because it needs more time to evaluate the adjustment made in December. Still, in order to enhance the bank's control of the yield curve, it expanded its lending facilities.
- Despite this, we think it may be difficult to improve market functioning. The BoJ will likely wait for solid wage growth before making further adjustments. We think there is a 70% chance of further tweaks to YCC in 2023, declining to 30% in 2024.
- If the BoJ abandons YCC, 10-year JGB yields could increase to 0.8–1.2%, in our view. This would be positive for Japanese financials, while the impact on the domestic economy would be limited as long as the central bank keeps the short-term policy rate at very low levels.

Source: iStock

What happened?

Despite market speculation to the contrary, the Bank of Japan (BoJ) kept its monetary policy settings unchanged in January. After the meeting, 10-year Japanese government bond (JGB) yields moved back to around 0.4%, USDJPY temporarily rose above 131, and the Nikkei index gained more than 2.5%.

While most economists did not expect additional policy adjustments, the market had priced in further tweaks to yield curve control (YCC), especially after a media report on 12 January claiming that the BoJ would review the side effects of its ultra-easy policy and may adjust its stance if necessary.

Instead of tweaking its YCC, the BoJ enhanced its liquidity-boosting framework by extending lending tenors from one to 10 years and made the lending rates for each year flexible depending on market conditions; they were set at 0% previously. This also provides the BoJ with another potential way to control the yield curve by giving private banks incentives to conduct JGB carry trades (purchasing JGBs in the market and selling them to the BoJ).

In its economic forecasts, the BoJ remains cautious about achieving 2% inflation within its target horizon (see Fig. 1). The bank revised its GDP forecast lower—mainly due to a global economic slowdown—from 1.9% to 1.7% for FY2023 (March 2024), and from 1.5% to 1.1% for FY2024 (March 2025). For core CPI (excluding fresh food), the BoJ kept projections unchanged at 1.6% for FY2023, but revised FY2024 higher to 1.8% from 1.6%. This is thanks to government subsidies lowering energy prices in FY2023.

This report has been prepared by UBS SuMi TRUST Wealth Management Co., Ltd. and UBS Switzerland AG. Please see important disclaimers and disclosures at the end of the document.

Figure 1 - BoJ expects below 2% infation

BoJ board members' economic outlook

	Real GDP % YoY	CPI % YoY Ex. Fresh Food	Ex. Fresh Food and Energy
Board member's median forecasts			
FY 2022			
January MPM	+1.9	+3.0	+2.1
(October MPM)	+2.0	+2.9	+1.8
FY2023			
January MPM	+1.7	+1.6	+1.8
(October MPM)	+1.9	+1.6	+1.6
FY2024			
January MPM	+1.1	+1.8	+1.6
(October MPM)	+1.5	+1.6	+1.6

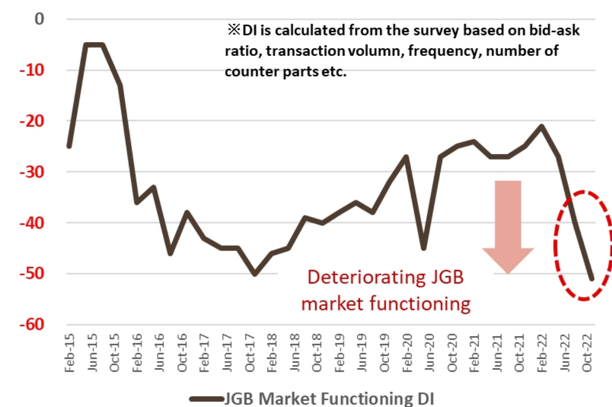
BoJ, UBS

BoJ needs more time to evaluate the adjustments

The BoJ's latest JGB market function ("DI") released in November showed a continuing deterioration (see Fig. 2), which might have triggered the surprise YCC adjustment in December. It seems the BoJ wants to wait and see whether JGB market functioning improves. Governor Kuroda emphasized in the press briefing that the bank needs more time to evaluate the policy adjustment made in December.

