MAR
10
2022

Around THE Curve

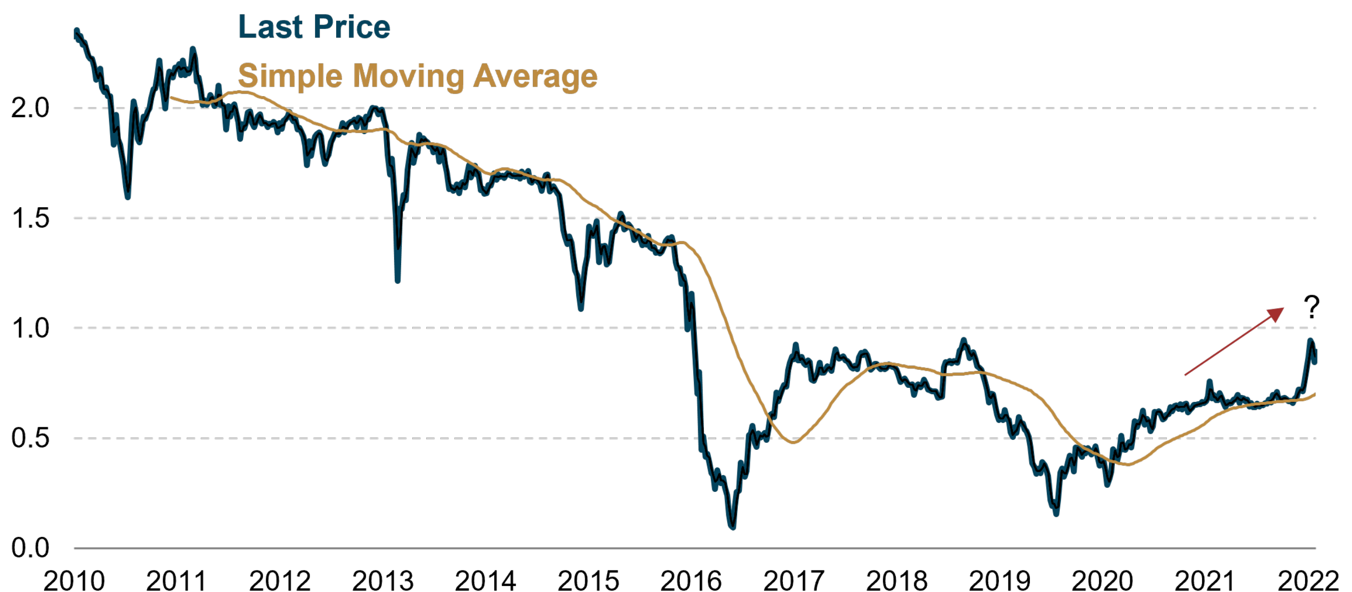
Awakening Japan’s Sleeping Giant

Carol Lye |

Since its start, 2022 has been a volatile year for global bond yields. Inflation concerns and central banks seeking to play catch-up have been top of mind for investors, sending yields higher. German bunds broke above 0% on February 2; U.S. 10-Year Treasury bonds topped 2% on February 15. Japanese government bonds (JGBs) also have not been spared. Since mid-January, 10-year JGBs have risen alongside global bond yields, nearing the top of the Bank of Japan’s (BOJ) yield curve control (YCC) band target of 0.25%. The super-long, 30-year end of the JGB curve jumped close to 30 basis points (bps) to reach almost 1% in a span of two weeks (see **Figure 1**). Even with the sharp increase in global uncertainty and geopolitical risks stemming from the conflict in Ukraine, JGB yields remain higher than at the start of the year.

After these recent moves, the questions are: What is going on in Japan’s sovereign bond market, and have JGBs awoken from their slumber? Furthermore, Japan faces even bigger questions around the persistency of inflation and whether the BOJ will move away from YCC.

