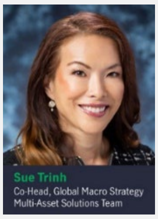


The Bank of Japan's recent decision to fine-tune its yield curve control policy may have caught investors off guard; however, the bigger surprise could be that the adjustment was less hawkish than expected. Sue Trinh, Co-Head, Global Macro Strategy of Multi-Asset Solutions Team, highlights her thoughts.

Bank of Japan tweaks its yield curve control policy: market implications

The Bank of Japan (BoJ) surprised the market by announcing an adjustment to its yield curve control (YCC) policy on July 28. A survey of analysts earlier in the month showed that only 18% of respondents had expected a tweak to take place in July, with the majority expecting any change to materialize in October at the earliest. While surprising in its timing, the actual detail in the YCC tweak, in our view, was perhaps a little less hawkish than the market had envisaged it to be.

What was the tweak?

The BoJ has kept its 10-year yield target at around 0% and maintained the official +/-50 basis points (bps) range. What's changed is that the central bank will now take a more flexible approach to implementing the policy in which the +/-50bps range will serve as a reference instead of a rigid limit. The policy adjustment seems to offer some scope to widen the trading range for Japanese government bonds (JGB) to +/-100bps by implementing a 10-year JGB buying operation at a 1% yield every business day through its fixed-rate operations.

The justification for the tweak was to mitigate the negative impact on bond market functioning from its policy, and we should be careful not to overinterpret the policy adjustment as a form of monetary tightening. In fact, the BoJ noted that it'll add to easing without hesitation and seemed to imply that additional quantitative easing remains a possibility.

Supporting that notion, the BoJ's inflation and growth forecasts were modest, although the bank did acknowledge that the balance of risks (in relation to its projections) was skewed to the upside.

BoJ's economic forecast, July 2023

	2023	2024	2025
GDP	1.3 (1.4)	1.2 (1.2)	1.0 (1.0)
Core CPI	2.5 (1.8)	1.9 (2.0)	1.6 (1.6)

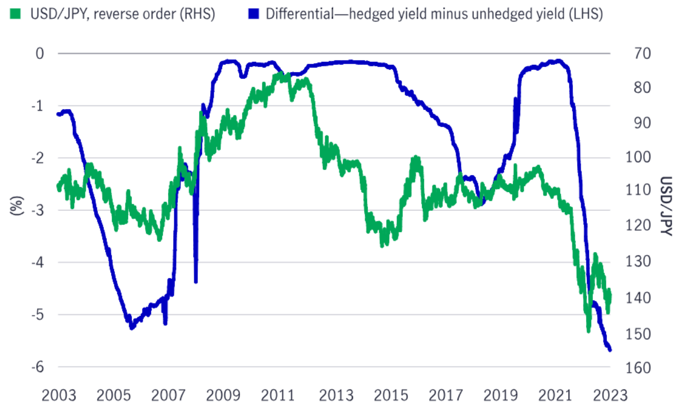
Source: Bank of Japan (BoJ), July 28, 2023. CPI refers to the Consumer Price Index. It tracks the average change of prices over time by urban consumers for a market basket of goods and services. It is not possible to invest directly in an index. Figures within parenthesis refer to the previous forecast.

Market implications

Following the announcement, the Japanese yen settled lower against the U.S. dollar and 10-year JGB yields settled a little higher. Unsurprisingly, the announcement sent global government bond yields higher, taking the 10-year U.S. Treasury (UST) yield above 4%[1]. Markets were concerned that a BoJ policy shift might prompt Japanese institutional investors to reduce their holdings of foreign government bonds—USTs, in particular—as the cost of hedging exchange-rate risks threaten to rise further.

[1] Bloomberg, as of 26 July 2023.

Prohibitive cost of FX hedging means bulk of flows into UST likely unhedged



Source: Bloomberg, Manulife Investment Management, as of July 28, 2023. FX refers to foreign exchange. UST refers to U.S. Treasury. USD refers to U.S. dollar. JPY refers to Japanese yen. LHS refers to left-hand side. RHS refers to right-hand side.

That said, we think that it would take a very substantial increase in Japanese long-term interest rates (or decline in foreign long-term rates) to eliminate the interest pickup, on an unhedged basis, which Japanese investors can get on their foreign investments. In that event, we believe the most likely outcome would be an orderly foreign bond sales from Japanese investors as opposed to a wholesale liquidation of their foreign bond holdings, similar to what we saw through most of last year. If that were to happen, we believe the most vulnerable bond markets would include Australia, the Netherlands, and New Zealand since Japanese investors represent a much larger share of outstanding bonds in those markets.

Japan's foreign bond holdings as a share of the government bond market (%)

Source: Bank of Japan, Manulife Investment Management, as of July 26, 2023.

While Japanese investors are the biggest holders of USTs outside the United States, their holdings represent less than 5% of the market. Although they did unload a significant amount of USTs in 2022, history suggests that a very large share of total Japanese bond holdings will likely be held to maturity. In our view, the broad direction of USTs will still be determined by how the monetary policy in the United States, as prescribed by the U.S. Federal Reserve, will evolve in the coming months.

Disclaimer

Manulife Investment Management is the global wealth and asset management segment of Manulife Financial Corporation. The information and/or analysis contained in this material have been compiled or arrived at from sources believed to be reliable but Manulife Investment Management does not make any representation as to their accuracy, correctness, usefulness or completeness and does not accept liability for any loss arising from the use hereof or the information and/or analysis contained herein. Neither Manulife Investment Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained herein.

This material was prepared solely for educational and informational purposes and does not constitute a recommendation, professional advice, an offer, solicitation or an invitation by or on behalf of Manulife Investment Management to any person to buy or sell any security. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. The economic trend analysis expressed in this material does not indicate any future investment performance result. This material was produced by and the opinions expressed are those of Manulife Investment Management as of the date of this publication, and are subject to change based on market and other conditions. Past performance is not an indication of future results. Investment involves risk, including the loss of principal. In considering any investment, if you are in doubt on the action to be taken, you should consult professional advisers.

These materials have not been reviewed by, are not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the following Manulife entities in their respective jurisdictions.

Indonesia: PT Manulife Aset Manajemen Indonesia. **Malaysia**: Manulife Investment Management (M) Berhad Registration No: 200801033087 (834424-U). **Singapore**: Manulife Investment Management (Singapore) Pte. Ltd. (Company Registration Number: 200709952G). **Vietnam**: Manulife Investment Fund Management (Vietnam) Company Limited. **Australia, South Korea and Hong Kong**: Manulife Investment Management (Hong Kong) Limited. **Philippines**: Manulife Investment Management and Trust Corporation. **Japan**: Manulife Investment Management (Japan) Limited. **Taiwan**: Manulife Investment Management (Taiwan) Co., Ltd. (Investment is not protected by deposit insurance, insurance guaranty fund or other protection mechanism in Taiwan. For the disputes resulted from the investment, you may file a complaint to the Securities Investment Trust & Consulting Association of the R.O.C. or Financial Ombudsman Institution. License No. 110 Jin-Guan-Cheng-Tou-Xin-001 "Independently operated by Manulife Investment Management (Taiwan) Co., Ltd." /3F., No.97, Songren Rd., Taipei, Taiwan 11073, Tel: (02)2757-5999, Customer Service: 0800-070-998.)