Figure 2 - JGB market functioning deteriorated sharply

JGB market functioning DI in the BoJ's Bond Market Survey (Diffusion Index)



BoJ, UBS

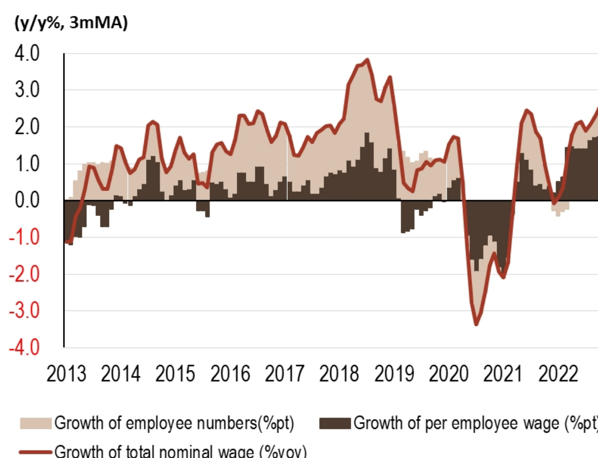
The BoJ could try to keep YCC in place for longer by enhancing liquidity operations this time. Under the new lending rules, private banks can borrow money from the BoJ for a maximum of 10 years by collateralizing JGBs with each year's yield determined by the central bank.

To evaluate these policy adjustments, the next bond market functioning survey due on 1 March will be important, particularly given the BoJ's next policy meeting is scheduled for 10 March—the last one under Governor Kuroda.

Additionally, the BoJ could think it is appropriate to keep the 10-year JGB yield cap at 0.5% for a while to support the Japanese economy. Wage growth is not enough to offset high inflation, and the GDP gap remains negative (see Fig. 3). Spring-time wage negotiations in March–June will also be in focus from this perspective.

Figure 3 - Wage growth is not yet strong enough

Total wage growth = per-employee wage growth + growth of employee numbers (y/y %, 3mMA)



MLHW, INDB, UBS

Our view on the BoJ's next move

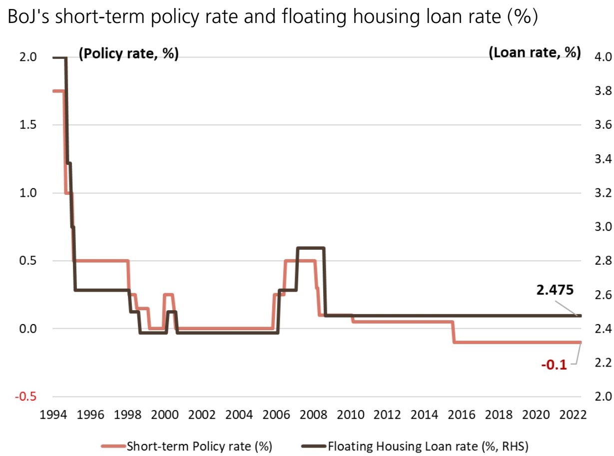
As we think JGB market functioning is unlikely to improve even with the recent adjustments, it may only be a matter of time before the BoJ makes further changes or even terminates YCC altogether, in our view. The market may continue to challenge the BoJ to keep tweaking policy, and this could drive the bank to give up the current YCC regime in the near future.

But from a fundamental economic point of view, we think it is too early for the BoJ to raise 10-year JGB yields further before confirming solid wage growth and a positive GDP gap. The result of spring-time wage negotiations (Shunto) will become clear around June. But there is some risk of a BoJ shift after a new governor take office in April and amid a potential revision of the joint statement with the government about inflation targets. Overall, we estimate a 70% probability of further changes to YCC, including doing away with it, in 2023 (25% for March, 15% for April–June, and 30% for 2H23), declining to 30% in 2024.

We think raising short-term policy rates from –0.1% is unlikely for a while yet, as this would potentially impact housing loans. About 70–80% of Japanese homeowners with a mortgage are on a floating rate, which mainly depends on the BoJ's short-term policy rate (see Fig. 4).

Figure 4 - Floating rate mortgages leave homeowners at the mercy of the short-term policy rate

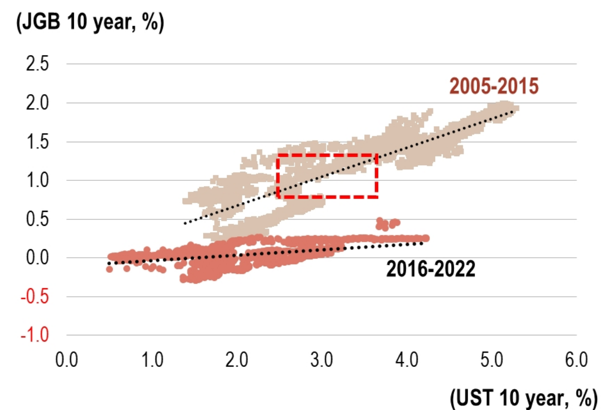
BoJ's short-term policy rate and floating housing loan rate (%)



BoJ, MUFG, UBS

Figure 5 - 10-year JGB yields around 0.8–1.2% correspond to 10-year UST yields at around 3%

JGB 10-year yield and UST 10-year yield (%)



Bloomberg, UBS

All eyes will be on who will be put forward as the next BoJ governor on 10 February. From past experience, we may see a candidate emerge in the media from late January to early February. To be sure, we think the direction of travel toward gradual policy normalization amid wage growth acceleration will likely be unchanged regardless of who takes up the post next.