1 **30-Year Japanese Government Bond Yields**
%, As of 3/8/2022



Source: Bloomberg (© 2021, Bloomberg Finance LP)

Reasons for the Recent Rise in JGBs

1. **View that the BOJ will abandon yield curve control –** First, JGB yields—especially in the super-long segment of the curve—have been used by overseas investors to express a view that the BOJ will ultimately abandon its YCC and move along with the rest of developed market central banks.

   During the week of January 14, some news releases suggested that the BOJ would move up its inflation forecasts and might start to debate how and when to begin signaling an eventual increase in interest rates. Negative interest rate policy (NIRP) is generally an unpopular program among banks. However, at the January BOJ meeting, Governor Kuroda flatly refuted that a change in stance was being discussed. The BOJ further defended this rhetoric with a new bond-buying operation in February to keep the 10-year yield within the target band.

2. **Domestic institutions holding off on buying –** Second, the super-long sector has traditionally been held down by domestic buyers, such as banks, pension funds, and insurance companies, which require a higher yield. However, domestic investors have been slow to buy bonds during the recent rise in yields. Why have they been holding off? From the angle of the purchasers, Japanese pension funds and banks have largely exhausted their quotas for purchasing bonds for the current fiscal year, which ends in March. In addition, Japanese life insurance companies need not continue to buy bonds to reduce their duration gap due to convexity. And to top it off, domestic investors have been partly waiting for the BOJ to send a stronger signal before purchasing more bonds.

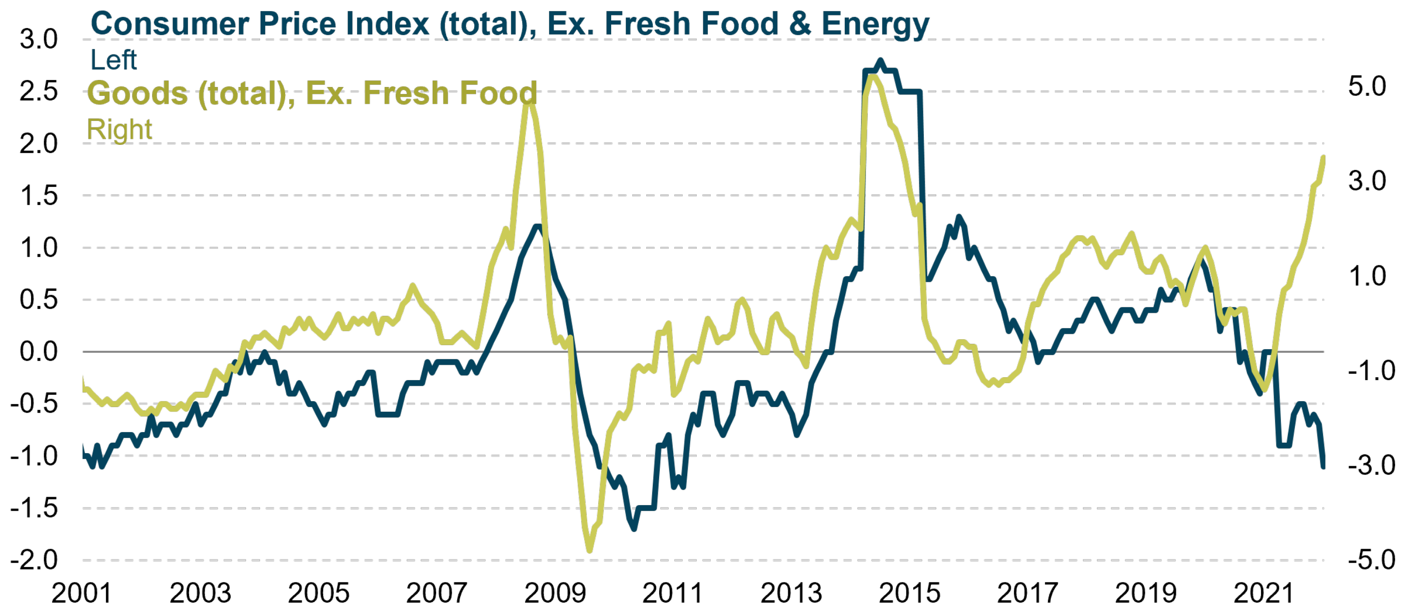
3. **Potential shift in YCC target –** Third, at the end of January, the International Monetary Fund (IMF) suggested the BOJ change its YCC target to 5-year bonds from the 10-year peg. This adjustment would allow bank profits to widen and the yield curve to steepen. However, the BOJ has dismissed this suggestion as premature, as it is not within Kuroda's time frame.

