RBC BlueBay
Asset Management

The global implications for a shift in Japan's yield curve control

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> "Bank of Japan (BoJ) established yield curve control (YCC) in 2016 to stimulate lending, growth and inflation."

Macro investing expert Russel Matthews, BlueBay Senior Portfolio Manager, offers some insight into his expectations for the end of Japan's experiment with yield curve control and why this is providing an important macro theme for the year ahead.

Fundamental policy analysis is crucial

This is a transitional year where you need to get the bottom-up right. It requires detailed fundamental policy analysis, calculating entry and exit points, and particularly good risk management. We are getting to the point where the US is likely to start to pause rate hikes, but we still have a view that in Europe that the situation with inflation is different. We believe that the European Central Bank and the Bank of England still need to hike rates a number of times, at least twice more. And the Bank of Japan has not even started yet, and it is the uncertainty around Japan's monetary policy that is providing us with one of our big structural trades for 2023.

Japan's experiment with yield curve control

For context, the Bank of Japan (BoJ) established yield curve control (YCC) in 2016 to stimulate lending, growth and inflation, by promising to purchase as many Japanese government bonds as needed to cap yields at a certain level to achieve their stable inflation target. The BoJ pinned short-term interest rates at -0.1% and 10-year government bond yields around a band which currently sits at 0.5% above and below zero. This controls the shape of the yield curve, suppressing short to medium-term rates while trying to keep long-term rates less affected.

The market is giving up on a yield curve control shift

The markets are giving up on the idea that the new Bank of Japan governor, Kazuo Ueda, will ever change Japan's yield control stimulus. We do not. What we believe is that in July, or potentially June, the Bank of Japan is going to do one of two things:

- widen the band of the yield curve control up to around 100 basis points
- or pull forward the point in the maturity of the curve that they are targeting to the five-year point of the curve, basically letting the 10-year run free.

And when it starts to happen, we believe that it is inevitable that they are going to move firmly along the path of normalisation and catch a huge yield differential change.

> **"The bottom line is that the environment remains very target rich, but it is going to be more difficult."**

The long and short of it

This is a big structural trade that we think could provide healthy returns when it starts to move so we have the trade on in two areas.

We have a straightforward short in the ten-year part of the curve in terms of the Japanese government bond futures and the other part of the trade is to put a simple 10-year paid position in a ten-year interest rates swap, very plain vanilla. Those two duration positions make up an overall short.

The other trade that we have is a 10% long position in the Japanese yen because we believe that the yen is currently undervalued. And as soon as they come off yield curve control and the interest rate differential starts to narrow, we think that there will be a lot of repatriation of funds and the yen could potentially move down to 130, (it is currently 137). And ultimately, if Japan continues to grow the way it is, if inflation holds up, and they not only remove yield curve control, but they also start to hike rates then we think that the target could be 120.

Massive volatility will be a consequence

Not only will this be a big event idiosyncratically, but we also anticipate that it will have an impact globally. This is likely to cause portfolio flows from big Japanese institutional investors and create a lot of volatility in rates markets but also a lot of volatility and appreciation for the yen. That is what we are playing for this year. We realise that the timing is a little uncertain, but we anticipate that it is going to happen sooner, rather than later. We believe that due to this, we will see more divergence and that in itself is going to create more opportunity. The bottom line is that the environment remains very target rich, but it is going to be more difficult.

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