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Global Policy & Central Banking Strategy

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Krishna Guha
202-872-5260
Krishna.Guha@evercoreisi.com

FED AND BOJ PREVIEW — EYES ON KURODA WITH STEADY AS SHE GOES FROM POWELL

Global yields sensitive to BoJ; base case lays foundation for later changes, but material risk wider yield tolerance zone

Summary: We expect this week's FOMC meeting will deliver a steady-as-she-goes message with only very modest changes to the statement and nothing that even hints at a possible change in strategy following public criticism of rate hikes by President Trump. The implicit signal will be that the Fed intends to ignore political pressure and focus on the data / outlook for the economy. By contrast the July Bank of Japan meeting is shaping up to be an important meeting. We think the BoJ will at least start to prepare the ground for a move to edge away from its zero ten year yield target. With global bond markets hyper-sensitive to even small tweaks in Japanese monetary policy, speculation around this meeting helped drive yields around the world materially higher / steeper over the past week. In our base case this meeting will indeed be an important one but more for the direction of travel it sets in favor of a moderately steeper yield curve that may be implemented late this year / early next than for actual decisions taken at the meeting. With global bond yields having repriced materially — more than Japanese yields which are constrained by BoJ operations — and Kuroda potentially seeing the need to insist that the BoJ remains committed to powerful monetary easing we think risks to global yields ex-Japan going in are now less one-sided than they were when we published our first note highlighting hawkish risk around the meeting two Fridays back.

In our base case the BoJ will set the foundation for a limited future recalibration of the curve steeper for sustainability reasons but will not make major changes to core policy settings at this week's meeting. Specifically, we think the likelihood that the BoJ will scrap its quantity JGB purchase target next week is moderate, the likelihood that it will pull back to target a five year horizon is low, the likelihood that it will raise the ten year target is very low and the likelihood that it will increase the negative 10 bp overnight rate is even lower — though the probability of each of these is not zero as the central bank would not telegraph a rip-the-band-aid move ahead of time. What we think is in play near-term are possible steps to mitigate the cost of current policy settings to the financial system and a possible formal or informal widening of the current de facto +/- 10 bp tolerance zone around its zero ten year target. We view a widening of the zone / softening of the +10 bp yield cap as a material risk albeit not in our baseline; such a step would have elements of a stealth hike. Even in our base case in which the zone is not widened at this meeting we think the BoJ will lean in favor of maintaining the slightly higher / steeper curve structure that has evolved in recent days and allow ten year yields to settle at the higher end of the existing range. As part of the effort to mitigate the costs of easing to the financial system we also see a high likelihood that the BoJ will signal an intent to tweak the way it conducts ETF purchases to focus more on the broader TOPIX index and less on the Nikkei and perhaps inject greater operational flexibility too.

On the Fed front:

- We believe the FOMC will leave interest rates unchanged and likely make no material changes to its policy statement outside the first paragraph that describes current economic conditions
- This view implies no change to the balance of risks assessment or new references to trade, the dollar or emerging market risks
- We are alert to the possibility that the second paragraph language regarding further gradual interest rate increases could be qualified with the phrase “for now” consistent with Chair Powell’s testimony to Congress — which would come over dovish — but we think probably not
- We think the Fed will over time continue to pare back its remaining forward guidance but the next steps are likely to come in September / December rather than August
- We read Powell’s recent testimony to Congress as framing out a two-phase approach to rates in the period ahead
- During the current phase — which extends for another six to nine months or two to three hikes — the FOMC has a default to continue to hike at a quarterly tempo in order to remove remaining accommodation and balance upside and downside risks
- In this phase because of strong momentum and upside as well as downside risks there is a fairly high hurdle to skip a quarterly hike and this would require a material deterioration in the outlook / balance of risks
- The current state of trade conflict and financial conditions do not meet this hurdle, though it is certainly possible that a sharp worsening of trade wars and severe further tightening of financial conditions could meet this hurdle and cause the Fed to slow down or pause before year end
- Sometime between December and March, with the federal funds rate either slightly below or slightly above 2.5 per cent, the phase of relatively automatic rate increases on a quarterly tempo will give way to a more empirical phase
- In this phase the FOMC will retain a bias to some possible further rate increases but much less of a default to any specific hiking pace — policy will be truly data-dependent as the Committee feels its way back to neutral and if necessary beyond
- This opens the door to a pause / decision to slow down in March or June but only if the data at that time warrants such a step
- The stopping rule and ultimate extent of Fed hiking in this second phase will not be determined by model estimates of the neutral rate or the slope of the 2-10 yield curve
- Instead it will be determined by the evolution of the outlook and balance of risks for unemployment and inflation informed by a broad array of incoming economic and market data

We will write more on Fed strategy and the outlook for US monetary policy in the weeks ahead.

