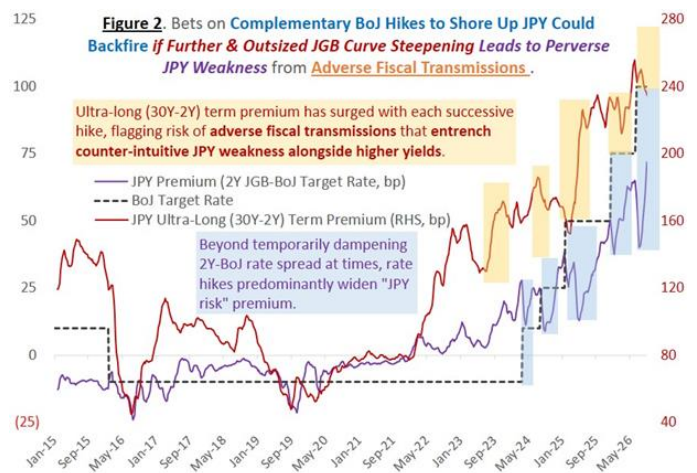
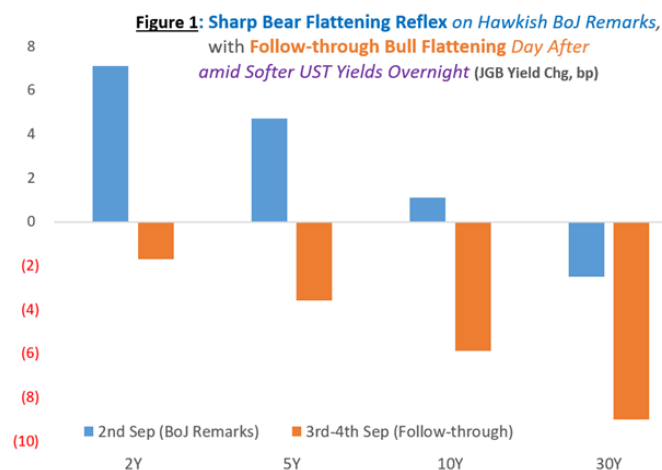


Why BoJ Hawks (Alone) Cannot Save the Day

"Circumstantial evidence is a very tricky thing. It may seem to point very straight to one thing, but if you shift your own point of view a little, you may find it pointing in an equally uncompromising manner to something entirely different" – Sherlock Holmes

In a Nutshell:

- **Hopes of BoJ hawks durably inspire ultra long-end JGB bulls** (sustaining softer long-end yields) are **exaggerated by coincident sharp JPY squeeze**.
- Whereas **until adverse Rates-Fiscal-JPY feedback dynamics are snapped**, BoJ rate hikes may continue to **disproportionately lift ultra-long JGB yields** (term premium").
- Admittedly, in response to **profoundly hawkish BoJ** pronouncements, ultra-long (30Y) yields have slumped, alongside a **surge in front-end (2Y) JGB yield** resulting in **emphatic JGB curve flattening**.
- So, to be fair, **JGB price (yield) action is superficially consistent with softer ultra-long JGB yields on sufficiently hawkish BoJ cues**.
- Nonetheless, it is **premature, arguably even misguided, to presuppose unfettered and overarching narrowing in "ultra-long, term premium" (30Y-2Y spreads) from BoJ hikes**.
- Crucially as **adverse Rates-Fiscal-JPY feedback loop, amplified by an exceptional intersection of acute geo-political risks, tie higher ultra-long JGB yields to a weaker JPY (and BoJ rate hikes)**.
- All said, **despite promising circumstantial evidence of backstop, a hawkish BoJ alone cannot unequivocally reverse JPY-JGB weakness**.
- **In fact, a hawkish BoJ may perversely amplify JPY-JGB pain amid unprecedented geo-political pressures, fiscal/debt sustainability issues and the geo-economic stress from (forced) capital commitments**.

