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ECONOMICS: JAPAN PERSPECTIVES

RISING JGB YIELDS: TREND OR NOISE?

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A sharp rise in Japanese government bond yields has given a surprise twist to the start of 2015. It runs counter to the narrative of the Bank of Japan's quantitative and qualitative easing program. We expect the narrative will eventually dominate, and cause yields to stabilize. Even so, the improving fundamental picture (particularly around wages growth) suggests that caution may be necessary.

Rising Yields Are a Key Theme

One major market controversy in Japan in recent weeks has concerned the behavior of Japanese government bond (JGB) yields. Is the sharp rise over the last month the start of a bear market trend? Or is it likely to be resolved as the weight of central bank purchases dominate?

First, some background. JGB yields rallied sharply following the surprise announcement of the Bank of Japan's (BoJ) expanded quantitative and qualitative easing (QQE) program in October, driving 10-year yields down to 20 basis points and 30-years close to 1%. Since the yield lows on January 19, however, it's largely been one-way traffic. Volatility has increased markedly and yields have backed up very sharply **(Display 1)**.

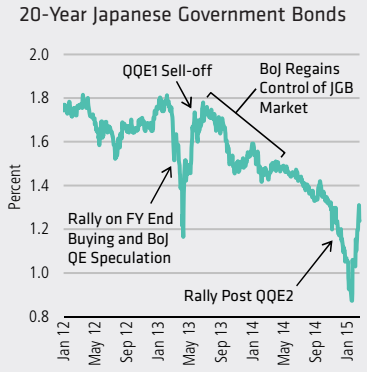
These episodes are not uncommon. There have been a number sharp reversals during Japan's 25-year JGB bull market marked by sharp reversals, only for the trend to eventually continue. Prior to the current episode, we had the turmoil post the 2013 introduction of QQE. And the most dramatic episode before that was the 2003 "value at risk" (VaR) shock: 20-year yields went from below 80 basis points to more than 2% in just two months.

To date, the BoJ has been dismissive of the volatility's impact, but this episode is clearly not quite running to script. The weight of central bank buying was supposed to prevent yields from rising. To be fair, that narrative still makes sense. The BoJ remains committed to buying ¥80 trillion of JGBs a year. The government's net new issuance task in the coming fiscal year is ¥37 trillion; given the recent strength in tax revenues it could well be smaller than that. The public pension funds are allocating away from domestic bonds—looking to cut current allocation by around 30% (that is, from 50% of total portfolio to 35%)—so that's maybe ¥30 trillion of additional net "supply" **(Display 2)**. But other holders are pretty "sticky," so the big picture still seems to favor an excess of demand over supply.

Market Dynamics Are Central

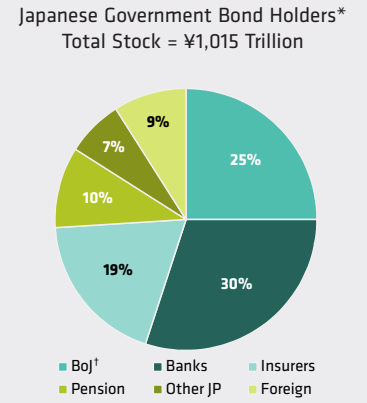
So, if nothing changes in the big picture of demand and supply balance, what then? A large part of the story concerns market dynamics and technical considerations—the relationship between the ministry of finance's auctions (at which primary dealers are obliged to bid) and the BoJ's purchase (Rinban) operations. Dealers are

Display 1
Yields Rise Sharply



As of January 18, 2015
Source: Bloomberg

Display 2
Most JGBs Are Tightly Held



As of September 30, 2014
*JGBs plus T-bills
†Includes other government holdings of JGBs and T-bills.
Source: BoJ Flow of Funds Accounts

unwilling to warehouse risk and—for whatever reason—are uncertain about their fellow dealers' behavior. So they are incentivized to bid as wide as (credibly) possible in the auctions. As a result, the auctions have been generally poorly received. Everyone else stands on the sidelines, a bit like "rubberneckers" driving past a freeway pile-up. In the absence of real-money purchasers, this leaves the dealer community as relatively aggressive sellers into the Rinban operations. Yields rise higher in a self-perpetuating loop.

The consensus story right now is that this loop should come to an end as real-money investors find the yield attractive enough to start buying. Nobody knows quite what that yield would be, and it's conceivable that "attractive" yields could be well above current levels. But given that the life insurance sector is structurally short duration and under pressure to close the gap, the story remains very plausible.

Alternatively, it might be that a circuit breaker is required to stem the volatility, courtesy of something "new" from the BoJ—perhaps tweaking the way the Rinban operations work, perhaps increasing the size of the program. That said, it's unclear whether that would be an effective circuit breaker. The dominance of the BoJ's program has left the JGB market anchorless—almost completely detached from fundamentals—and arguably that's reinforcing this aberrant behavior.

Has the Fundamental Anchor Dragged?

In light of that, it's worth considering whether anything has changed on the fundamental side. This is an important consideration particularly when we draw comparisons with the 2003 episode. As now, the initial phase of that sell-off reflected market dynamics: a poor 20-year auction in mid-June of that year sparked the initial sell-off (20-year yields rose 30 basis points in two days); the higher volatility caused many investors' VaR-based risk limits to be breached, leading to positions being unwound, which exacerbated the sell-off.

But shifting fundamentals became a key part of the of the second phase of the sell-off **(Display 3**), caused mainly by changing Fed expectations and better Japanese data (sound familiar?).

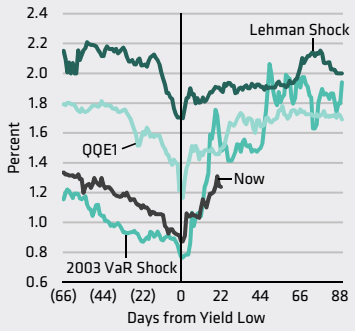
So, has the fundamental anchor been dragged out of position? It may seem odd to argue the "yes" case given the disappointing GDP result earlier this week and the high likelihood of negative headline consumer price index readings in coming months. But I'm going to anyway, on the basis of the three markers we have consistently pointed to as indicators of "success": (1) export volumes are now increasing sharply. January's data—albeit distorted to some extent by timing of Chinese New Year—show export volumes up 14% year on year; (2) business capital spending, which was up 3.8% in 2014, looks set to continue to recover, as suggested by the recent strength in machinery orders; (3) wages have broken out of their deflation-era range. Compensation per employee is now running at 1.5% year on year **(Display 4)**. Not massive, but current indications are that this year's Shunto (annual wage negotiations) is likely to generate higher outcomes than last year, so chances are that this will accelerate further.

If these trends continue then there's plenty of scope for the BoJ to disappoint this year by making no further easing, and by starting to undermine the big picture demand/supply balancing act.

So while a valuation story is starting to emerge, the fundamental picture continues to suggest caution. ■

Display 3
Sell-off Episodes Compared

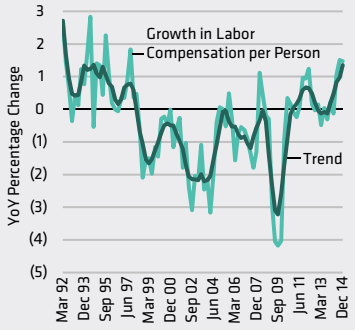
20-Year Japanese Government Bond Yields



As of February 18, 2015
Source: Bloomberg

Display 4
Wages Back to Pre-Deflation Days

20-Year Japanese Government Bond Yields



As of February 18, 2015
Source: Bloomberg