On the BoJ front

- The July BoJ meeting is shaping up to be the reset meeting early in Kuroda’s second term that takes a step back and reframes the central bank’s economic and policy thinking
- This is a difficult exercise because a lack of progress on inflation is forcing tough trade-offs that are exposing differences on the Policy Board

- Staff research presented at the July meeting will explore why it is proving so hard to raise inflation / inflation expectations and conclude that while the task is not hopeless it will require a long-haul effort to move Japan more deeply into a positive output gap for a longer period
- Consistent with this the Policy Board will reduce previously unrealistic projections for inflation with the median projection for fiscal year 2019 likely to fall from 1.8 per cent to around 1.5 per cent (which would still be on the optimistic side)
- The deepening recognition that the BoJ is engaged in a marathon not a sprint has important implications for policy: it means the BoJ needs to stay easy for longer but it also means that policy has to be calibrated in a way that is sustainable for longer with increased attention to costs that may rise in time
- The two main costs relate to JGB market functioning and the viability of financial business models, though the BoJ is also sensitive to criticism that it is distorting equity markets through its equity ETF purchases
- The move to YCC (yield curve control) in late 2016 solved the scarcity of bonds to buy while releasing the curve beyond ten years bailed out the life insurers, but did not solve loss of JGB market liquidity and the stress on tier two regional and Shinkin banks that operate on the ultra-low and ultra-flat segment of the curve out to ten years that is pinned down by the BoJ
- With inflation stalled far below target, the BoJ has a difficult challenge weighing costs and benefits: any move to edge away from current ultra-easy policy settings for cost reasons could risk its inflation-promoting credibility as well as mechanically pushing the yen higher, and import prices and non-financial equities lower
- We think the central bank is searching for ways to mitigate the costs — one or more might be ready in time to deploy at the July meeting though Kuroda may instruct the staff to do more work and report back in the fall
- JGB market functioning could be improved by abandoning the ¥80 trillion a year quantity purchase target that is already secondary to the yield target — but we think this is unlikely at the July meeting as it would be firmly opposed by the three doves on the Board; we see a widening in the tolerance zone around the target / softening of the hard cap as more likely
- Stress on tier two regional and Shinkin banks could be alleviated by tweaking the negative rate, further enhancing concessional funding operations to contain pressure on net interest margins, and regulatory relief — in particular activities-based regulatory relief to allow these banks to invest in commercial real estate — though the latter decision lies with Japan's FSA
- Distortions from equity ETF purchases could be reduced by shifting the weight of these purchases towards the broader TOPIX index; over time we expect bigger changes in the direction of greater flexibility in monthly purchases
- Assuming the BoJ can find only modest scope to mitigate the costs from the current yield curve, the July meeting in effect will start the countdown clock on a limited recalibration to steepen the curve moderately for cost / sustainability purposes — though different BoJ policymakers have quite different views as to how fast that clock runs down
- A moderate steepening of the curve would ease pressure on interest margins a little and give small banks with low loan-to-deposit ratios a positive return on risk-free securities that have no capital charge and do not need to be marked to market — but could also have an outsized influence on inflation expectations

