

Special Report

Unwinding the Policy: Japan's Yield Curve Control



Contents

Historical Overview	02
Japan's YCC – Introduction and Historical Overview	
Factors Influencing Japan's YCC	03
Major Factors Influencing Japan's YCC	
Implication on Various Asset Classes	05
Impact on Various Asset Classes	
Opportunities of Japan's YCC	06
Opportunities at the End of Japan's YCC	

Japan's Monetary Policies Through The Years

- Japan's borrowing boom made asset prices skyrocket.
- Inflation soared, prompting interest rate to hike from 2.5% to 6%, The rise in the interest rates ultimately led to the bursting of the Japanese economic bubble.
- This economic bubble crashed due to an interest rate hike after exceptionally low rates from 1985 to 1987.

- From 2004 to 2010, The BoJ maintained its Quantitative Easing (QE) to ease deflation and adopted Zero Interest Rate Policy (ZIRP) during the global financial crisis in 2008.
- In 2013, the BoJ implemented Quantitative and Qualitative Easing (QQE) for purchasing Japanese government bonds (JGBs). From April 2013 to August 2018, the BoJ's balance sheet witnessed a sharp rise from JPY140 trillion to JPY380 trillion and a large monetary base by 2018.
- The BoJ introduced the yield curve control (YCC) in September 2016 under the framework known as QQE with YCC.

