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Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 099 // **February 6, 2023**

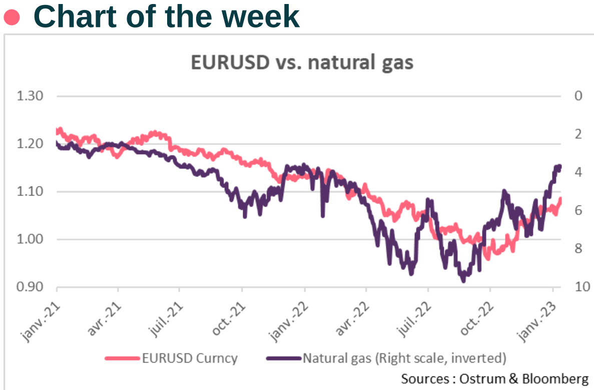
Topic of the week: The Bank of Japan at a turning point

- **The BoJ created a surprise by widening the fluctuation band framing the 10-year rate;**
- **This generated expectations of monetary policy tightening;**
- **For the moment, the BoJ is buying time, leaving the heavy task to the next governor;**
- **More flexibility should be given to the 10-year rate in April;**
- **Wage growth remains too moderate to anticipate a rapid withdrawal of the negative interest rate policy;**
- **The yen will be the big winner from the normalization of monetary policy.**

Market review: Lost in translation

- **Central banks losing control of markets;**
- **Risky assets ignore multiple rate hikes;**
- **Robust US job creation at +517k in January;**
- **Nasdaq up 16% YTD.**

Chart of the week



The Euro and natural gas prices continue to move in sync as they have since 2021 and throughout the energy crisis. The increase in the price of gas, but also of other energies, has weighed on European growth and thus contributed to depreciate the euro.

Conversely, the fading energy crisis is helping the Euro to recover. However, we must keep in mind the proportions: natural gas, at the time of writing, is priced at almost 60 EUR/MWh, a huge decrease compared to a peak of over 300 reached in August. This remains well above the 2020 level or earlier, closer to 20.

Figure of the week

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Source : Ostrum AM

Billions of dollars invested in the renewable in 2022, up 17% from 2021 ($423 billion), including solar ($308 billion, up 36% from 2021).

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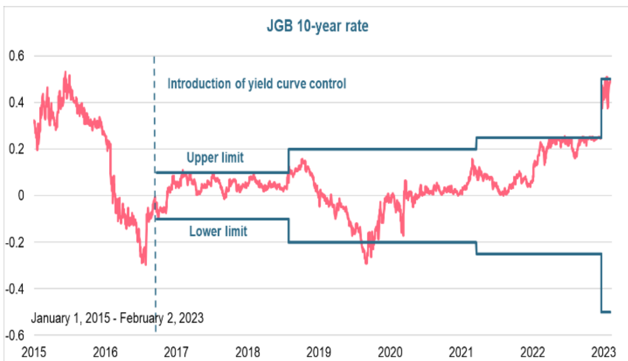
Topic of the week

The Bank of Japan at a turning point

The Bank of Japan surprised markets by widening the fluctuation band of the 10-year rate in December. This decision led investors to anticipate an imminent tightening of monetary policy, the BoJ being the only major central bank to maintain a very accommodating policy despite a marked acceleration in inflation. What is it really ?