- The timing and extent of any recalibration will reflect the balance of cost concerns with inflation progress informed by current inflation, FX market developments and the balance of risks to the outlook, as well as perhaps some political considerations relating both to the LDP leadership election and Trump trade risks
- Some of these factors (in particular the strength of the dollar) favor a move as early as this week but on balance we think Kuroda would judge it too risky in terms of inflation credibility to recalibrate yields higher immediately after a disappointing June inflation print at the meeting at which the Board cuts its inflation projections
- Our base case is therefore a two-step process in which the July meeting sets the foundations for a future move to moderately steepen the curve most likely late this year / early next — the wider window of opportunity extends from October to March, September to March if Abe sees a need to head off an adverse finding on FX manipulation — but does not immediately change any core policy settings
- However, we do see a material risk that the BoJ could this week widen the existing de facto tolerance band of +/-10 bp around the zero yield target — and in doing so at least permit yields to move at times above 10 bp; monetarist doves might not be categorically opposed as this would make it easier to implement large quantities of purchases
- Such a move could be signaled either via a formal Policy Board decision to establish a wider band, an informal steer from Kuroda in the press conference that the BoJ will soften the +10 bp cap, or by the operations of the BoJ market desk itself; the informal steer seems the most likely
- The choice as to whether to widen the de facto tolerance band at this meeting will pivot on whether or not the BoJ thinks it is a sufficiently dominant player in a JGB market mostly populated by price-insensitive domestic holders to maintain control of yields in the period between pointing to a potential recalibration some months ahead and actually tweaking policy settings
- In our base case scenario in which the BoJ follows a two-step process a gap could emerge between the observed JGB yield capped by BoJ interventions and a “shadow yield” that captures expectations of a later move and may be expressed in swaps; global yields may be influenced as much by the shadow yield as the actual yield

Our full note focuses on the BoJ and sets out in detail our thinking about the outlook for policy in Japan.

JULY BOJ MEETING IS THE RESET MEETING FOR THE SECOND TERM — BUT COMPLICATED BY INTERNAL DIFFERENCES

The July Policy Board meeting is shaping up to be the reset meeting early in Kuroda's second term with a new team of deputy governors — the meeting that takes a step back, looks at the big picture and recalibrates the message on the outlook and policy strategy. This exercise is challenging because disappointing progress on inflation, a lack of policy space and evidence of costs to easing presents a challenging set of policy choices / trade-offs that are exposing divisions in the Policy Board.

We see three firm doves — second Deputy Governor Wakatabe, Harada and dissenter Kataoka — two firm hawks — Masai and Suzuki — and a center group made up of Governor Kuroda, first Deputy Governor Amamiya, Funo and Sakurai. This center group has been edging just a fraction less dovish and contains its own differences, with the core leadership pair of Kuroda and Amamiya themselves each wrestling with how to weigh costs against benefits and perhaps coming up with slightly different assessments.

DEEPENING CONVICTION THAT RAISING INFLATION IS A MARATHON NOT A SPRINT IN WHICH SUSTAINABILITY OF POLICY SETTINGS IS KEY

The backdrop to this exercise of framing the arc of policy for the second term is a deepening conviction that in Japan at least the task of raising inflation and inflation expectations is a marathon not a sprint. QQE at the outset was designed and calibrated for a sprint in the belief that the best hope of raising the trend rate of inflation was to shock expectations and the markets with maximum force and the strongest conviction to achieve the inflation target at the earliest possible date — a belief we also shared at the time. Now the BoJ increasingly accepts that what it has learned over the intervening years is that it will take much longer to raise inflation.

If raising inflation turns out to be a marathon not a sprint this has important implications for policy strategy. In particular, the longer the haul the more important sustainability of policy settings becomes, and the more the calibration of policy becomes an exercise in balancing costs — that may rise in time[1] — with benefits principally associated with higher inflation but also the maintenance of easy financial conditions that have supported relatively solid per capita growth and employment. At the same time, there are costs / risks in the direction of pulling back from easing too: in particular retreating at a moment when inflation is not progressing in the right direction could deeply damage the BoJ's credibility — a consideration we think is important to Kuroda as well as the doves on the Policy Board.

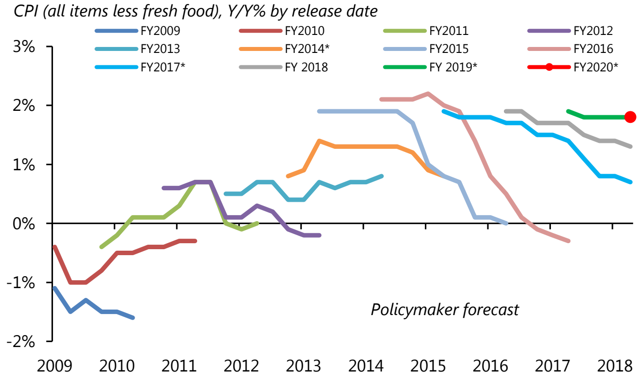
NOT A NEW REVALATION BUT THE NEXT PHASE IN A TRANSITION THAT BEGAN WITH THE SHIFT TO YIELD CURVE CONTROL IN 2016

The recognition that raising inflation is a marathon not a sprint is not a sudden new revelation on the part of the BoJ. The central bank's thinking has been in transition in this direction for at least a couple of years. Indeed the shift to YCC in late 2016 was intended to reflect the need to put policy on a more sustainable footing for a longer haul and contain costs in two main directions — the JGB market and financial institutional sustainability — while continuing to maintain firm pressure in the direction of the 2 per cent inflation target.