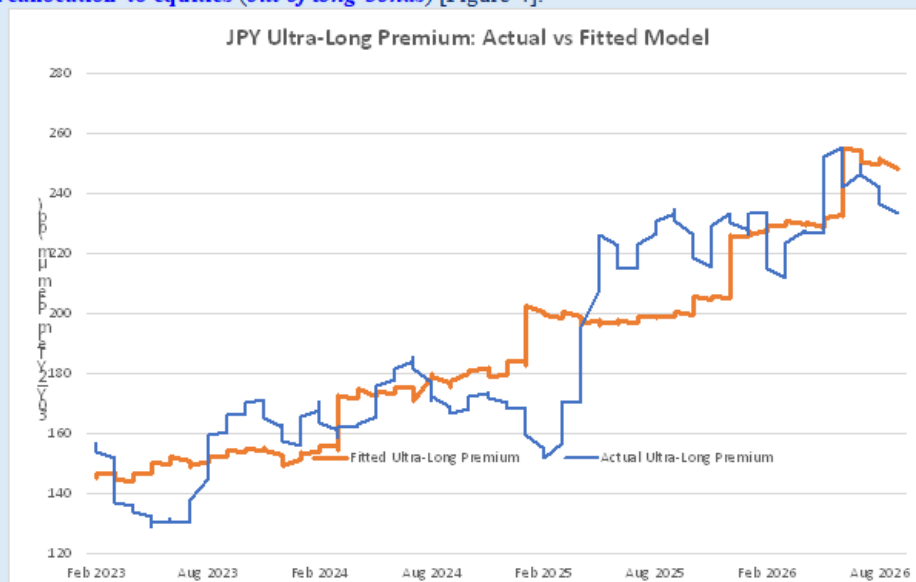


- The emerging narrative of **BoJ hawks inspiring ultra long-end JGB bulls** (sustaining softer long-end yields) is **overly optimistic** as it is *obfuscated, if not exaggerated, by the brutal, coincident, JPY squeeze*.
- Whereas **until adverse Rates-Fiscal-JPY feedback dynamics are snapped**, BoJ rate hikes may continue to **disproportionately lift ultra-long JGB yields**, driven by *outsized corresponding increase in ultra-long "term premium"*.

- For the record, **in response to profoundly hawkish* BoJ** pronouncements on Wednesday (2nd Sep), the **JGB curve has flattened emphatically** [Figure 1].
 - Driven initially by *a surge in front-end (2Y) JGB yield* (of 6-7bp), which may be ascribed to **dialed-up BoJ rate hike expectations**.
 - And remarkably, accompanied by a *slump in ultra-long (30Y) yields* (of 11-12bp). *Albeit*, likely exaggerated by softer UST yields.
- So, to be fair, **JGB price (yield) action is superficially consistent with softer ultra-long JGB yields on sufficiently** hawkish BoJ cues**.
- Presumably, from **“virtuous inflation expectations dynamics”**.
- **Whereby marginal dis-inflation compounded into the long-end – from convincingly taming/anchoring inflation expectation – overwhelms the rate hike effects**.
- Nonetheless, it is **premature, arguably even misguided, to presuppose unfettered and overarching narrowing in “ultra-long, term premium”**** (30Y-2Y spreads) from BoJ hikes**.
- In fact, there is **compelling, empirical evidence to the contrary** – with **BoJ hikes lifting “ultra-long, term premium”** [Figure 2, Box 1].

Box 1. Model of Ultra-Long (30Y-2Y) JGB Term Premium based on BoJ Rates, USD/JPY & Nikkei-to-S&P500

- ❖ The bigger picture is that **empirical evidence (since BoJ started hiking rates in May 2024) suggests that “ultra-long, term premium” will rise** (likely lifting 30Y JGB yields with it) **on**:
 - *BoJ rate hikes*
 - *Weaker JPY*
 - *Relative Nikkei out-performance* (vis-à-vis S&P500).
- ❖ The former two (BoJ rate hikes and weaker JPY) via by **adverse Rates-Fiscal-JPY feedback loop**.
- ❖ Whereas **rising relative Nikkei Outperformance could drive ultra-long JGB yields higher, pressured by increasingly compelling reallocation to equities (out of long bonds)** [Figure 4].