Outlook for 10-year JGB yields

We think the BoJ will maintain the current 0.4–0.5% cap for 10-year JGB yields in 1H23. But if Japan sees solid wage growth and a positive GDP gap, the BoJ is likely to increase the upper limit further to 0.75%, or even abandon YCC altogether. This could cause 10-year yields to increase to 0.8–1.2%, in our view, corresponding to 10-year US Treasury yields around 3–3.5% (see Fig. 5). Still, the BoJ could try to keep a lid on JGB yields by accelerating the pace of its bonds purchases. All in all, we believe 10-year JGB yields could end 2023 at around 0.8%.

If we assume there are no further changes to monetary policy and put potential GDP growth for Japan at around 0.5%—with long-term inflation expectations near 0.5–1.0% and taking into account some risk premium from government debt—then we think the neutral rate of the 10-year JGB yield would technically be around 1.5%.

Implications for Japanese equities

The decision to leave monetary policy unchanged was welcomed by Japan's equity market, with the Nikkei 225 jumping almost 2.5%. This underscores our view that Japanese stocks are resilient to a global slowdown thanks to the domestic reopening and relatively low stock valuations. Markets are overestimating the potential of a BoJ policy overhaul, in our view, and we believe the recent sell-off in the Nikkei 225 offers an attractive entry point for Japanese equities. For more information, see our latest Japanese equity report on 6 January.

We also think Japanese financials remain attractive, as the BoJ may allow the 10-year yield to rise to 0.8% by the end of the year. Many Japanese banks and insurance companies are trading well below their book values and offer more than 4% dividend yield. Thus, we expect the shift toward normalizing monetary policy should help these stocks rerate in 2023.

Japan's macroeconomic outlook

As long as the BoJ keeps short-term policy rates low enough, we think the damage to the domestic economy of raising the 10-year yield would be limited or easily absorbed by a recovery in demand.

The correlation between capex and real yields has been low since 2000, suggesting companies are not factoring borrowing costs into decisions about capex. For the housing market, 70–80% of Japanese homeowners have floating rate mortgage loans, which are at the mercy of the BoJ's

short-term policy rate. Hence, as long as these are kept very low, the impact on the housing market should also be limited.

A strengthening yen fueled by rising JGB yields could harm manufacturing sentiment, but the impact can be mitigated by fiscal policies as long as the pace of appreciation is moderate. In all, we continue to expect real GDP growth of above 1% for 2023 thanks to the recovery in domestic demand, after growing 1.5% in 2022 and 1.6% in 2021.

