MNI BoJ Preview - January 2023

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Central Bank Watch - Bank of Japan

January 16, 2023

MNI Bank of Japan Data Watch List

Inflation		Current	3m ago	3m Chg	6m ago	6m Chg	2Y History	Hit / Miss	Vs Trend	Surprise Index	Z-Score
Tokyo CPI	% y/y	4.0	2.8	↑	2.3	↑					1.80
Tokyo CPI - Ex Fresh Food	% y/y	4.0	2.8	↑	2.1	↑					1.53
PPI	% y/y	10.2	10.3	↓	9.6	↑					1.37
Inflation Swap 5y5y	%	0.90	0.95	↓	0.80	↑					0.94
Economic Activity		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Industrial Production	% m/m	-0.1	3.4	↓	-7.5	↑					-0.06
Tertiary Industry Index	% m/m	0.2	-0.5	↑	1.3	↓					-0.33
Core Machinery Oders	% m/m	5.4	5.3	↑	10.8	↓					0.58
Exports	% y/y	20.0	22.0	↓	15.8	↑					-0.07
Monetary Analysis		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
M2 Money Supply	% y/y	2.9	3.3	↓	3.3	↓					-0.85
Bank Lending	% y/y	2.7	2.3	↑	1.2	↑					0.98
Loans Outstanding (Bus)	% y/y	4.72	3.87	↑	1.98	↑					1.02
Housing Starts	% y/y	-1.4	4.6	↓	-4.3	↑					-0.16
Consumer / Labour Market		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Retail Sales	% y/y	2.6	4.1	↓	3.7	↓					0.13
Household Spending	% y/y	-1.2	5.1	↓	-0.5	↓					-1.10
Unemployment Rate	%	2.5	2.5	→	2.6	↓					-1.21
Ave Monthly Cash Earnings	% y/y	0.5	1.7	↓	1.0	↓					-1.70
Markets		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Nikkei 225	Index	25814	25937	↓	26393	↓					-1.71
Japanese 10-Year Yield	%	0.51	0.24	↑	0.23	↑					2.36
Japan Yield Curve (2s-10s)	bps	47.4	29.3	↑	28.9	↑					2.20
JPY TWI	Index	100.26	92.98	↑	95.52	↑					0.91

Source: MNI, Bloomberg

MNI POV (Point Of View): Stick Or Twist

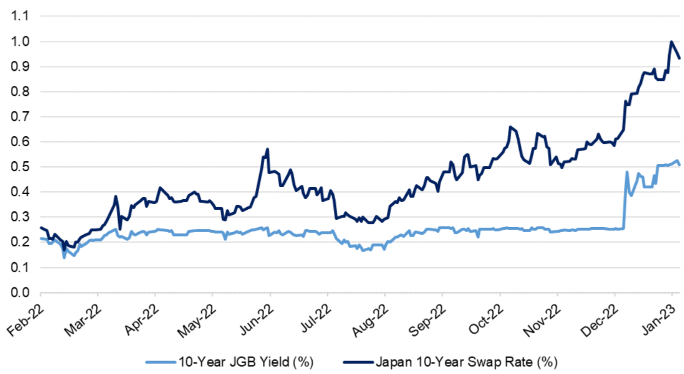
The recent round of well-documented press speculation, indicating that the BoJ will conduct a review of the side effects of its ultra-loose policy settings at the upcoming monetary policy meeting, coupled with the shrouding of trust in the Bank's communication channels after last month's surprise YCC tweak, has led to a meaningful market test of the BoJ's will ahead of the meeting. Note that we may not get any findings from the touted review of the side effects of the Bank's policy settings this time out, but the mere suggestion of the presence of the formal discussions on the matter has the markets questioning the validity of the BoJ's YCC scheme.

10-Year JGB yields have breached the upper limit of the Bank's YCC band on 3 consecutive days, triggering a record round of Bank purchases to defend the 0.50% mark, as well as the integrity of its monetary policy settings. The worrying thing for the Bank is that the latest test came in lieu of a relatively notable rally in core global fixed income markets during the early rounds of '23 trade, with idiosyncratic matters clearly dominating.

The well-documented kink around the 10-Year point of the JGB curve remains evident, even in light of the YCC tweak. This market functioning issue (the apparent focus area of last month's policy action, per Kuroda, even after he had previously equated such a move to a rate hike) is no doubt magnified by the diminished liquidity in the space as the BoJ upsizes its bond purchases. There has also been an apparent jump in basis trade activity owing to the deviation in JGB futures vs. underlying bonds, meaning that market functioning has deteriorated further. The Bank is essentially in a bind, and that is without any fresh pressure from wider core global fixed markets.