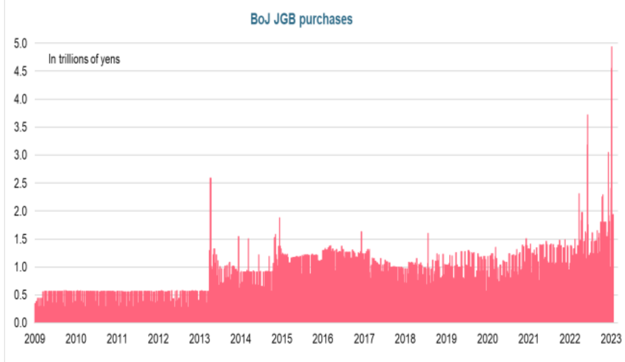
The BoJ surprised the markets

The Bank of Japan created a surprise, on December 20, by deciding to widen the fluctuation band of the 10-year rate. The target remains close to 0% and the rate can now vary between [-0.50%; +0.50%] versus [-0.25%; +0.25%] previously. This decision resulted in a sharp rise in the 10-year rate on December 20, +15 bp to close at 0.40%, the largest since 2003. It then occasionally exceeded the 0.50% threshold. Investors tested the ceiling, as the following chart shows.



Sources : Bloomberg, Ostrum AM

These tensions forced the BoJ to intervene massively via record purchases of sovereign bonds (JGB). These interventions were colossal: the central bank bought 32.4 trillion yen in total, between December 20 and January 17, which represents nearly 6% of GDP. These are clearly not sustainable over time.



Sources : Datastream, Ostrum AM

This surprise announcement led investors to anticipate the forthcoming normalization of monetary policy and the end of the yield curve control policy (YCC), implemented in September 2016.

What's the yield curve control policy?

This policy aims to keep long rates at a low level by setting a target around 0% for the 10-year rate and setting up a fluctuation band to control it. In September 2016, the BoJ did not explicitly determine it but investors fixed it ex post between [-0.10%; +0.10%]. At the same time, the BoJ's intervention rate remains in negative territory at -0.10%, and this since January 2016. The fluctuation band had previously only been widened twice and at the margin: +/-0.10% in 2018 and +/-0.05% in 2021.

The BoJ remains firm and determined

At the January 17-18 meeting, the BoJ unanimously decided to keep the YCC terms unchanged. The central bank has been firm in its determination to maintain a very accommodative monetary policy. It reiterated the fact that the widening of the fluctuation band decided in December aimed to improve the functioning of the market and to strengthen its very accommodative monetary policy and in no way signaled an upcoming normalization of the latter.

The central bank buys time

Although the BoJ did not modify the parameters of the YCC in January, it did on the other hand strengthen and provide more flexibility to its financing operations against collateral. Loan maturity has been increased from a maximum of 2 years to a maximum of 10 years. The rate will also be flexible and no longer set at 0% as previously. The BoJ can thus determine the rate of the loans that it grants to commercial banks in order to adjust the yield curve according to market conditions. BoJ Governor Haruhiko Kuroda also indicated that this rate could be negative if necessary, in order to encourage commercial banks to borrow from the BoJ in order to buy JGBs.

These measures have saved time for modifying or even abandoning the YCC, as shown by the new tensions on the

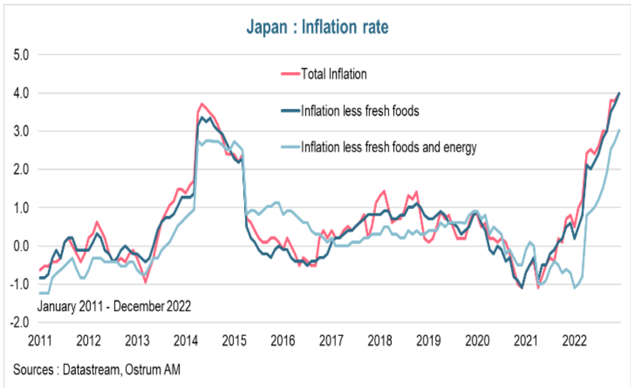
10-year rate. Haruhiko Kuroda's term as head of the BoJ comes to an end on April 8 and a new governor will be appointed by the government in February. While the BoJ is expected to leave its monetary policy unchanged at the March meeting, the markets anticipate a change at the April meeting with the arrival of the new governor.

Abandonment of the YCC in April?

The BoJ has pledged to maintain its monetary policy of quantitative and qualitative easing (QQE) and the YCC until inflation returns to the 2% target in a sustainable way. Has the objective been achieved?