The reasons above are more technical in nature. The fundamental question, however, is whether there is a reason for the BOJ to abandon its YCC. Will inflation forecasts be revised upward? And will inflation be persistent?

Japan's Big Inflation Question

Japan's inflation has been structurally anemic. The reasons for this weakness are well documented—aging demographics are a drag, and technology advances have helped keep wages at bay while increasing productivity.

Cyclically, however, there are reasons to believe that headline inflation could breach 2% temporarily before coming back down toward 1.5%. Currently, headline inflation is a dismal 0.5% year-on-year. Core CPI, which excludes food and energy, was -1.9% year-on-year. After April this year, the temporary base effect of the mobile phone price cut will disappear, driving core CPI immediately higher toward 1.5%. Energy prices have been increasing, and that rise has been feeding into core goods prices (see **Figure 2**). We have been hearing that Japanese food manufacturers, restaurants, and major retailers will be raising prices due to higher cost prices. That pressure on price increases had been expected to help sustain core CPI at 1.5% for the rest of this year. Now, these inflationary pressures may be even higher as the conflict in Ukraine could send energy, commodities, and food costs skyrocketing.

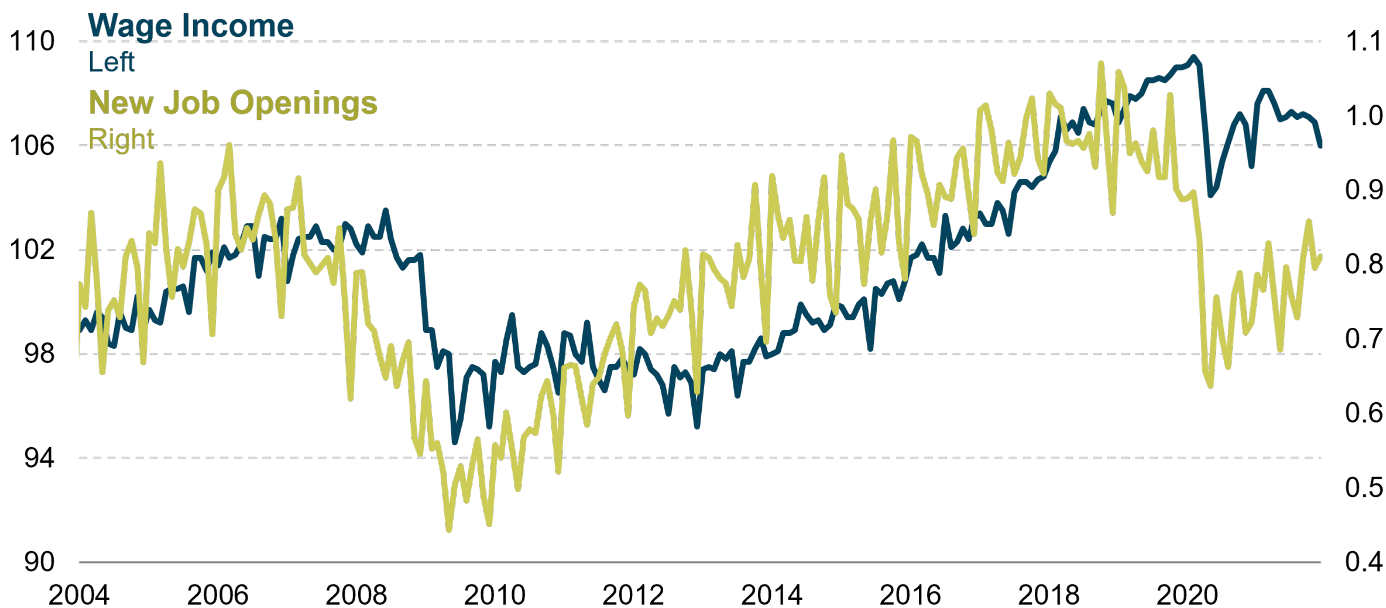


Source: Brandywine Global, Macrobond, Japanese Statistics Bureau, Ministry of Internal Affairs & Communications

Ultimately, for inflation to be more persistent, what Japan needs is higher wages. In that respect, it may still be tough for inflation to be more than transitory. The BOJ's Kuroda quoted a 3% increase in annual wages as needed to achieve sustainable price inflation. Unions this year are generally setting their sights on higher wages compared to last year due to stronger corporate profits. However, new job openings, which correlates well with wages, have been weak and lagging other countries (see **Figure 3**). In addition, Japan's Phillips curve, which models the relationship between the unemployment rate and inflation rate, has been unusually flat since the 2010s, undermining the chances of a spike in inflation driven by a wage-growth spiral.

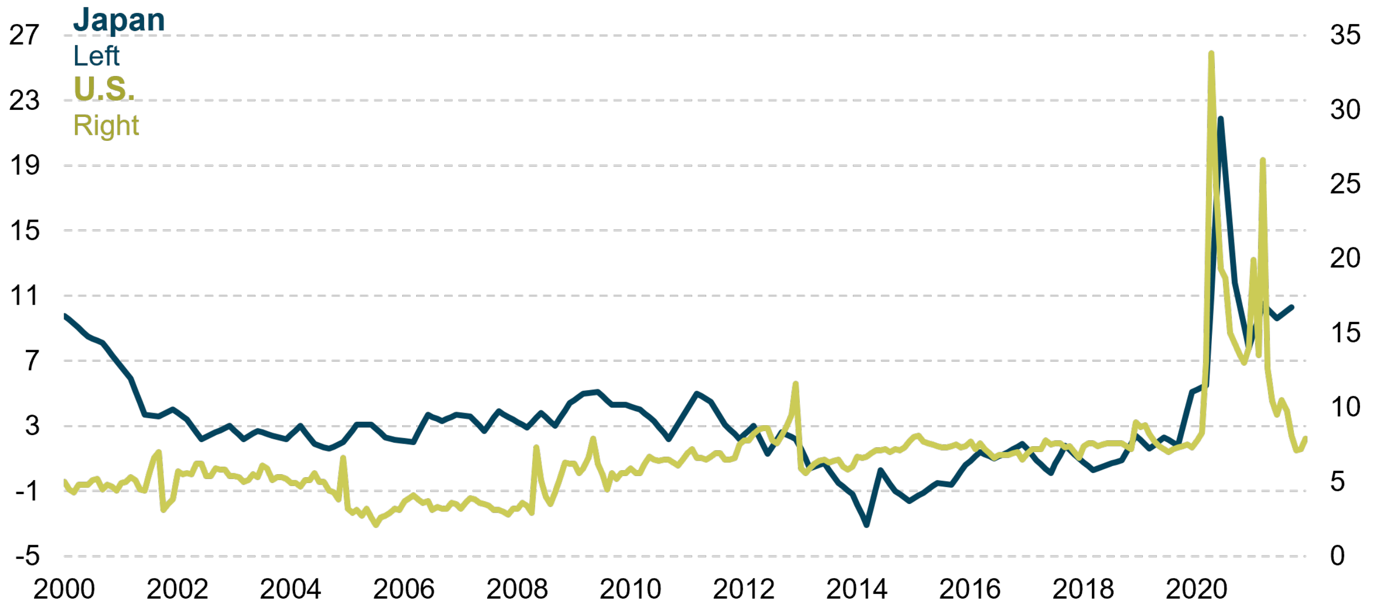
3 **Japan’s New Job Openings and Wages**