[1] BoJ Policy Board members talk about cumulative costs.

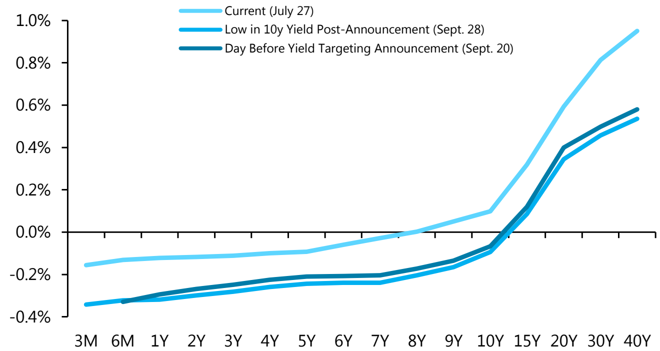
Bank of Japan inflation forecasts

CPI (all items less fresh food), Y/Y% by release date



Source: Bank of Japan * *indicates exclusion of effects of consumption tax*

Japan sovereign yield curve since yield targeting announcement



Source: Bloomberg

In effect the shift to YCC solved half of each of the BoJ's two main sustainability / cost challenges. Shifting the primary focus from a quantity to a price target for QE solved the problem of there not being enough JGBs to buy but did not restore market liquidity. Letting go of the yield curve beyond ten years and allowing it to steepen provided substantial relief for life insurers but did nothing to help regional banks that live on the ultra-low and ultra-flat segment of the yield curve from the overnight rate of -10 bp to the ten year yield of zero.

FOLLOWS FURTHER STEP IN APRIL THIS YEAR TO DROP THE SPECIFIC TIMEFRAME FOR ACHIEVING 2 PER CENT INFLATION

Another change in the direction of recognizing that raising inflation is a marathon not a sprint occurred in April when the BoJ finally dropped its commitment that the inflation target would be met in roughly two years — which remained in place up to January 2018 when the Policy Board said it would reach 2 per cent inflation "around fiscal 2019." This was both a concession in the direction of realism away from attempting to signal determination in order to shore up inflation expectations and a brake against pressure in particular from Kataoka to further increase monetary stimulus.

As long as the specific timeline remained in place any deterioration in inflation momentum / expected progress towards the 2 per cent target logically called for additional easing. By removing the specific timeline the Policy Board implicitly recognized limits to policy space imposed by costs and its readiness to accept a slower rise in inflation rather than push policy to further extremes, though we have always thought of this as an assessment of costs and benefits at a particular juncture rather than necessarily a statement for all times and all conditions. High frequency indicators of inflation expectations in financial markets were not badly impacted by this decision but have made no real progress either.