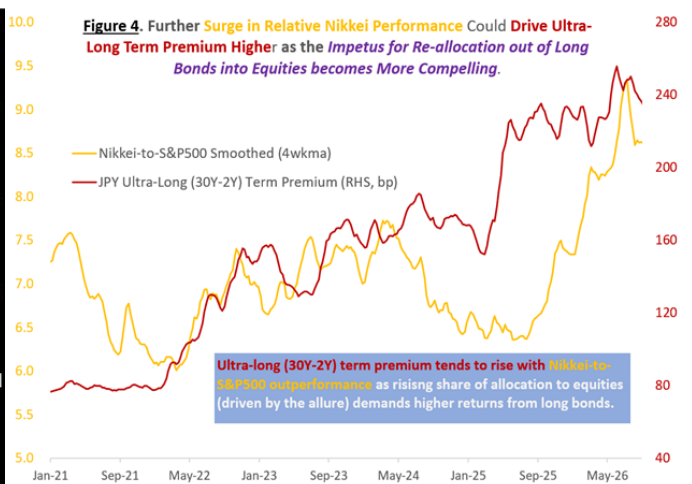
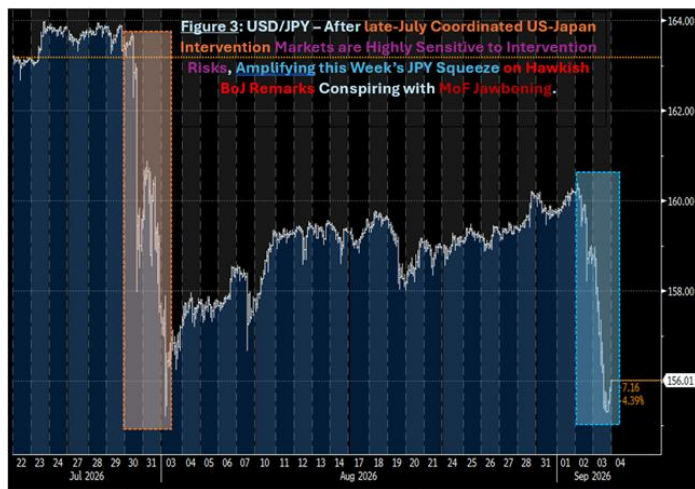
- Instead, a **sharp contemporaneous JPY surge** amid **amplified JPY intervention fears** [Figure 3] is **likely to have helped dampen 30Y yields – notably, by narrowing the “ultra-long, term premium”**.
- **Admittedly correlating a stronger JPY with lower ultra-long JGB yields is counter intuitive**.

- But **adverse Rates-Fiscal-JPY feedback loop** amplified by an exceptional intersection of acute geo-political risks tie higher ultra-long JGB yields to a **weaker JPY** (and **BoJ rate hikes**).
- And **insofar that a stronger JPY mitigates pressures for more aggressive BoJ hikes**, this adverse **Rates-Fiscal-JPY feedback** may be alleviated.
- All said, **despite promising circumstantial evidence of BoJ backstop, a hawkish BoJ alone cannot unequivocally reverse JPY-JGB weakness** amid;
 - unprecedented geo-political pressures *via* **energy, shipping** and **wider supply chain shocks**;
 - fiscal/debt sustainability issues as “**fiscal dominance**” risks linger, and;
 - the overarching *geo-economic stress from (forced) capital commitments*, led by large, “**post-Liberation Day**” capital investment commitments.
- In fact, **a hawkish BoJ may perversely exacerbate JPY-JGB vulnerabilities**, as *exceptional geo-economic stress factors entrench adverse Rate-Fiscal-JPY dynamics*.

* Notably, with Governor Ueda's hint of an imminent hike being amplified by hawkish board member Takata's allusion to scope for an upsized (>25bp) hike and/or quick succession of hikes.

** Sufficiently in the sense of being able adequately and appropriately timely enough to anchor inflation expectations

*** The 30-2Y JGB premium is a far better determinant of whether a hawkish BoJ may anchor (cap/lower) ultra-long JGB yields as the BoJ rate hike impact/expectations are excluded from.



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