



GLOBAL MARKETS UPDATE

How DM bonds may weather JGB market normalisation

- We think the 10-year Japanese government bond (JGB) yield will rise over 2024 as the Bank of Japan (BoJ) lifts its policy rate early next year and constraints on the JGB market ease. And while that may exert some upward pressure on bond yields in other developed market (DM) economies, we still expect those yields to fall a bit next year and continue to shift yield gaps in favour of the yen.
- Investors have seemingly revised down their expectations for the policy rate in Japan and the 10-year JGB yield has dropped over 10bp since BoJ meeting earlier this week, where the policy statement and, in particular, Governor Ueda’s press conference were more dovish than investors had expected. But although those moves have added to the paring back of investors’ interest rate expectations across DMs in recent weeks and the resulting falls in global bond yields, the bigger picture is that investors expect the BoJ to begin a *tightening* cycle next year, in contrast with its DM peers. (See Chart 1.) Money markets still discount the BoJ’s policy rate to reach ~0.20% by the end of 2024 and to peak at ~0.30% in the middle of 2025, from -0.1%.
- That said, the BoJ is set to become *less of an outlier going forward than it’s been over the past couple of years, as monetary policy there normalises* – with hiking its policy rate being a critical part of that, as it implies ending the era of negative interest rates. The other, equally important, part is the phasing out of the Bank’s unconventional Yield Curve Control (YCC) policy. On this front, the past twelve months have been quite eventful for the JGB market: exactly one year ago, when the 10-year JGB yield was pushing against the ceiling of the +/-25bp tolerance band around 0% in place then, the Bank unexpectedly widened that band to +/-50bp. Then this July, as yields surged globally, the Bank widened that band again, to +/-1%. And finally, at the end of October, it downgraded that ceiling to an “upper bound reference” and abandoned its daily fixed-rate JGB buying operations.
- We think there are four points worth noting about what monetary policy normalisation in Japan means for the domestic and global bond markets and the yen.
- First, we expect the 10-year JGB yield to rise a bit in the coming months as the BoJ hikes next year. Even though we think investors are overestimating the degree of tightening to come, we broadly share their view that the BoJ will end the era of negative interest rates: we expect the Bank to deliver only one symbolic hike in this cycle, from -0.1% to 0.1%, as inflation returns to the 2% target by end-2024 in our view. And even as the BoJ disappoints investors’ expectations, they will likely continue to discount some chance of higher policy rates further into the future. That’s because the Bank has already made clear it wouldn’t take the policy rate further into negative territory, skewing the risks around future rates to the upside.

Chart 1: OIS-Implied Changes In Policy Rates (bp)

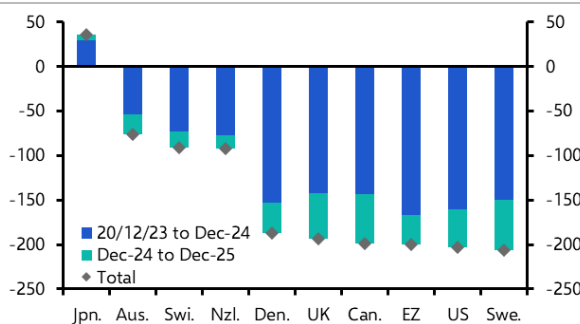
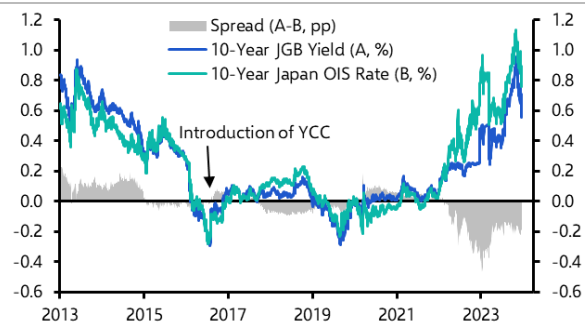


Chart 2: 10-Year JGB Yield & OIS Rate



Sources: Refinitiv, Capital Economics.