JULY MEETING TO FRAME OUT WHY SO HARD TO RAISE INFLATION AND WHY POLICY NEEDS TO BE CALIBRATED FOR THE LONG HAUL

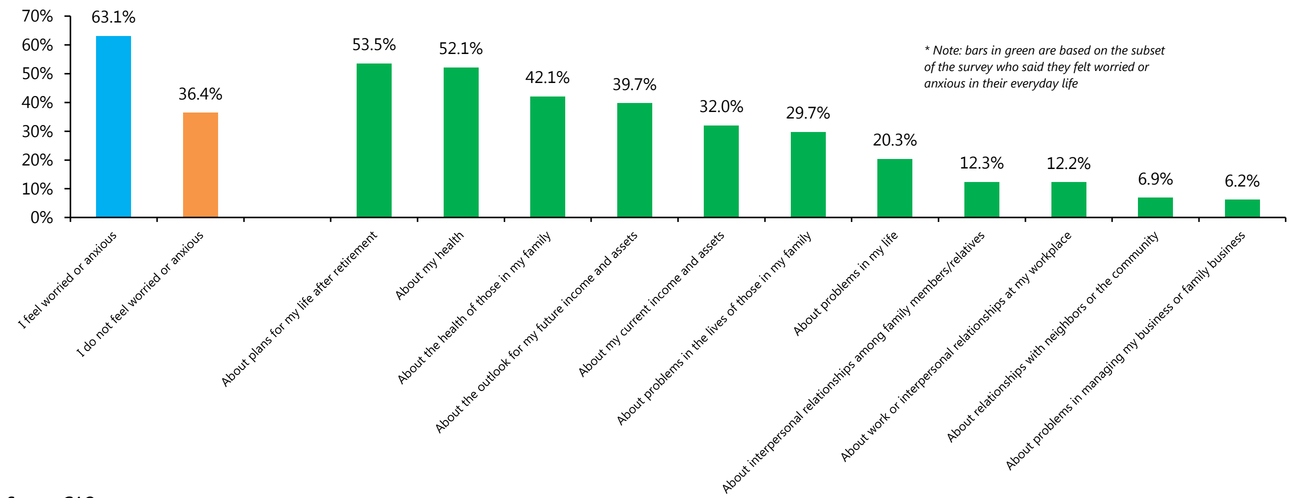
We view the July meeting as the next big step in this process of adapting to a marathon from a sprint. This reflects diminishing hopes that stabilization on the inflation front last year after setbacks in 2016 might lead to substantial progress on prices this year. At the meeting the BoJ staff will present research that seeks to explain why the process of raising inflation has turned out to be much more protracted than anticipated at the onset of QQE — while claiming that it is not an impossible task as witnessed by the end of deflation and market / household based inflation expectations moving up to roughly 50 bp during the QQE period.

This research will cite a number of factors:

- The long-recognized stickiness of deflation / noflation expectations
- Demographic factors and long-term insecurities on the part of households and firms
- The failure of the initial wave of import price-led inflation to push up inflation expectations and shift the Phillips curve higher in the absence of concurrent increases in domestic wage and price inflation
- Positive supply shocks from increased labor force participation and investment in capital-labor substitution
- Amazon-type disinflationary impulses from technology

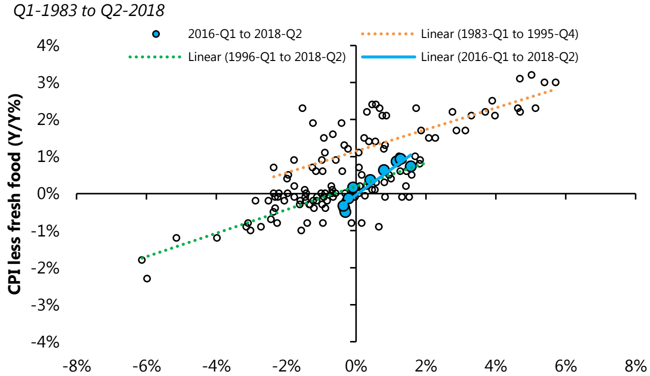
The work will not conclude that the BoJ's task is hopeless but it will suggest that the BoJ will need to push the economy deeper into a positive output gap for much longer before both actual inflation and inflation expectations will move steadily and decisively higher. This in turn calls for policy to be easier for longer but requires the calibration to be sustainable for longer too — the crux of the BoJ Policy Board dilemma.

Japan Public Opinion Survey on the Life of the People - % worried/anxious in everyday life & sources of those worries / anxieties