1980–1992

1993–2004

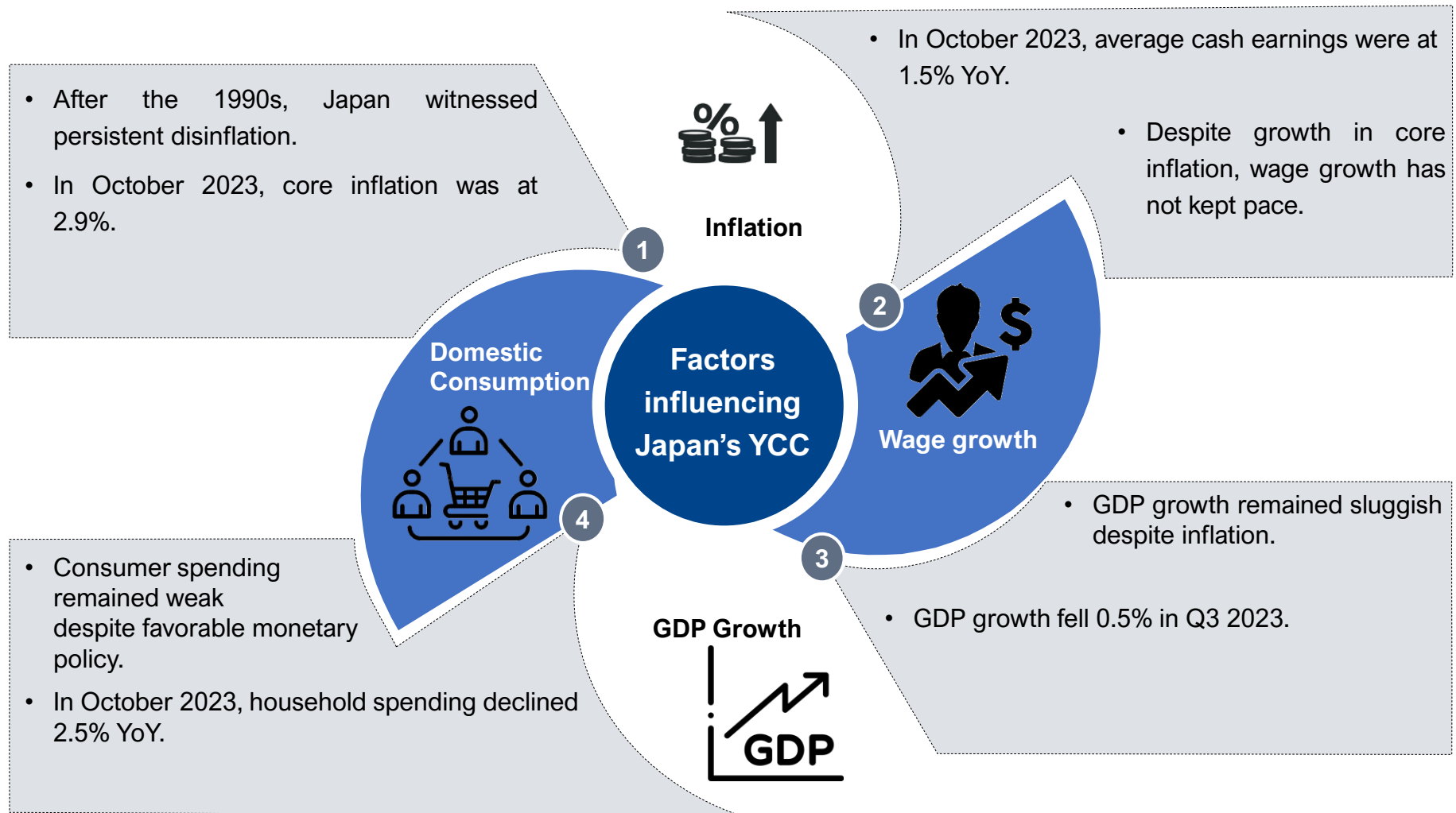
2004–2016

2017–Current

- After the economic bubble burst, Japan witnessed a deflationary environment.
- Core inflation sharply plummeted at the end of 1994, leading the Bank of Japan (BoJ) to slash interest rates to 0% from 1999–2002 to counter deflation and slow GDP growth.

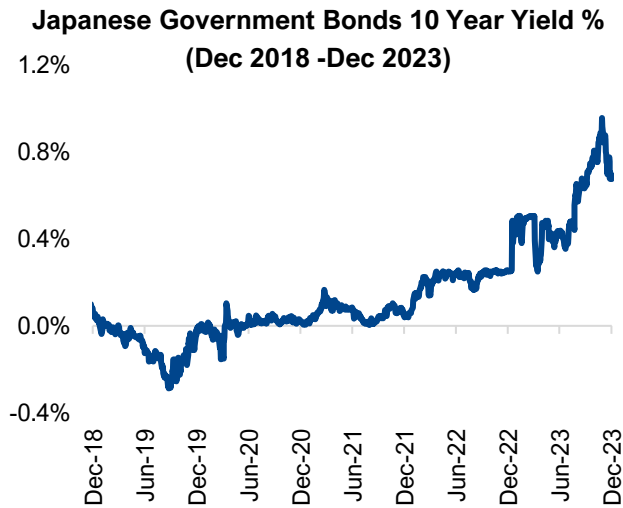
- The bank aimed for 10-year JGB yields to be "around zero percent" and kept YCC at the ± 10 bps fluctuation band, thus reducing yield volatility.
- In December 2022, the band was further stretched to ± 50 bps and a new ± 100 bps "strict cap" was introduced.
- In October 2023, the target level for JGB was at 0% and ± 100 bps was taken as the upper bound reference rate.

Deflationary Environment Leading To Sluggish GDP Growth

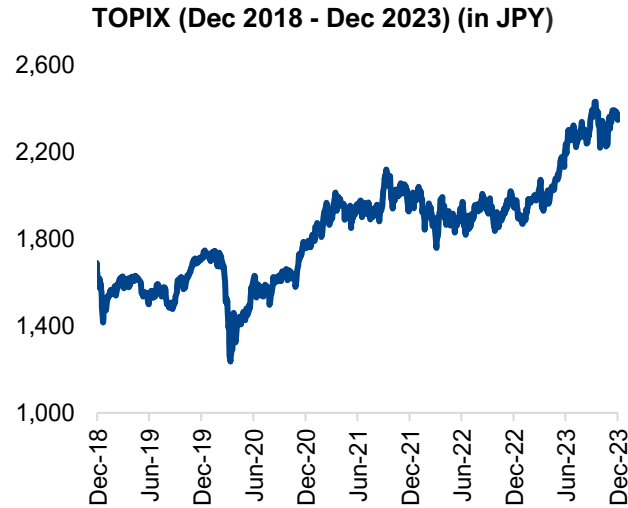


Implications On Various Asset Classes

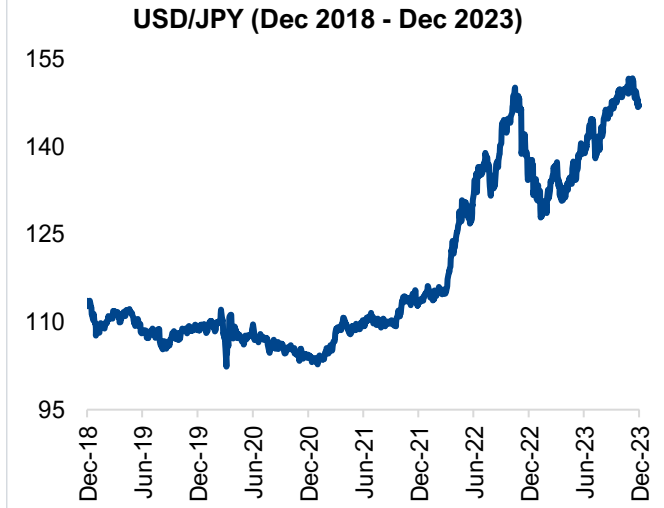
JGB Yields Weakened Amid Greater Flexibility In YCC



- The BoJ's announcement on 10-year JGB yields triggered a sell-off, with yields crossing 0.8%.
- The bank responded by buying back JPY300 billion in bonds, allowing yields to reach 1.0%.