Appendix

UBS Chief Investment Office's ("CIO") investment views are prepared and published by the Global Wealth Management business of UBS Switzerland AG (regulated by FINMA in Switzerland) or its affiliates ("UBS").
The investment views have been prepared in accordance with legal requirements designed to promote the **independence of investment research**.
Generic investment research – Risk information:
This publication is **for your information only** and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS). All information and opinions as well as any forecasts, estimates and market prices indicated are current as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria.
In no circumstances may this document or any of the information (including any forecast, value, index or other calculated amount ("Values")) be used for any of the following purposes (i) valuation or accounting purposes; (ii) to determine the amounts due or payable, the price or the value of any financial instrument or financial contract; or (iii) to measure the performance of any financial instrument including, without limitation, for the purpose of tracking the return or performance of any Value or of defining the asset allocation of portfolio or of computing performance fees. By receiving this document and the information you will be deemed to represent and warrant to UBS that you will not use this document or otherwise rely on any of the information for any of the above purposes. UBS and any of its directors or employees may be entitled at any time to hold long or short positions in investment instruments referred to herein, carry out transactions involving relevant investment instruments in the capacity of principal or agent, or provide any other services or have officers, who serve as directors, either to/for the issuer, the investment instrument itself or to/for any company commercially or financially affiliated to such issuers. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS and its employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is not suitable for every investor as there is a substantial risk of loss, and losses in excess of an initial investment may occur. Past performance of an investment is no guarantee for its future performance. Additional information will be made available upon request. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information.
Tax treatment depends on the individual circumstances and may be subject to change in the future. UBS does not provide legal or tax advice and makes no representations as to the tax treatment of assets or the investment returns thereon both in general or with reference to specific client's circumstances and needs. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein.
This material may not be reproduced or copies circulated without prior authority of UBS. Unless otherwise agreed in writing UBS expressly prohibits the distribution and transfer of this material to third parties for any reason. UBS accepts no liability whatsoever for any claims or lawsuits from any third parties arising from the use or distribution of this material. This report is for distribution only under such circumstances as may be permitted by applicable law. For information on the ways in which CIO manages conflicts and maintains independence of its investment views and publication offering, and research and rating methodologies, please visit www.ubs.com/research. Additional information on the relevant authors of this publication and other CIO publication(s) referenced in this report; and copies of any past reports on this topic; are available upon request from your client advisor.
Options and futures are not suitable for all investors, and trading in these instruments is considered risky and may be appropriate only for sophisticated investors. Prior to buying or selling an option, and for the complete risks relating to options, you must receive a copy of "Characteristics and Risks of Standardized Options". You may read the document at https://www.theocc.com/about/publications/character-risks.jsp or ask your financial advisor for a copy.
Investing in structured investments involves significant risks. For a detailed discussion of the risks involved in investing in any particular structured investment, you must read the relevant offering materials for that investment. Structured investments are unsecured obligations of a particular issuer with returns linked to the performance of an underlying asset. Depending on the terms of the investment, investors could lose all or a substantial portion of their investment based on the performance of the underlying asset. Investors could also lose their entire investment if the issuer becomes insolvent. UBS Financial Services Inc. does not guarantee in any way the obligations or the financial condition of any issuer or the accuracy of any financial information provided by any issuer. Structured investments are not traditional investments and investing in a structured investment is not equivalent to investing directly in the underlying asset. Structured investments may have limited or no liquidity, and investors should be prepared to hold their investment to maturity. The return of structured investments may be limited by a maximum gain, participation rate or other feature. Structured investments may include call features and, if a structured investment is called early, investors would not earn any further return and may not be able to reinvest in similar investments with similar terms. Structured investments include costs and fees which are generally embedded in the price of the investment. The tax treatment of a structured investment may be complex and may differ from a direct investment in the underlying asset. UBS Financial Services Inc. and its employees do not provide tax advice. Investors should consult their own tax advisor about their own tax situation before investing in any securities.
Important Information About Sustainable Investing Strategies: Sustainable investing strategies aim to consider and incorporate environmental, social and governance (ESG) factors into investment process and portfolio construction. Strategies across geographies and styles approach ESG analysis and incorporate the findings in a variety of ways. Incorporating ESG factors or Sustainable Investing considerations may inhibit the portfolio manager’s ability to participate in certain investment opportunities that otherwise would be consistent with its investment objective and other principal investment strategies. The returns on a portfolio consisting primarily of sustainable investments may be lower or

higher than portfolios where ESG factors, exclusions, or other sustainability issues are not considered by the portfolio manager, and the investment opportunities available to such portfolios may differ. Companies may not necessarily meet high performance standards on all aspects of ESG or sustainable investing issues; there is also no guarantee that any company will meet expectations in connection with corporate responsibility, sustainability, and/or impact performance.

External Asset Managers / External Financial Consultants: In case this research or publication is provided to an External Asset Manager or an External Financial Consultant, UBS expressly prohibits that it is redistributed by the External Asset Manager or the External Financial Consultant and is made available to their clients and/or third parties.

USA: Distributed to US persons by UBS Financial Services Inc. or UBS Securities LLC, subsidiaries of UBS AG. UBS Switzerland AG, UBS Europe SE, UBS Bank, S.A., UBS Brasil Administradora de Valores Mobiliarios Ltda, UBS Asesores Mexico, S.A. de C.V., UBS SuMi TRUST Wealth Management Co., Ltd., UBS Wealth Management Israel Ltd and UBS Menkul Degerler AS are affiliates of UBS AG. **UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons. All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate. The contents of this report have not been and will not be approved by any securities or investment authority in the United States or elsewhere. UBS Financial Services Inc. is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the "Municipal Advisor Rule") and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule**

For country information, please visit ubs.com/cio-country-disclaimer-gr or ask your client advisor for the full disclaimer.

Version D/2022. CIO82652744

© UBS 2023.The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.