Bank of Japan defies market speculation; keeps policy steady

In keeping its key rate and yield curve control policy unchanged at today's meeting, the Bank of Japan probably wanted to convey a message to the market; don't fight the BoJ. After the decision, the Japanese yen plunged to the 131 level while the 10Y JGB yield reached 0.38%. We think market volatility can continue for a while yet

Bank of Japan Governor Haruhiko Kuroda

-0.1% Policy balance rate

As expected

0.0% 10-year JGB yield target

As expected

BoJ watch

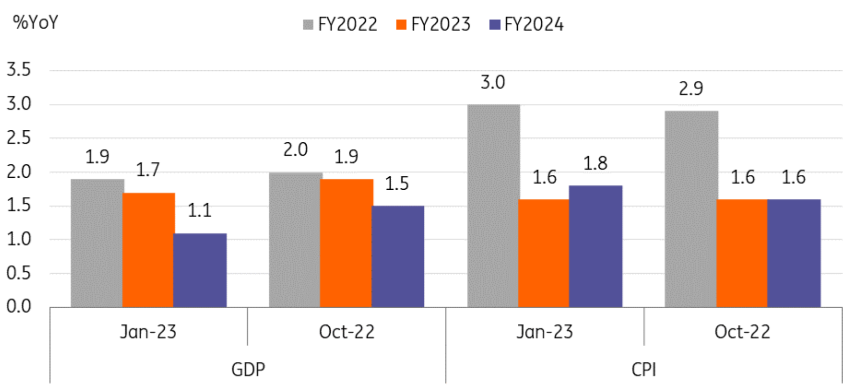
The next BoJ meeting will be held on 9 and 10 March, the last of which will be led by Governor Haruhiko Kuroda. His successor's nominee will be submitted to the parliament around 10 February and thus we will know who will replace him by then. We think it will be difficult to make a major policy change at his last meeting, and so the next move should be taken after the new governor comes on board. Although Governor Kuroda emphasised today that there is no need to widen the yield range further and yield curve control is sustainable, this view could change under the new governorship. As such, we think that today's comments will only be valid until early April.

We maintain our view that the BoJ will keep its negative policy rate and yield curve control policy by the end of 2023, for now. We expect the new governor to first adjust the BoJ's forward guidance and then call for a policy review, but we will revisit our BoJ policy outlook once we know who is the next governor.

The BoJ downgraded its GDP outlook

The Bank of Japan also released its latest forecast for economic activity and prices today. The BoJ trimmed down its GDP outlook for FY22 from 2.0% year-on-year to 1.9% and from 1.9% to 1.7% for FY23. Meanwhile, in the case of CPI, the FY22 forecast is slightly raised from 2.9% to 3.0%, but the FY23 forecast remains unchanged at 1.6%. The new set of forecasts indicates that the BoJ will continue to pursue its 2.0% "sustainable" target as the recent higher-than-usual CPI is only transitory and will soon pass the peak. We believe that risks to growth are skewed to the downside based on recent weak activity and forward-looking data thus the economy is not ready for a reduction in stimulus yet.

A lower growth outlook



Source: BoJ

USD/JPY: A volatile bear trend

The BoJ's decision to leave its policy tools unchanged clearly disappointed an FX market positioned for further adjustment. Arguably the market had got ahead of itself, where the recent run-up in two-year yen swap rates to 0.30% suggested that a rate hike might even be on the table in the not-too-distant future. These swap rates have now dropped back to 0.15%, taking the yen with them.

USD/JPY remains priced as one of the most volatile currencies in the G10 FX space and notably delivers on those expectations of volatility. One week realised volatility is being delivered at 20% versus the priced levels of 19%. We expect that volatility to continue, especially in the March/April window when Governor Kuroda will hand over the reins of the BoJ governing board.

USD/JPY has been at the vanguard of the broad dollar decline since October – helped in part by the $70bn of FX intervention undertaken by Japanese authorities. We expect further broad dollar weakness this year as Federal Reserve easing expectations build in the second quarter. This should probably mean the current USD/JPY correction stalls in the 132.50/133.00 area, with outside risk to 135. We have an end 1Q23 target of 128 and our current year-end target of 125 should probably be closer to 120.

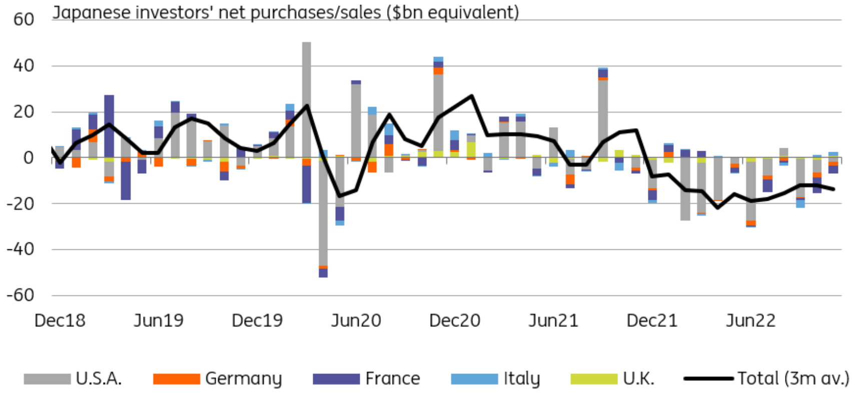
JGB: No change in YCC means more JGB purchases, but slow foreign spillover

Even after the BoJ's failure to lift the YCC cap on 10Y JGB yields once more after its December move, it seems the widely held view in the market is that that cap will have to be lifted, or removed altogether, at some point this year. Even after today's drop, 10Y JPY swaps still trade around 0.80%, well above the JGB cap, and we expect them to return to the 1% area soon. Trading JGBs has become a risky endeavour with shorts prohibitively expensive and longs liable to get run over by another surprise move by the BoJ.

> *Delaying further changes to YCC will likely force it to continue purchases*

The BoJ has reportedly bought JPY 34tn of JGBs since its decision to lift the cap from 0.25% to 0.50% in December. Delaying further changes to YCC will likely force it to continue purchases even if selling pressure slows in the coming days. Cornering the JGB market even more does not sit well with the stated aim of improving JGB market functioning in our view, but it seems a willingness to shield broader markets and the economy from too abrupt a move has taken precedence.

Japanese investors were net sellers of foreign bonds for most of 2022



Source: Japanese Ministry of Finance, ING

We think the short-covering seen in Treasuries and Bunds today overstates the spillover from BoJ decisions into foreign markets. As JGB yields rise, and rate differentials narrow, we think Japanese investors will increasingly favour domestic bonds over foreign ones. This should occur progressively, however. Net selling of foreign bonds already started in 2022 and only amounted to $14bn equivalent per month. This will add up over time, but this is not enough to change the trajectory of the US and European bond markets on their own.

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