CAPITAL ECONOMICS

CAPITAL DAILY

Global economic and market analysis from Capital Economics

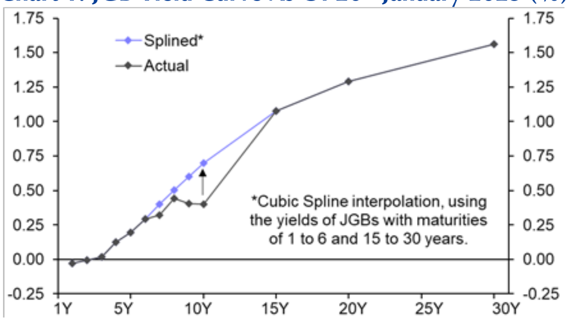
Reconciling our latest forecasts for JGBs and the yen

- **We expect rate hikes in Canada, Colombia, South Africa and Thailand…**
- **…but expect central banks in Hungary and Chile to leave rates on hold**
- **US data likely to show that economic momentum faded in December (Thu. & Fri.)**

Key Market Themes

Although the **10-year JGB yield** has dropped back by about 10bp since the **Bank of Japan** (BoJ) refrained this week from abandoning **Yield Curve Control** (YCC), we think the yield will rebound when – or quite possibly before – a new Governor ditches the policy in April. After all, there is still a significant "kink" in the curve that suggests the 10-year JGB yield would be closer to 0.75% than 0.5% if it weren't being held down by the Japanese central bank's bond purchases. (See Chart 1.)

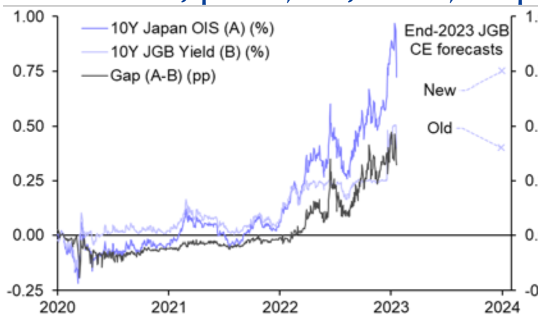
Chart 1: JGB Yield Curve As Of 20th January 2023 (%)



Sources: Refinitiv, Capital Economics

We don't expect, however, the eventual discarding of YCC to be followed any time soon by significantly higher short-term interest rates and suspect the new BoJ Governor (whoever ends up taking over) will be keen to send that message. So even if the 10-year JGB yield rose above 1% in the short term, we doubt it would stay there very long – particularly against a backdrop of weakening economic growth and falling inflation at home, and a further widespread downward drift in sovereign bond yields elsewhere. The upshot is that while we are revising up our previous end-2023 forecast for the 10-year JGB yield – which was originally based on an assumption that YCC would continue this year – the increase is not huge. The new projection is 0.75%, compared to the old one of 0.4%. (See Chart 2.) We are also revising up our prior end-2024 forecast for the yield to 0.5%, from 0.25%.

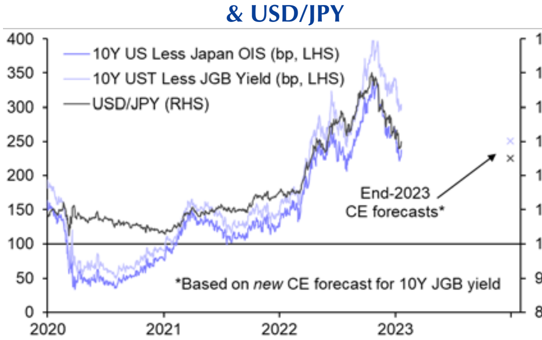
Chart 2: 10Y Japan OIS, 10Y JGB Yield, & Gap



Sources: Refinitiv, Capital Economics

Nonetheless, we aren't changing our end-2023 and end-2024 forecasts for **USD/JPY** from 125 and 120. Admittedly, it tends to be influenced by the gap between long-term yields in the **US** and Japan. But, the 10-year overnight indexed swap (OIS) rate in Japan has not been directly depressed by YCC – it is already much higher than the 10-year JGB yield. (See Chart 2 again.) And when we look at the gap between 10-year OIS rates in the US and Japan, the current level of USD/JPY, of ~130, does not appear to us to be out of whack. (See Chart 3.) That said, speculative positioning and the yen's valuation suggest to us that it has a bit more upside against the dollar. (**John Higgins**)

Chart 3: 10Y US Less Japan OIS, 10Y UST Less JGB Yield, & USD/JPY



Sources: Refinitiv, Capital Economics

Selected Data & Events

				GMT	Previous*	Median*	CE Forecast*
Wed 25th	🇨🇦	**Can**	Bank of Canada Policy Announcement	15.00	4.25%	4.50%	4.50%
Thu 26th	🇿🇦	**SA**	Interest Rate Announcement	-	7.00%	-	7.50%

*m/m(y/y) unless otherwise stated; p = provisional

Key Data & Events

US

We estimate that GDP increased at a 1.9% annualised pace in Q4 as stronger consumption and business investment more than offset a drop back in exports. Other data releases next week are likely to show that both consumption and investment growth lost considerable momentum as the fourth quarter progressed, however – we calculate that both real consumption and core durable goods orders fell in December. (Paul Ashworth)

Europe

Next week, we expect to learn that the **euro-zone** PMIs and the **German** Ifo rose further in January. Meanwhile, **Spain's** Q4 GDP data will provide more clues on the extent of the resilience of the euro-zone economy at the end of 2022.