High inflation is linked to imported good prices

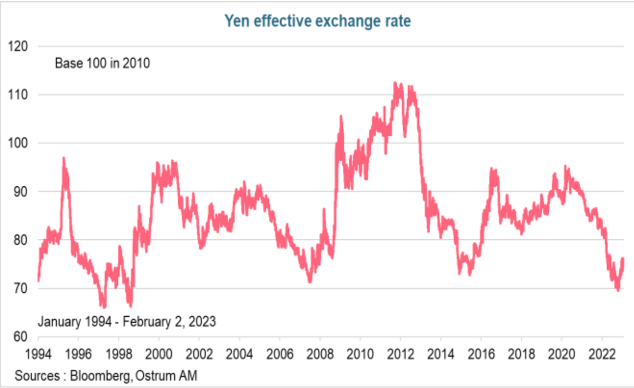
Inflation accelerated sharply in 2022 to easily exceed 2% and reach 4% in December 2022. Inflation excluding fresh produce is also at 4%, a 41-year high, and inflation excluding fresh produce and energy stands at 3%. At first glance, the objective seems to have been achieved.



The problem is that this high inflation comes mainly from the sharp rise in the price of imported goods. The latter increased by nearly 50% over one year, between June and September, to return in December to around 20% and remain high.

This is due on the one hand to the sharp rise in the price of energy, and in particular of oil, of which Japan imports a lot, and to tensions in the production chains following the reopening of the economies.

The sharp depreciation of the yen against other currencies during 2022 also played a major role. The effective exchange rate of the yen (weighted average of the exchange rate of the yen against the currencies of the main trading partners) reached its lowest level since 1998 in October. The central bank intervened on an ad hoc basis. This sharp depreciation resulted from the sharp divergence in monetary policies, the BoJ being the only major central bank to maintain an ultra-accommodative policy while the others quickly tightened their monetary policy to fight against excessively high inflation. From the end of October, the yen recovered, remaining at a low level, due to the moderation in the pace of rate hikes by other central banks.



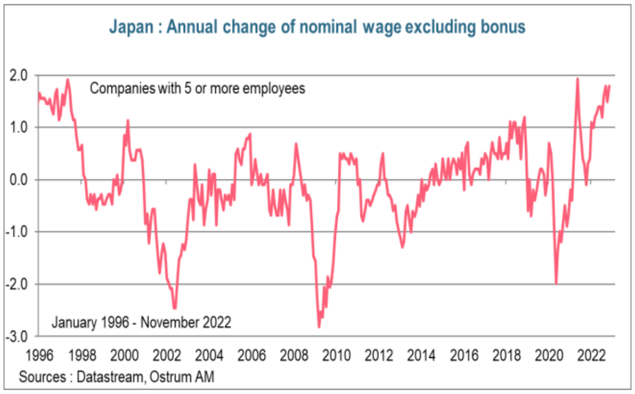
This high inflation is therefore not due to domestic demand but to a rise in production costs. It is not sustainable. In February, households and businesses will benefit from new measures to reduce the impact of rising energy prices. In addition, inflation will moderate significantly due to strong base effects. Energy prices, and oil in particular, will become significantly lower than they were a year ago, reducing price pressures. Finally, wages are only increasing moderately.

The BoJ thus forecasts a sharp slowdown in inflation over the course of the year. Inflation excluding fresh products is expected at 1.6% at the end of the 2023 fiscal year (in March 2024) and at 1.8% for inflation excluding fresh products and energy. For fiscal year 2024, it is expected at 1.8% and 1.6% respectively.

The key lies in the evolution of wages

For inflation to stay on the 2% target for a long time, a sustained increase in wages is necessary. It will be able to permanently change household inflation expectations and allow domestic demand to strengthen and thus lay the foundations for a return of inflation to the target. According to the BoJ, to sustainably achieve the 2% inflation target, wages must increase by 3%.