- Second, we think that an improved functioning of the JGB market will also help the 10-year yield settle at a higher level. In light of the effective ending of YCC and the recent halt to the daily fixed-rate JGB purchases, we think the 10-year JGB yield has been and will increasingly be driven by market forces. To



gauge the degree of upward pressure still to come from this factor, Japan’s 10-year OIS rate is arguably a good indication, given that a spread between it and the 10-year JGB yield formed only as that yield started pushing against the tolerance band ceiling, forcing the BoJ to purchase huge amounts of JGBs. If that spread eventually closes again, **we wouldn’t be surprised if the 10-year yield rose as much as 20bp regardless of the near-term monetary policy outlook.** (See Chart 2.)

- **Taken together, the return to positive rates and a free floating 10-year yield in Japan informs our view that the 10-year JGB yield will end 2024 at 1%, from 0.55% now.**
- **Third, we expect the rise in JGB yields that we predict to exert some upward pressure on long-dated government bond yields in the US and other DMs, although we doubt it will be significant.** Given Japan is a very large investor in foreign assets, more attractive domestic yields pose a risk of accelerated sales of other high-grade bonds. Indeed, the effective ending of YCC was arguably one of the reasons behind the rise in the Treasury 10-year term premium over the summer. However, there are also some countervailing forces, such as FX hedging costs, that may prevent a stark change in Japanese investors’ foreign allocations. (See [here](#).) And besides, now that DM bond yields have generally come a long way down since their recent peaks and are trending lower, a rise in the JGB yield to a relatively small 1% may not cause a global bond market rout, judging by times in the past when the 10-year JGB yield neared that level. (See Chart 3.) Our overall view remains that, as central banks ease policy more than investors expect, most of the DM bond market rallies have a bit further to run. (See our [Global Markets Outlook](#) for our detailed view.)
- **And fourth, we expect the resultant shift in bond yield differentials between JGBs and other DMs in favour of the yen to boost the yen against the US dollar and most other G10 currencies over 2024.** As the global rally in bond markets over recent weeks has pushed yields elsewhere down more than in Japan, the yen has started to recover some of the ground lost over the last couple of years – for example, since late October it strengthened by ~4% against the US dollar. (See Chart 4.) Given our view that this will continue and that the yen is undervalued on a real, trade-weighted basis, **we forecast the USD/JPY to reach 130 by the end of 2024, from ~144 now.**

Chart 3: 10-Year Government Bond Yields (%)

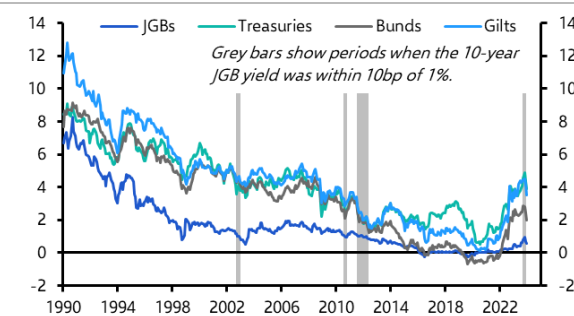
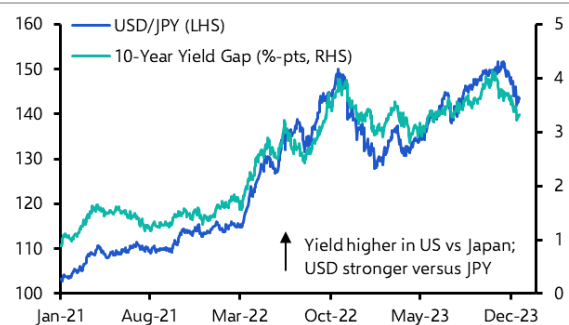


Chart 4: USD/JPY & 10-Year Treasury Less JGB Yield Differential



Sources: Refinitiv, Capital Economics.



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