As mentioned, speculators are clearly keen to test the BoJ's will, with 10-Year swap rates closing above 1.00% on Friday, breaching that psychological level for the first time in over a decade (we have since pared back from those levels). The 10-Year swap spread has widened since Dec's YCC tweak, heaping further pressure on the Bank.

Fig. 1: 10-Year JGB Yields Vs. Japan 10-Year Swap Rate



The above mix of issues sends us into the January meeting with no real strong conviction in view. We would suggest that the Bank will have a preference towards holding policy settings steady and lean into this as our baseline pre-meeting assumption. The anchor point to this idea is essentially that the Bank will not want to tweak policy settings so quickly after December's surprise move, with a lack of evolution in its fundamental reasoning observed over that time frame. However, market dynamics may force its hand into a widening of its YCC band (say to -/+0.75%or -/+1.00%). We don't believe that the Bank will fully discard YCC settings at this meeting, as some are suggesting. If the Bank does stick with the current YCC parameters, expect a further increase in the size of the JGB purchases deployed, at least short-term.

We don't believe the target maturity of YCC will be shortened at this stage, as that would represent too much of a wholesale alteration before Governor Kuroda's departure. We are doubtful that such a move will take place over a longer horizon, with such a tweak having the potential to add further furl to the speculatory fire. The markets would likely view that move as capitulation from the Bank and quickly target the new policy settings via fresh speculative attacks. We also see the ~25bp of tightening priced into OIS markets for this year as extreme.

Expect a mark-up in underlying inflation forecasts, although the Bank will not suggest that its inflation goal has been met, given the cost-push nature of the move in inflation and the want to foster a meaningful wage growth.

The government's choice of successor to Kuroda will of course be key in shaping policy in the relatively immediate term, especially with the government set to conduct a review of the inflation agreement held between itself and the Bank. The government has been relatively tight-lipped in recent weeks, although Chief Cabinet Secretary Matsuo recently noted that the BoJ is expected to continue with appropriate policy settings, while accounting for the economic, inflationary and financial situation. Recent press reports have suggested that nominees may be outlined by the government early next month, while it would seem that Deputy Governor Amamiya remains the favourite to succeed Kuroda, although his future intentions are somewhat unclear.

Major Forecasts From BoJ Outlook For Economic Activity And Prices (October 2022)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2022	+1.8 to +2.1 [+2.0]	+2.8 to +2.9 [+2.9]	+1.8 to +1.9 [+1.8]
Forecasts made in July 2022	+2.2 to +2.5 [+2.4]	+2.2 to +2.4 [+2.3]	+1.2 to +1.4 [+1.3]
Fiscal 2023	+1.5 to +2.0 [+1.9]	+1.5 to +1.8 [+1.6]	+1.5 to +1.8 [+1.6]
Forecasts made in July 2022	+1.7 to +2.1 [+2.0]	+1.2 to +1.5 [+1.4]	+1.2 to +1.4 [+1.4]
Fiscal 2024	+1.3 to +1.6 [+1.5]	+1.5 to +1.9 [+1.6]	+1.5 to +1.8 [+1.6]
Forecasts made in July 2022	+1.1 to +1.5 [+1.3]	+1.1 to +1.5 [+1.3]	+1.4 to +1.7 [+1.5]

Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.

3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

MNI BOJ WATCH: YCC Options On Table Amid Market Pressure

By Hiroshi Inoue

TOKYO (MNI) - The Bank of Japan's meeting this week could consider options including promising more unlimited purchases of bonds or reducing the maturity of its yield curve control framework as markets continue to probe its commitment to ultra-easy monetary policy, MNI understands.

While the BOJ is determined to keep its overnight policy rate at -0.1%, investors continue to push the yield on 10-year Japanese government bonds just above 0.5%, the upper limit of its yield curve control tolerance band. Options to address this market pressure could include announcing fixed-rate purchases along the whole curve, boosting the scale of monthly buying, possibly to JPY30 trillion, or increasing unlimited purchase operations that currently target the 5-10-year sector.

Another possibility would be to lower the maturity targeted in the yield curve framework from 10 years to 5 years. This area of the curve would give a more direct impact on economic activity and bank lending rates, while the BOJ would continue to buy 10-year JGBs to dampen rates, albeit without a fixed target. (MNI POLICY: BOJ Eyes Maturities As Yield Pressure Persists)

Bank officials are likely to prepare several policy options for the board to discuss, leaving a final decision to the governor, who will be guided by an examination of risks from any additional policy action, including the impact on the yen.