While wages have firmed up since the Covid-19 crisis, their rise is still moderate. Excluding special elements (including bonuses), they increased by 1.8% in November over one year. Real wages, on the other hand, contracted by 3.9% due to high inflation.



To permanently stave off the risk of deflation, Prime Minister Fumio Kishida has called on companies to increase wages at a higher rate than inflation. Uniqlo responded to the call by announcing that it wanted to proceed with a 40% increase, Canon is also considering a significant increase in wages like other companies. Large exporting companies, whose profits have largely benefited from the sharp depreciation of the yen, are more inclined to heed the call of the government.

On the other hand, this is not the case for most SMEs which represent the bulk of the Japanese industrial fabric and are therefore the only ones in a position to create a real boost on wages. According to a recent survey by Daido Life Insurance Co, quoted by the Japan Times, a third of SMEs plans to increase wages and among them, the increase in wages will be less than 3%. This will not be enough.

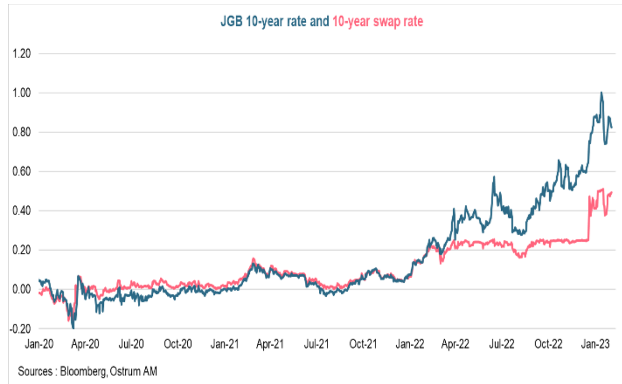
The spring wage negotiations between unions and companies, called “shunto”, will be one of the key elements to watch. While the increase in wages should be higher, these negotiations mainly concern large companies and, as we have seen, SMEs do not seem to be willing to make significant increases.

Implications for the BoJ

As the conditions are not yet met for a lasting return of inflation to around 2%, monetary policy must remain accommodative. The intervention rate will therefore remain at -0.1% and will only be raised when wages have firmed up sufficiently. This will require clear communication from the BoJ on its intentions and the conditions for raising rates, at the risk, otherwise, of creating undue tensions. Market expectations for a quick rate hike are excessive.

The fact that investors are continually testing the 10-year rate ceiling, despite the new measures taken, argues for more yield curve flexibility, and this will probably start in April.

The BoJ could thus decide to widen the fluctuation band again. As the following graph shows, markets are anticipating a much higher 10-year rate since the widening of the fluctuation band. The 10-year swap rate is close to 0.80%, after peaking at 1% on January 13, before the BoJ meeting.



Another possibility is that the central bank targets shorter maturities, such as the 5-year rate, in order to give flexibility to the 10-year rate. The cap could still be tested by investors.

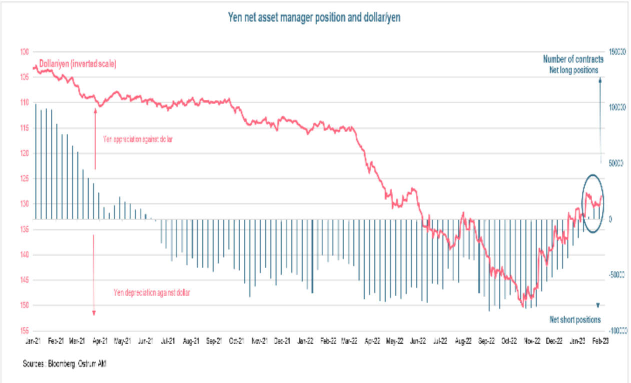
A third hypothesis lies in the abandonment of control of the yield curve. Rates would thus become flexible again and the BoJ would keep them at a low level by making massive purchases of sovereign bonds, as it did before the introduction of the YCC and like the Fed and the ECB just a short time ago.