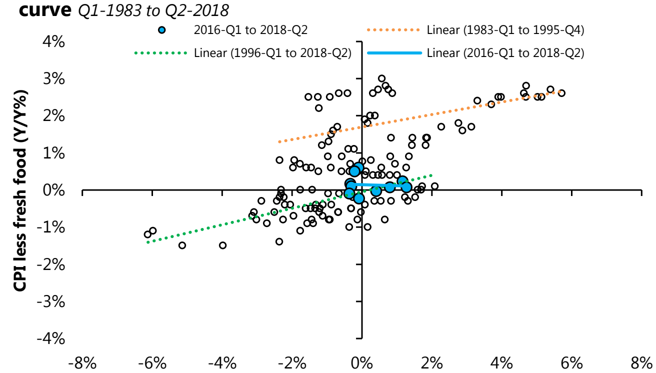
Source: CAO

Japan CPI less fresh food / output gap Phillips curve
Q1-1983 to Q2-2018



Source: BoJ, MIC

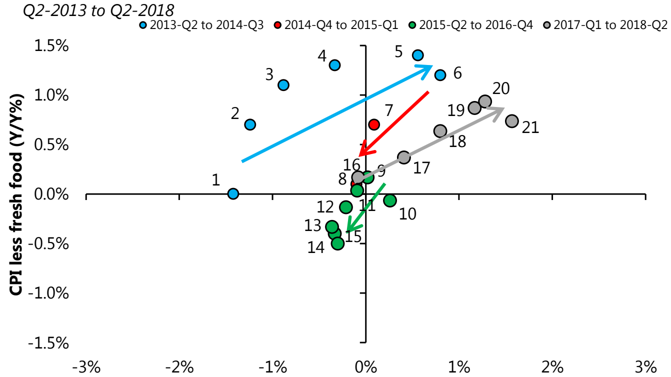
Japan CPI less food and energy / output gap Phillips curve *Q1-1983 to Q2-2018*



Source: BoJ, MIC

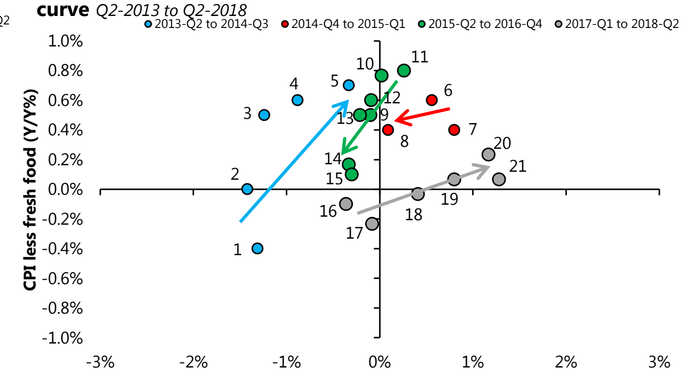
Japan CPI less fresh food / output gap Phillips curve

Q2-2013 to Q2-2018



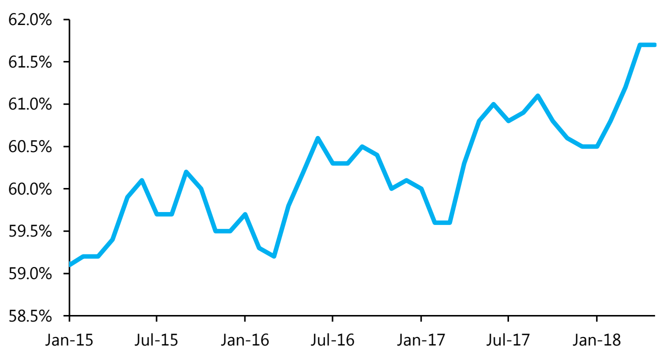
Source: BoJ, MIC

Japan CPI less food and energy / output gap Phillips curve *Q2-2013 to Q2-2018*



Source: BoJ, MIC

Japan labor force participation rate



Source: Ministry of Internal Affairs and Communications

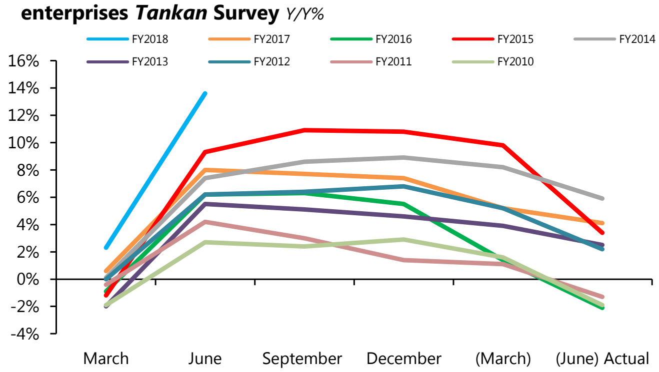
Share and number of employees

Ten thousands

		2007	2017	Difference
Men	Under 60	48.7% (3,133)	44.1% (2,881)	-4.6%p (-252)
	60 and Over	9.8% (628)	12.1% (790)	+2.3%p (+162)
Women	Under 60	35.6% (2,288)	35.6% (2,322)	+0.0%p (+34)
	60 and Over	5.9% (378)	8.2% (538)	+2.4% (+104)

