

The coming BoJ pivot to banks

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In coming months, Japan's monetary policy is likely to move back to center stage. This is not just because Prime Minister Abe will have to make a decision on the next Governor, but, more importantly, because the case for a change in the operational targets of the BoJ's Yield-Curve-Control is growing stronger. Specifically, I expect a possible change in the BoJ duration target: a pivot away from targeting the 10-year yield to targeting the 5-year or 7-year yield could greatly enhance BoJ reflation credentials.

The benefit of such an operational shift—which is possible without abandoning the 2% inflation target—could be threefold:

First, it would further re-liquify private banks activity in the bond market, that is, effectively “crowding in” private investors' bond investments. Of course, a BoJ pivot away from the 10-year sector may result in higher 10-year bond yields, but this transition is poised to be welcomed by private asset managers currently starved of longer-maturity quality assets.

Second, the steepening of the curve past the new pivot point will raise profit margins and carry-trade arbitrage opportunities. Banks and Insurers would see their profit margins beginning to expand while, at the same time, short- and medium-term Yen funding costs would still be capped a zero up to the new pivot point. A “hockey stick” steeper yield curve may boost private banks profits.

Third, I believe the impact on Japanese equities would likely be very positive, thus adding to the reflationary momentum. This is because Japan's bank sector has been a huge drag on Japanese equities—while TOPIX has surpassed its “Abenomics” 2015 high, the Bank index is trading about 40% below it. Make no mistake, this huge underperformance is due to the BoJ's negative rate policy compounded by the 10-year zero yield control. An inward pivot to capping 5-year or 7-year bonds should trigger a positive inflection for banks' future earnings, and thus allow a positive re-rating of Japanese financials in general, banks in particular.

In addition, an inward pivot should not have significant impact on global carry trades and the exchange rate. By anchoring short- and medium-term Yen funding costs at zero, the rising interest differential between Japan and the US should still push up the US dollar, in my view.

At this stage, the first trail balloons on a possible change in the operational target of the BoJ's yield curve control appears to be floated with, for example, deputy Governor Nakaso hinting at flexible scenarios that might be considered. In my view, “Team Abe” is likely to look favourably on a BoJ operational shift that raises the profitability of banks and thus furthers the reflation agenda.

In my view, the time has come to raise allocation to Japanese financials in general, banks in particular. If I am right on the coming BoJ pivot, the next BoJ move will be re-flationary—precisely because it allows a turning point in banks' profitability prospects.

Chart 1: Japanese TOPIX and Banks TOPIX—Sharp underperformance by banks because of 10-year yield control since September 2016



Source: Bloomberg

Chart 2: BoJ has anchored the 10-year JGB Yield into a tight box zero-to-10bp—no room for bank profits to grow



Source: Bloomberg

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