BOND BUYING OPTIONS

A less likely move would be for the BOJ to again widen the tolerance range around its targeted 10-year yield of 0%, after shocking investors by doubling it from +/- 25 basis points in December.

The most extreme option, albeit unlikely at this meeting, is to drop yield curve control altogether -- but pledge to buy all JGBs necessary in order to stabilise bond yields.

Bank officials would prefer to hold off from acting in January, and to allow the December move more than a month to bed in, but they realise that this may be impossible given market pressures, which continue to mount amid speculation of a possible retreat from easy policy following the end of Governor Haruhiko Kuroda's term in April.

Reflationist board members, such as Deputy Governor Masazumi Wakatabe and Asahi Noguchi, could oppose any move this week, but staff could argue that action would boost overall quantitative and qualitative easing.

Sell-Side Views

Bank of America: Our base case is for a hold, but with low conviction, and see a significant risk that the BoJ announces the end of YCC as the dysfunctions in the bond markets that prompted Dec's YCC modifications have turned worse. We don't believe another incremental band-widening, or shortening the duration of the long-rate target, will solve the challenges to YCC. Our client checks suggest domestic investors see YCC removal as a base case. However, the likelihood of a hike to IOER (ending NIRP) is low, in our view.

- The yen rates and FX markets are priced for the BoJ's further "rate hike" or removal of YCC this week, removal of NIRP in H123, and continued rate hikes into 2024. 10-Year swap rate above 1% is understandable given the potential of the JGB yield overshooting on YCC removal, but the front-end pricing seems too hawkish as we don't believe the BoJ can enter a proper tightening cycle. USD/JPY is also pricing in YCC and NIRP exit to a significant extent.

Barclays: We expect the BoJ to stand pat on policy, while revising up its core CPI inflation forecasts to over +3% for FY22 and to over +2% for FY23 and FY24. Attention to the sustainability of inflation will be another focus of the quarterly Outlook Report

- To avoid potentially disruptive scenarios, the BoJ may feel the need to act sooner rather than later. One action our Japan economists have considered is a phasing out of YCC through a shortening of the targeted sector: i.e. rather than again widening the YCC band of permissible fluctuation for long-term yields, it would shorten the YCC target gradually to the 5y (eg, 0% +/-25bp) and then the 2y sector. Eventually, it would return to conventional monetary policy with short-term policy rates (overnight call rate) as its only operating variable, then also shifting from negative interest rate policy (NIRP) to zero interest rate policy (ZIRP).
- However, with the ongoing pressures on long-term yields, such a phased revision may no longer be realistic, raising the probability of a full abandonment of YCC combined with discretionary intervention. One could argue that the current global environment of reduced pressures on long-term yields, with 10-Year UST yields back to below 3.5%, may have created a window of opportunity for such a move.

CBA: We expect no policy change from the Bank of Japan. Market speculation is strong of a policy change in coming months following the BoJ's widening of the trading range around JGBs. If the BoJ decide to change policy, they could widen the trading range again or dump it altogether. It is also possible the BoJ decrease the share of reserves (from half) that have the -0.1% policy balance rate applied.

Citi: The BoJ 10-Year Yield Target and the CPI current forecast for Q1 will both be in focus. Citi Economics and CitiFX Strategy expect YCC to be abolished. Our strategist thinks that the Bank will begin its transition to Quantitative Easing (QE) or at least reinforce its bond purchase program, while a report from Nikkei informs that the CPI forecast may also be raised closer to the 2% level.

Daiwa: After Kuroda pulled a surprise last month, doubling the YCC target range for the 10-Year JGB yield to +/-0.50%, the outcome this time around is hard to predict with confidence. While Kuroda suggested that there will be no further amendments, the markets have continued to test his resolve, requiring record outright bond purchases to defend the 10-Year yield target, as well as record lending of its holdings back to the market to try to support bond market functioning. Indeed, while Kuroda's justification for December's policy adjustment was supposedly to help improve the functioning of the JGB market, the market has become increasingly dysfunctional as many participants continue to bet that further adjustments to policy will be made by Kuroda's successor (due to arrive in April) if not beforehand by Kuroda himself.