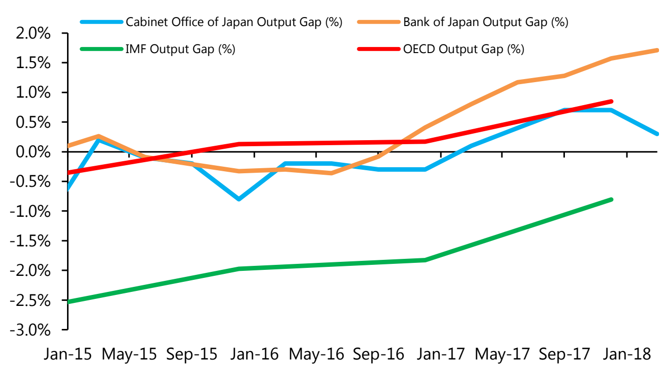
Source: MHLW, BoJ

Japan business fixed investment plans - large enterprises *Tankan* Survey *Y/Y%*



Source: Bank of Japan

Japan output gap estimates



Source: Cabinet Office of Japan, BoJ

BOJ POLICY BOARD MEMBERS WILL PRESENT MORE SOBER, LESS UNREALISTIC PROJECTIONS FOR INFLATION

Consistent with the staff analysis, BoJ policy board members will finally abandon the QQE-era practice of submitting unrealistically high projections for inflation over the forecast horizon in a bid to pull up inflation expectations that survived the initial decision to drop the set timeline for achieving 2 per cent in April — and submit lower projections that are more realistic though still significantly higher than market. These revisions will be significant: we think the median member will likely project around 1.5 per cent underlying inflation in fiscal year 2019 rather than 1.8 per cent at the last forecast round.

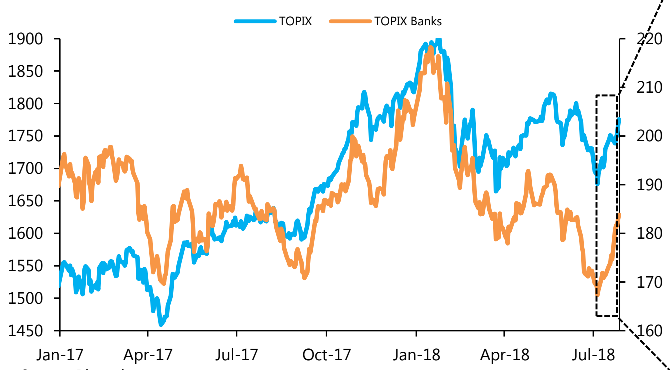
The downward revisions to the inflation path will not be accompanied by any additional easing in the present, which may threaten further weakness in inflation expectations, though the BoJ leadership may argue that efforts to increase the sustainability of policy settings and improve the BoJ's ability to stay the course over a long period of time could be read as adding easing in the dimension of time. We think this is not a wholly absurd argument, though we are wary that it can be used as a fig-leaf for a retreat from stimulus — and the public / markets may read it that way.

RATE SETTING UNDER YCC IS A COST-BENEFIT EXERCISE — COSTS NOW SEEN MOSTLY IN THE DIMENSION OF REGIONAL / SHINKIN BANK BUSINESS MODELS AND DRYING UP OF JGB MARKET LIQUIDITY

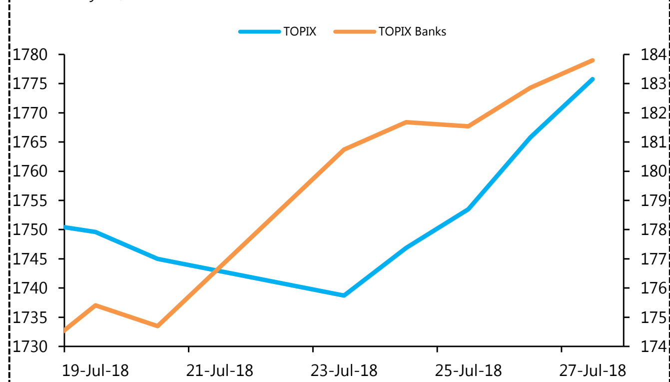
The BoJ Yield Curve Control (YCC) framework is often summarized as adding a ten year yield peg of zero to the overnight target of minus 10 bp but the BoJ has always resisted this characterization, arguing that the rate settings are not pegs and can be varied — with the calibration of an optimal yield curve established on the basis of a cost-benefit analysis. The market curve is then shepherded in the direction of the desired optimal curve through a combination of target rates at the overnight and ten year horizon, fixed rate tenders around the ten year target and ongoing large-scale QE-type purchases both within and beyond the ten year horizon spanned by the target rates, with BoJ influence extending to ultra-long horizons. At present the principal costs that are drawing additional attention as the realization that QQE is a marathon not a sprint deepens relate to market liquidity and the sustainability of the business models of tier two regional banks and cooperative Shinkin banks (inside the BoJ a third cost consideration, BoJ profitability / capital has some weight in its thinking, more than we think is warranted).