Market impact

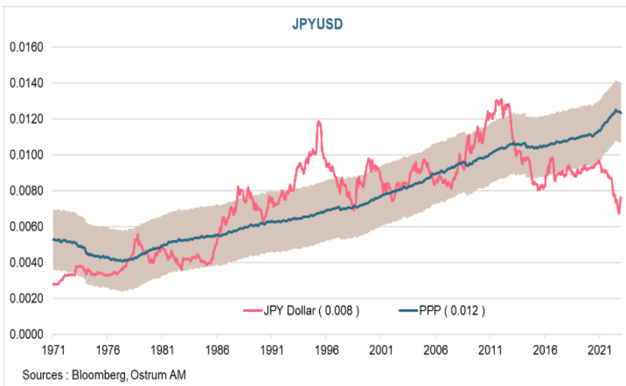
Yen appreciation

The next BoJ governor will have the daunting task of normalizing monetary policy without generating excessive market stress or a recession. After 10 years of ultra-accommodative monetary policy, the yen will be the big winner from the normalization of the BoJ's monetary policy. It will also come as other central banks slow the pace of rate hikes and are about to stop raising them.

Investors are starting to position themselves. Net speculative short positions on the yen have been reduced significantly since the end of December. The net positions of asset managers even became longs from the January 17 week and this for the first time since May 2021.

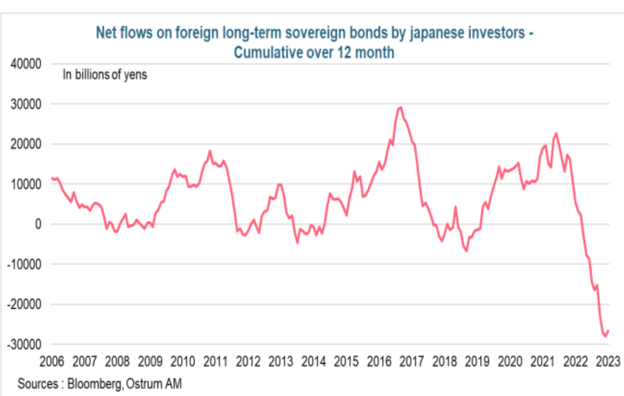


The rise in the yen should be all the more significant as the currency turns out to be very undervalued expressed in purchasing power parity (PPP).



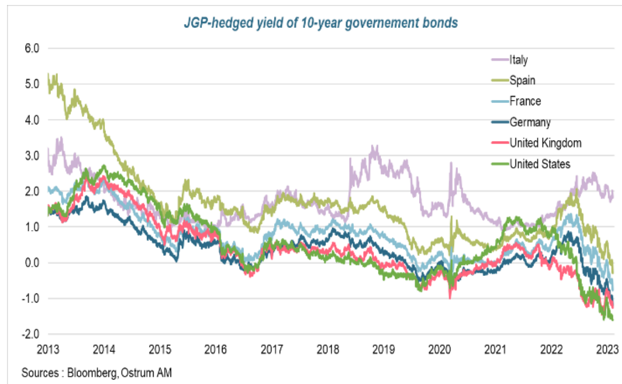
Japanese capital outflow

The prospect of higher rates should encourage Japanese investors to repatriate part of their investments made abroad. In this context, the risk turns out to be more marked for the Treasuries market, with Japan being the United States' leading creditor, ahead of China, with $1,082 billion of Treasury securities held at the end of 2022. In Europe, the France is the most exposed. We note that Japanese investors became net sellers of foreign sovereign bonds from April 2022, reaching a record amount in December 2022: -28,000 billion yen.



The explanation lies in the sharp increase in the cost of protecting returns for a Japanese investor following the sharp depreciation of the yen against other currencies. Thus, despite the sharp rise in bond rates in other countries, 10-year hedged yields for a Japanese investor have become negative in most major countries, with the notable exception of Italy where the hedged yield still remains relatively attractive.