- The JGB curve remains significantly kinked around the 10-Year yield, while 10-Year swap rate continues to flirt with 1.00% and short-dated OIS point to policy rate hikes before the end of the year. With the Yomiuri newspaper last week having reported that the Policy Board will review the side-effects of its monetary policy and may take further measures to "correct distortions" in the yield curve this week, it would not be a major surprise to see further adjustment to the YCC framework on Wednesday, whether via another increase in the 10-Year target, or indeed the abolishment of the target altogether, with or without the introduction of a new target for shorter-dated yields which the BoJ believes are more relevant for inflation and growth.

- Nevertheless, the BoJ-watcher for Daiwa Securities in Tokyo thinks that Kuroda will hold his nerve, leave the current framework intact this week and ultimately also leave it for his successor to disband the YCC framework later in the year. She also thinks the BoJ's updated Outlook Report will revise up the Bank's forecast for core inflation to 1.8%Y/Y next fiscal year and 2.0%Y/Y in FY24, with the implied achievement of the target in a couple of years' time used to justify the current policy stance rather than motivate a further adjustment.

DBS: Japan's bond and FX markets reacted significantly on news report that the Bank of Japan will review the side effects of massive easing at next week's meeting.

- Examining the side effects of monetary easing does not mean the BOJ will shift to a hawkish stance at next week's meeting. The ultra-loose monetary policy has indeed weakened the yen, and boosted inflation through the trade channel (latest Tokyo CPI: 4.0% YoY in Dec). But the imports-driven inflation may not sustain for long in Japan, considering the economy's negative output gap, persistent decline in GDP deflator, and contraction in real wages.
- Further widening the 10-Year yield band is not very likely at this week's meeting. The distortion of the JGB yield curve has continued after the 25bps band widening in December, which requires further measures to rectify. Back-to-back policy adjustment, however, could create the perception that the BOJ is losing its control over the yield curve and fuel speculations about an abandoning of YCC. For now, our base case forecast is still for the BOJ to make further YCC tweaks at the April meeting.

Goldman Sachs: We expect the BOJ to maintain yield curve control (YCC) at its monetary policy meeting, though some tweaks may be introduced. However, following a media report, a skeptical view on the sustainability of YCC had spread substantially in the JGB market, and yields increased across the curve. In this regard, we flag the possibility that these developments might lead the BOJ to finally decide on a major unwinding of YCC.

- We expect the BOJ to raise both its FY2023 and FY2024 inflation outlooks in its Outlook Report to close to +2%, following +3% in FY2022. Accordingly, the BOJ would need to clarify the conditions for achievement of the 2% inflation target.
- While the BOJ widened the 10-year yield band at its December MPM, the yield has already risen to the new upper limit of +0.50%, and yield curve distortion has not yet been rectified. The BOJ will therefore need to decide whether to take a second step now or adopt a wait-and-see stance for the time being.

ING: The BoJ is expected to stand pat after delivering its unexpected decision in December to expand the yield curve band. Governor Haruhiko Kuroda's future guidance will remain dovish, but apart from that, the market appears to be pricing in additional normalisation steps from the next BoJ governor. Considering that Tokyo CPI inflation hit 4% year-on-year, national CPI inflation for December is likely to climb up to 4%. But, pipeline prices, such as import price and producer price, are expected to be lower than in the past month.

J.P.Morgan: As the amount of the BoJ's JGB purchases has increased even after the December policy adjustment with persistent market expectations for further policy normalisation, we cannot rule out the possibility of additional YCC tweaks. However, we do not think the BoJ believes that it can't control such expectations to the extent that the bank will be forced to completely remove the YCC immediately. Also, if it further widens the 10-Year YCC band consecutively, controlling the market expectations for additional policy normalisation would likely become even more difficult for the BoJ. Thus, if the BoJ intends to conduct some kind of review, we think it is likely to justify the December decision and curb expectations for further policy normalisation. If this is the case, the BoJ could hint at ranges of the yield curve, which it considers appropriate, in order to guide market expectations.

- In our view the immediate challenge for the BoJ is to curb expectations for additional policy normalisation. The BoJ appears to have started aiming for policy normalisation, and it cannot be ruled out that political factors could move the BoJ, but we think the significance of swiftly proceeding with the process likely will be low. Although domestic demand has started to recover and inflation continues to rise, the economy is not heating up to the extent that a sharp rise in interest rates and potential risk of large currency appreciation can be tolerated. Thus, we think the economic environment does not strongly support consecutive policy changes. In the outlook report, although the BoJ is likely to revise up its inflation outlook, we expect the BoJ core inflation rate forecasts for FY2024 to be kept slightly lower than the target of 2%, reflecting the bank's intention to curb expectations for additional policy normalisation.