In the **UK**, the 1.0% m/m fall in retail sales volumes in December, released on Friday, meant sales volumes fell by 1.3% q/q in Q4 and were 5.4% below their level at the start of the year. We expect that weakness to continue as the drags on activity, particularly from higher interest rates, intensify in 2023. (See here.) We expect January's composite flash PMI, released on Tuesday, to reflect that weakness with a renewed fall from 49.0 to 48.5. Meanwhile, real GDP probably held up better than the OBR expected in Q4 2022, which means public borrowing in the 2022/23 fiscal year is likely to undershoot the OBR's forecast of £177bn. (Franziska Palmas & Olivia Cross)

Other Developed Markets

In **Canada**, retail sales edged down in November but the preliminary estimate for December pointed to 0.5% m/m rise. That is despite the double-digit fall in gasoline prices, and implies that sales volumes rose sharply at the end of 2022. That is another sign that the economy carried more momentum into 2023 than we initially expected and is another reason to think the Bank of Canada will raise interest rates next week. We anticipate a 25bp hike and think that will mark the end of the Bank's tightening cycle; that said, we doubt it will go as far as to explicitly acknowledge that in its policy statement. Indeed, if anything, the Bank seems more likely to add new guidance that interest rates will need to remain high for some time. We will be discussing the announcement in a Drop-In next week.

Inflation data for both **Australia** and **New Zealand** are due next Wednesday – we expect a further rise in the former but a small slowdown in the latter. Elsewhere, in **Japan**, CPI data released this week showed that headline inflation rose to 4% in December. This came on the back of increases in both energy and food inflation, while underlying inflation hit 3%. We think inflation will fall back below the BoJ's 2% target by mid-2023 as the boost from the weaker yen fades and government subsidies reduce electricity and gas bills. We expect Tokyo inflation data for January, due next Friday, to show a slight dip in headline inflation and a further rise in underlying inflation. (Stephen Brown, Marcel Thieliant and Darren Tay)

China

The Loan Prime Rate (LPR) was left on hold on Friday as widely expected. This is presumably because the announcement is on the last working day before the Lunar New Year break, which is not the best time to make a policy change. But we still expect a rate reduction later this quarter. China will be on holiday all of next week, with its onshore markets shut. Those in Hong Kong will be closed until Thursday. (Julian Evans-Pritchard)

Other Emerging Markets

In Latin America, we expect **Chile's** central bank to keep its policy rate on hold at 11.25% at next week's meeting, and think that policymakers in Colombia will deliver another 100bp rate hike, to 13.00%. That will probably mark the last hike in Colombia's cycle, but with price pressures still strong and the external position fragile, we don't expect rate *cuts* before the second half of this year. Elsewhere, mid-month CPI data from Brazil and Mexico are due out next week – we think they are likely to show that inflation fell to 5.8% and 7.6%, respectively, over the first half of January.

The highlights of the coming week in Emerging Asia are the publication of Q4 GDP figures for the **Philippines** and **Korea** (both due on Friday). We expect the data to show that economic growth slowed in both countries last quarter. Otherwise, there are also monetary policy meetings scheduled in **Sri Lanka, Thailand** and **Pakistan**. We are expecting hikes in the latter two, but expect rates to be left on hold in Sri Lanka.

Meanwhile, we expect **Hungary's** central bank to leave its base rate on hold, at 13.00%, for a fourth consecutive meeting on Tuesday. And we don't think policymakers will start cutting interest rates until Q3 of this year at the very earliest.

In Sub-Saharan Africa, we expect policymakers in **Nigeria** to draw the monetary tightening cycle to a close and keep the benchmark rate on hold, at 16.50%. Their peers in South Africa are likely to press ahead with further tightening, albeit at a slower pace – we expect a 50bp hike, to 7.50%. (Kimberley Sperrfechter, Gareth Leather, Nicholas Farr & Virág Fórizs)

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Editor: **John Higgins**
john.higgins@capitaleconomics.com

Enquiries: **Harry Chambers**
harry.chambers@capitaleconomics.com

TORONTO NEW YORK LONDON SINGAPORE

Email **sales@capitaleconomics.com** Visit **www.capitaleconomics.com**