This explains the outflow of Japanese capital from sovereign bonds in most countries from the spring of 2022, despite higher interest rates in the United States and the euro zone. If the movement has started well, it should intensify in the perspective of the normalization of the monetary policy of the BoJ. This could generate pressure on the rates of the countries concerned.



Conclusion

The next BoJ governor will have the daunting task of normalizing monetary policy after 10 years of ultra-accommodative policy. This will initially take place through a change in the yield curve control policy. This could take place as early as April in order to give more flexibility to the 10-year rate by raising the fluctuation band surrounding it or by abandoning it. The BoJ will then continue to normalize its monetary policy when it is confident enough that wage growth is consistent with the sustained return of inflation to the 2% target. The yen will be the big favorite, as the BoJ is the only major central bank that has yet to raise rates and it is currently significantly undervalued.

Aline Goupil-Raguénès

Market review

Lost in translation

Central banks have lost control of the markets, which are already playing the pivot, real rates are collapsing to the benefit of risky assets.

The central banks' week was set to unfold as follows: a dovish hike from the Fed, a more aggressive ECB and a BoE raising rates in line with market expectations. In reality, whatever the stance of the central bankers, the reaction of the markets was the same: the hunt for shorts everywhere was clearly open. The tightening announcement sparked a *plunge* in real yields (breakeven inflation rates are almost unchanged) and another sharp run-up in risky asset prices. The Nasdaq, despite announcements of restructuring from mega-cap stocks, is now up 16% in 2023. The Euro Stoxx 50 gains 11%. The T-note yield fell, dropping to recent lows around 3.32% in the wake of Fed and ECB meetings before a rapid turnaround to the 3.5% area following the release of US non-farm payrolls and the service ISM. The Bund also tumbled 20 bps briefly below the 2.10% threshold. Gilts posted the best performance with a 30bp rally to around 3%. Credit spreads, and high yield in particular, have tightened markedly. The iTraxx Crossover thus broke its floor by 400 bps. The dollar is moving in a 1.5% wide range but without a real trend until the employment release spark a dollar bounce. The euro-dollar rate hit $1.10 as markets digest central bank communications. The dollar-yen exchange rate fell below 130 in, line with a stronger Chinese Renminbi driven by improving business surveys.

The FOMC raised the Fed funds rate by 25 bps to 4.50-4.75%. The rate hike, in line with market expectations, is also consistent with the December projections. The plural used to describe the next rate moves points to two similar increases in March and May before a status quo until the end of the year. However, the financial markets doubt the determination of the Fed, which is taking comfort from the incipient disinflation. Thus, Jerome Powell does not seem to be concerned about the easing of financial conditions since the start of the 4th quarter of 2022. However, rising equity markets risk spurring demand and delaying the return to price stability. The publication of US non-farm payrolls (+517k in January, unemployment at 3.4%), which came in much stronger than expected, eventually reversed the bond/equity bullish backdrop. The employment cost index at 5.1%y remains objectively incompatible with inflation sustainably at 2%.

The ECB raised interest rates by 50 bps and is projecting another 50-bp hike in March bringing the deposit rate up to 3%. Christine Lagarde did not rule out continuing to raise interest rates, but other policy instruments (QT, TLTRO redemptions) will contribute to tighten monetary conditions further. Core inflation is running at a 5.2% clip in January. The resilience of the euro area economy supported by public transfers, the pricing power of companies and the impact of China's reopening on commodity prices represent inflationary factors for the ECB to watch. The BoE seems to have regained market confidence and is raising rates in line with market expectations. The repo rate now stands at 4% closing in on its terminal level. The Bank has turned more confident about the disinflation process and has reduced the magnitude of the expected recession. Persistent wage pressures will be key to price stability.

