THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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Will this time be different for Japan?

The Bank of Japan has reacted to a persistently flat yield curve by adjusting its Rinban operations and by signalling that a potential rate cut is around the corner. But will these attempts to steepen the curve be sustainable?

Fundamentals:

Japan's export-oriented economy faces rising uncertainties amid a slowdown in global trade. The consumption tax rise, which recently took effect, also adds to concerns around domestic growth. Although neutral from a fiscal perspective, the tax hike will likely still be negative for the economy as the effect on consumer confidence tends to have an immediate and broad-based impact on growth, while the offsets, such as spending on free education and medical subsidies, tend to feed through less quickly. According to the Cabinet Office, consumer confidence has fallen to its lowest level since 2011. At the same time, financial conditions have tightened, with the yen strengthening amid trade uncertainties, while inflation momentum seems to have waned as businesses find it harder to raise prices into a slowing economy. We think it is therefore increasingly likely that the Bank of Japan will cut rates from -0.1% to -0.2% at its next meeting on 31 October. Japan's central bank is also directing more of its Rinban purchases towards the front end of the curve while reducing purchases at the back end. The aim is to lower short and medium-term rates to provide a boost to the economy and prevent too much currency appreciation, while targeting higher long-term rates in a bid to provide life companies and pension funds with yields that are attractive enough to invest in.

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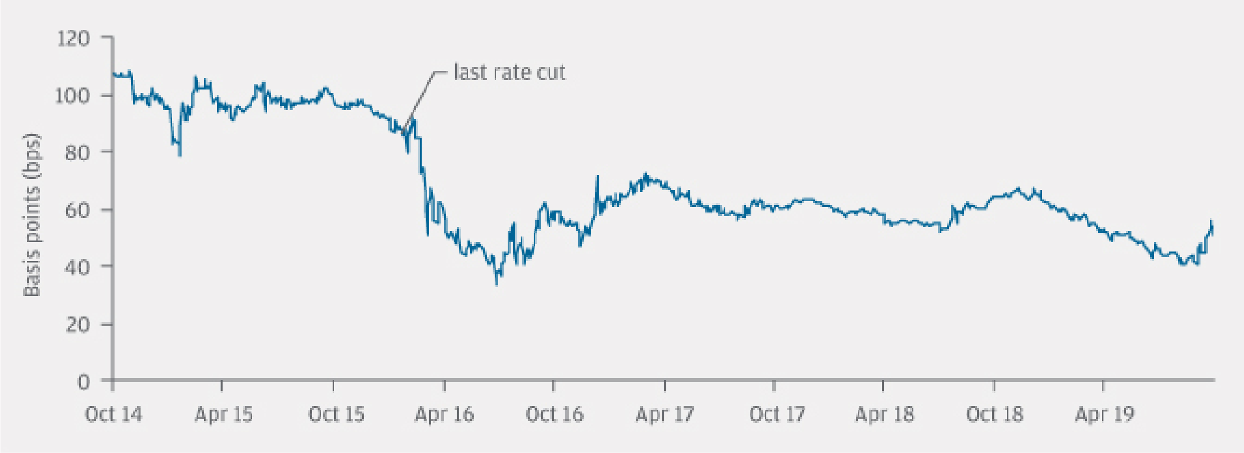
Quantitative valuations:

Japan's government bond yield curve has been steepening since 6 September, when Bank of Japan governor Haruhiko Kuroda indicated in an interview with the Nikkei that he is inclined to align policy measures to achieve a steeper curve. The spread between the seven-year and 20-year yield has since moved from a recent low of 40 basis points (bps) on 4 September to 54bps on 2 October. The last time the Bank of Japan cut rates in January 2016, the initial curve steepening was followed by a sharp flattening, so it is no surprise that investors are questioning whether the current steepening will be sustained.

Japan's government bond yield curve



Source: Bloomberg, Japan sell seven-year and buy 20-year bond yield spread (JPCYC7Y20 Index); data as of 1 October 2019.

Technicals:

Supply and demand conditions for Japanese Government Bonds will undoubtedly have a significant part to play in the shape of the yield curve. Japan's Government Pension Investment Fund (GPIF) poses a threat to demand, as it has announced that it will classify hedged foreign bonds as domestic debt, enabling more foreign bond purchases at the expense of domestic debt. Given the sheer size of assets the pension fund owns, being the world's largest pool of retirement savings, investors will be watching developments closely and potentially increasing foreign bond allocation targets.

What does this mean for fixed income investors?

Investors will look to get more clarity on the Bank of Japan's strategy from its upcoming rate setting meeting. The market is also looking to assess the impact of the GPIF's classification change on foreign bonds and the effect of potential fiscal measures. However, we are of the view that this time round won't be different for Japan. We think monetary policy will remain constrained, while Japan's ageing demographic will continue to act against attempts to steepen the curve, as life and insurance companies look to buy the long end of the curve once it looks sufficiently attractive.

About the Bond Bulletin

Each week J.P. Morgan Asset Management's **Global Fixed Income, Currency and Commodities** group reviews key issues for bond investors through the lens of its common Fundamental, Quantitative Valuation and Technical (FQT) research framework.

Our common research language based on **Fundamental, Quantitative Valuation and Technical** analysis provides a framework for comparing research across fixed income sectors and allows for the global integration of investment ideas.

Fundamental factors include macroeconomic data (such as growth and inflation) as well as corporate health figures (such as default rates, earnings and leverage metrics)

Quantitative valuations is a measure of the extent to which a sector or security is rich or cheap (on both an absolute basis as well as versus history and relative to other sectors)

Technical factors are primarily supply and demand dynamics (issuance and flows), as well as investor positioning and momentum

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