- Financial firms and banks saw significant gains after the BoJ announced "greater flexibility," as investors believe that the potential end of YCC could aid interest income for these institutions.
- Mitsubishi UFJ Financial Group Inc. saw a 5.6% increase while Mizuho Financial Group Inc. and Sumitomo Mitsui Financial Group Inc. also benefited. The Tokyo Stock Exchange TOPIX Banks Index surged 25.6% due to YCC flexibility.

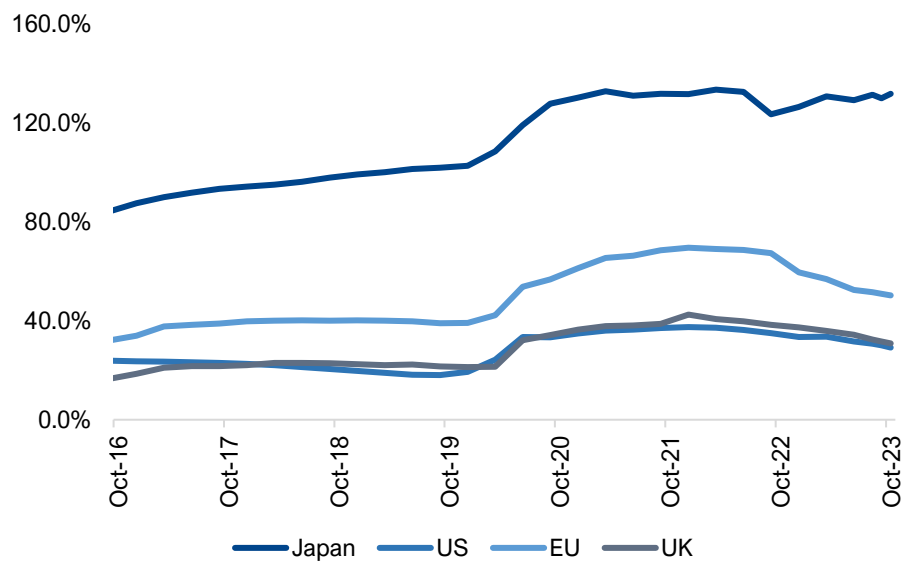


- The BoJ's QQE has led to a sharp devaluation of the JPY. This devaluation has worsened over the years due to strong monetary stances by the Federal Reserve (Fed) and European Central Bank (ECB) amid rising commodity prices, and worsening inflation.
- The JPY recently surpassed 150, reaching its highest level since the 1990s.

Japan's Yield Curve Control And Its Opportunities (1/2)

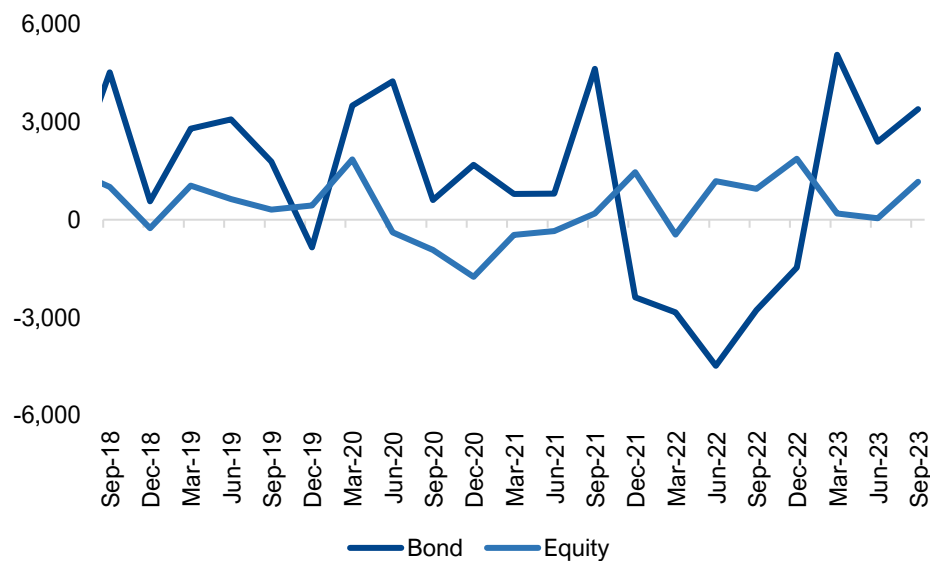
Easy Monetary Policy and Japanese Carry Trade: Impacting Global Asset Classes

Balance Sheet as % of GDP (Oct 2016 - Oct 2023)



- The balance sheets of major central banks are crucial to influence longer-term interest rates. When aiming to stimulate the economy, they increase their asset purchases and expand their asset portfolio.
- Since the 1990s, the BoJ's balance sheet has grown significantly, making it one of the most leveraged compared to any major economy. In October 2023, it stood at 131.8% of GDP, with only the ECB at 50.3% being closer.