Nominal, Seasonally Adjusted, Index (Left), Number of Persons, million (Right), As of 12/1/2021



Source: Brandywine Global, Macrobond, Cabinet Office, Japanese Ministry of Health, Labour & Welfare

Lastly, the Japanese savings rate remains near a pandemic high. In contrast, the U.S. has seen a drop in its savings rate (see **Figure 4**). Japan’s still-high savings rate may continue to act as a buffer to consumption and persistent inflation in the coming quarters.



Yield Curve Control: Hard to Quit Entirely

Given that core inflation likely is not able to meet the central bank's 2% target, the BOJ will find it difficult to abandon YCC. However, that does not preclude the BOJ from revising its YCC target range to make the policy more sustainable. We could see the BOJ tinkering with YCC through various combinations, such as moving from 10 years to 5 years and/or increasing the YCC target band from +/-0.25% to +/-0.5%. Policymakers last revised the target range in March 2021.

The Risk Event to JGBs and JPY in 2022-23

To summarize, the latest rise in JGB yields has been driven largely by overseas speculation around a change in the BOJ's YCC policy. So far, the BOJ has won the battle against bond vigilantes. And, the recent geopolitical conflict in Europe will add to a downward bias in JGB yields. Beyond that, based on the lack of persistent wage inflation, there is even less reason for the BOJ to change its stance on monetary policy this year.

A rise in JGB yields would have an impact on the yen. However, as long as the BOJ keeps yields within target, and U.S. yields continue to stay more elevated, the yen could continue to remain on the weaker end this year. One caveat to this outlook is the yen's status as a perceived safe haven in periods of uncertainty.

However, we cannot remain naïve about possible shifts in inflation in 2022 that could result in a change in the BOJ's dovish stance. Political backlash over the negative interest rate policy could occur if imported inflation—especially now with food and energy prices skyrocketing—continues to result in generalized price hikes, to which Japan's elderly population is sensitive. We therefore will be keeping a close watch on the trend of inflation, especially in May and June this year.

The biggest domestic risk event to JGBs—with possibly an even stronger trend in the yen—is the appointment of a new Governor of the Bank of Japan when Kuroda's term expires in spring of 2023. Japanese banks have long been unhappy

over the costs of NIRP and likely want to see the yield curve steepen. Along with higher inflation, this change in leadership could tip the balance toward a shift in the BOJ's monetary stance.

Therefore, between now and the spring of 2023, JGB volatility may be higher than usual. Furthermore, the market may continue to test the possibility of an eventual policy shift via the super-long sector, even before the new governor is elected.

Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.

©2022 Brandywine Global Investment Management, LLC. All Rights Reserved.

Social Media Guidelines

Brandywine Global Investment Management, LLC ("Brandywine Global") is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Brandywine Global may use Social Media sites to convey relevant information regarding portfolio manager insights, corporate information and other content.

Any content published or views expressed by Brandywine Global on any Social Media platform are for informational purposes only and subject to change based on market and economic conditions as well as other factors. They are not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Additionally, any views expressed by Brandywine Global or its employees should not be construed as investment advice or a recommendation for any specific security or sector.

Brandywine Global will monitor its Social Media pages and any third-party content or comments posted on its Social Media pages. Brandywine Global reserves the right to delete any comment or post that it, in its sole discretion, deems inappropriate or prevent from posting any person who posts inappropriate or offensive content. Any opinions expressed by persons submitting comments don't necessarily represent the views of Brandywine Global. Brandywine Global is not affiliated with any of the Social Media sites it uses and is, therefore, not responsible for the content, terms of use or privacy or security policies of such sites. You are advised to review such terms and policies.