- We expect the BoJ to eventually remove the YCC sometime in 2023 or 2024. If the global hiking cycle, including that for the Fed, ends after mid-2023 and Japan's inflation rate peaks, the market's expectation for the equilibrium 10-Year bonds yield likely will decline. If this outcome materializes, the BoJ would be able to exit from YCC without causing major market turmoil. This is a path that the BoJ would probably consider desirable.
- There is still some possibility that market pressure will force the BoJ to further adjust or exit the YCC. If global inflation, including in Japan, further pushes up expectations for higher rates, the BoJ could be forced to further widen the 10-Year YCC band, or to abolish the YCC in a form accompanied by a sharp rise in 10-Year JGB yields. We can't deny this possibility, but at this stage we do not consider it a main scenario.

Mizuho: It is only a month ago that the BOJ voted to widen the long-term yield band. Conventional wisdom says the board will leave policy unchanged this month as it observes the impact of that change. However, communication between the Bank and the market appears to have broken down in the wake of that decision, leaving traders nervous about the possibility of further action this time. They are rattled because last month's shock decision looks very much like the BOJ caving into pressure from foreign speculators. The Yomiuri reported on the 12th that the board will assess the side-effects of its current policy at this month's meeting, and "will make further changes if needed."

- A number of media reports suggest that the new outlook report will include upward revisions to the board's core CPI forecasts at all time horizons. Kyodo News claimed on 6 January that the FY24 forecast may be exactly 2% YoY, although that would not represent stable and consistent price growth because inflation is set to spike in FY24 after this year's government action to contain electricity and gas prices, and the current inflationary surge is chiefly the result of supply shocks. Even so, a change to the Bank's inflation outlook could provide speculators with further impetus to short JGBs

Morgan Stanley: We expect the BoJ to remain on hold, but acknowledge the existence of some risk of the BoJ suddenly modifying or abolishing YCC at each future meeting, including the January MPM.

MUFG: We expect the central bank to keep monetary policy unchanged.

- The BoJ's decision last month to expand the range for the 10-Yearr JGB yield from 25bps to 50bps under its yield curve control operations came as a surprise, but we think the BoJ will continue to use JGB purchases and pooled collateral operations to manage yields for now, ahead of the nominations for the new BoJ Governor and Deputy Governors in the January ordinary Diet session.

Societe Generale: Scenario1: 50% probability. The BoJ will assess various measures conducted under the current framework and make public its findings, likely at the March monetary policy board meeting.

- Scenario 2: 25% probability. The BoJ will announce the results of its assessment but will not change the current framework and also reinforce JGB purchases. For example, there will be no JGB purchase limitations per month and it will also increase the types of bonds that are available, etc.
- Scenario 3: 25% probability. The BoJ will announce the results of its assessment and will widen the fluctuation range permitted for the 10-year JGB yield to ±75bp.
- According to a Bloomberg report, BoJ officials see little need to rush into making another big move to improve bond market functioning, and that for now it is likely to assess the impact of last month's yield adjustments. In addition, due to the side effects of the current framework, the BoJ has given importance to the shape of the JGB yield curve. We believe this indicates that there is a possibility it will further increase and reinforce JGB purchases.
- We expect core CPI (CPI excluding only fresh food) forecasts for FY22, FY23 and FY24 to increase due to the rise in food prices, price pass-through of past yen depreciation and government support for electricity and gas bills. In addition, we also expect core-core CPI (CPI excluding fresh food and energy) forecasts for FY22, FY23 and FY24 to rise. However, the BoJ will likely indicate that the annual change of core-core CPI will gradually decline and not reach 2% in FY23 and FY24.

TD Securities: We expect a further widening of the YCC band by another 25bp at this meeting, and if not now, at the March meeting. Market functioning has not improved as reflected in large unscheduled bond buying operations.

Additionally, there are growing signs of broadening inflation pressures. At the very least we expect the BoJ to revise its inflation forecasts higher.

UBS: We do not expect any policy change Wednesday, but we cannot rule out further widening of YCC band from +/-50bp to +/-100bp as the reason for the widening decision in the last meeting was to improve the bond market function and the function has deteriorated by bond selling pressure. We believe abandoning of the YCC and/or end of negative interest rate is not the issue for next week. These policy changes are an outright policy shift that should be the exit from current policy framework of QQE and YCC. Without the judgement that the Bank's inflation target is close to be achieved, it is hard to rationalize the exit, at least under the current policy paradigm with Governor Kuroda, in our view.