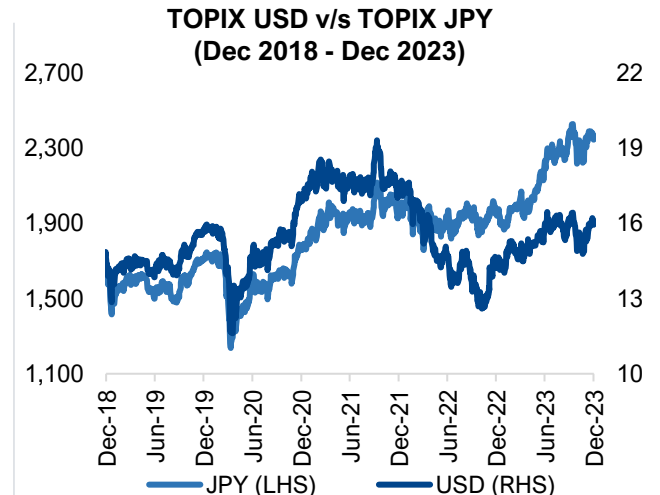
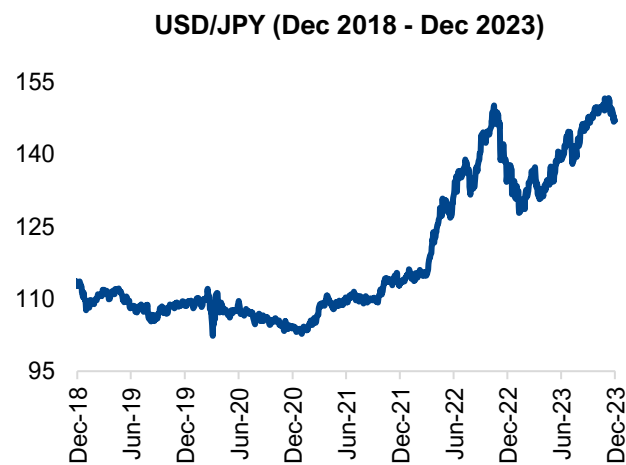
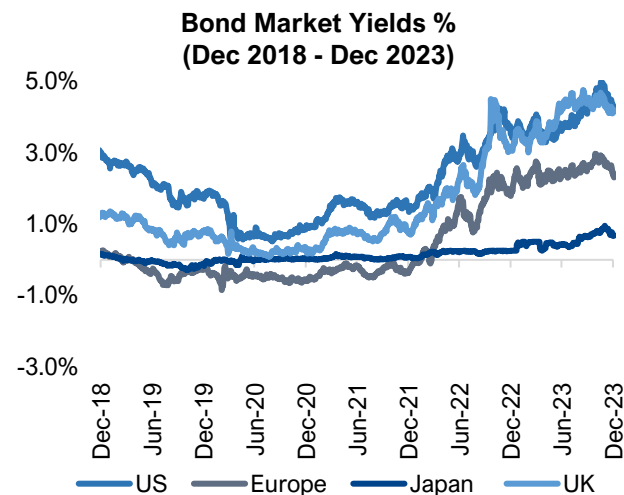
Japanese Net Purchase-Bond and Equity (Sep 2018 - Sep 2023) (in JPY)



- The BoJ's accommodative monetary policy has empowered investors to secure positions in the international market, leading to the emergence of the JPY carry trade.
- Japan has established itself as a formidable investment powerhouse, channeling trillions of Japanese Yen into the global bond and equity markets. In September 2023, Japanese investors allocated JPY3,396 billion (USD 23.68 billion) to international bond markets and JPY1,165 billion (USD 8.12 billion) to foreign equities.

Japan's Yield Curve Control And Its Opportunities (2/2)

End of YCC may lead to the unwinding of the Japanese carry trade



- The end of YCC would severely impact the bond markets worldwide. Japanese investors have always invested in bond markets abroad due to the depressed yields received in the Japanese market as a result of the YCC cap, preventing yields from rising further.
- The end of YCC or further flexibility could lead to higher yields in international bond markets as investors flock to domestic markets.
- JPY has witnessed a significant devaluation since the introduction of its loose monetary stance. The JPY depreciated by 9.0% YTD.
- If YCC ended, it would severely hamper the JPY carry trade as borrowing becomes expensive, leading to a stronger JPY.
- TOPIX and JPY/USD have a negative correlation, meaning Japanese equities fall when the JPY gains and vice versa. If the JPY strengthens due to the end of the YCC framework, it may lead to a drop in Japanese equities.
- Conversely, a quick strengthening of JPY/USD could benefit unhedged USD investors. This creates a correlation between JPY changes and USD returns over time.



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