The rise in financial markets in 2023 is quite impressive. The most-shorted stocks are now the best performers. On the day following the FOMC, the most-shorted stocks gained 7% in New York trading. Unprecedented volumes of short-dated equity options are fueling violent market reversals. The low level of 1-month implied volatilities (VIX, V2X) is a paradox as it reflects the lower perceived uncertainty on the terminal policy rates. The US yield curve remains inverted (2-10 years at around -70 bps) and the downward adjustment in long-term real bond yields is puzzling. Markets act as if inflation has already disappeared. This decline in market volatility (and in risk premia) offsets the contraction in earnings for the S&P500 (-4% year-over-year after around 250 earnings releases).

The slightly positive growth in the euro area (+0.1% in 4Q 2022) validates the optimism glimpsed at the start of the year, as do the new European investments responding to the US Inflation Reduction Act. This may further encourage risk taking…as long as the ECB does not see public spending as a driver of inflation. Handouts will have to be reduced or risk a tightening of monetary policy. Bond yields ignored the rise in rates and fell back below 2.10% on the German 10-year. The appetite for duration is only justifiable in the event of a hard-landing recession or an immediate return to price stability. Fed on the opium of "immaculate disinflation", the markets appear to have almost forgotten the strongly negative carry on long-term bond yields. However, the speed of the adjustment in 10-year yields caused 10s30s spreads to widen in the United States and the euro area.

Spreads are tightening across all market segments. Euro area sovereign spreads are narrowing, by as much as 20 bps in Greece (10-year bonds) over the past week. IG credit spreads (144 bps vs. Bund) are 23 bps below their annual close despite fund inflows slowing somewhat lately. European high yield maintained its outperformance with spreads down 15 bps over the week. The iTraxx crossover index is trading 88 bps below the yearly close at 386 bps.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	05-Feb-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.55%	-3	-12	-22
EUR Bunds 10y	2.19%	-5	-20	-38
EUR Bunds 2s10s	-36.2bp	-2	-7	-16
USD Treasuries 2y	4.29%	+9	-8	-14
USD Treasuries 10y	3.52%	+2	-21	-35
USD Treasuries 2s10s	-77bp	-7	-13	-21
GBP Gilt 10y	3.06%	-27	-60	-62
JPY JGB 10y	0.5%	+1	+7	+6
€ Sovereign Spreads (10y)	**05-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	44.96bp	-1	-1	-9
Italy	183.27bp	-2	-3	-30
Spain	92.24bp	-6	-7	-16
Inflation Break-evens (10y)	**05-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.31%	+2	-14	-23
USD 10y Inflation Swap	2.44%	-8	-6	-9
GBP 10y Inflation Swap	3.69%	+5	-19	-22
EUR Credit Indices	**05-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	142bp	-9	-28	-25
EUR Agencies OAS	72bp	-4	-6	-7
EUR Securitized - Covered OAS	80bp	-2	+0	-3
EUR Pan-European High Yield OAS	436bp	-24	-75	-76
EUR/USD CDS Indices 5y	**05-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	72bp	-5	-14	-18
iTraxx Crossover	380bp	-26	-67	-94
CDX IG	69bp	-3	-11	-13
CDX High Yield	419bp	-12	-59	-65
Emerging Markets	**05-Feb-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	427bp	-13	-30	-26
Currencies	**05-Feb-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.079	-0.718	2.547	0.8
GBP/USD	$1.203	-2.811	1.058	-0.4
USD/JPY	JPY 132	-1.903	0.763	-1.0
Commodity Futures	**05-Feb-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$79.9	-$6.5	-$2.2	-6.67
Gold	$1 865.0	-$63.1	$25.5	2.25
Equity Market Indices	**05-Feb-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 136	1.62	6.20	7.7
EuroStoxx 50	4 258	1.91	5.98	12.2
CAC 40	7 234	1.93	5.44	11.7
Nikkei 225	27 509	0.46	5.91	5.4
Shanghai Composite	3 263	-0.04	3.35	5.6
VIX - Implied Volatility Index	18.33	-0.97	-13.25	-15.4

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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