In recent months JGB market liquidity has deteriorated even further, unsettling some within the BoJ who worry about market infrastructure and signals decaying. Meanwhile the tier two regional and Shinkin banks face a cumulative squeeze from the ultra-low and ultra-flat yield curve in the zero to ten year segment pinned down by YCC that compounds what in our view are much more fundamental structural problems with overbanking and business models that cannot survive population decline and competition from larger banks and new fin-tech companies. For more see our report from last year highlighting these issues (BOJ / GLOBAL YIELDS — WEIGHING THE RISK OF AN EARLIER 10Y TARGET HIKE) as well as the BoJ's latest financial stability report (http://www.boj.or.jp/en/research/brp/fsr/fsr180419.htm/). There is no obvious market or other indication that large numbers of these banks are in imminent danger of distress but the fall in their stock prices from the start of the year until the recent speculation of a BoJ policy shift underlines that the longer inflation weakness keeps the current policy settings in place the greater the cumulative damage to their businesses.

TOPIX & TOPIX banks

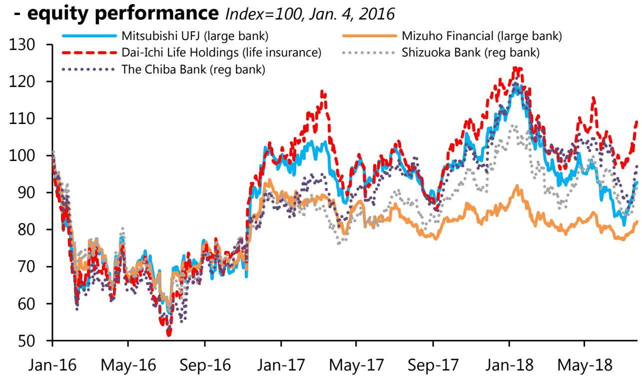


Source: Bloomberg



Source: Bloomberg

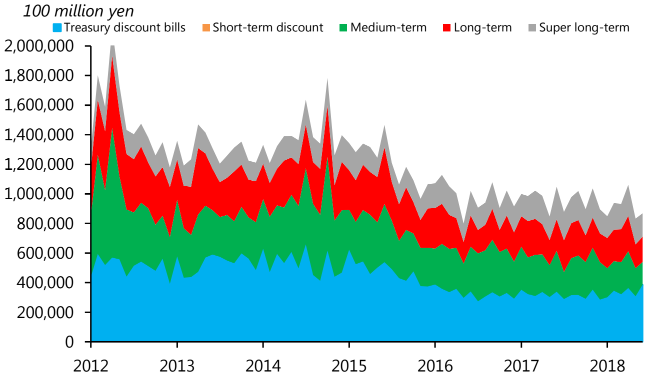
Select Japan large banks/life insurers/regional banks - equity performance *Index=100, Jan. 4, 2016*



Source: Bloomberg, Evercore ISI

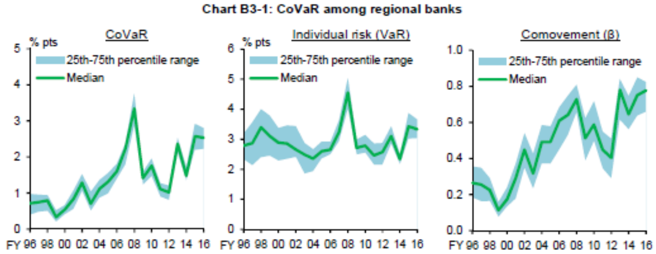
JGB trading volume by category

100 million yen



Source: JDSA

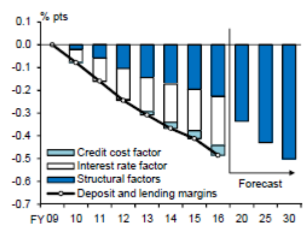
Chart B3-1: CoVaR among regional banks



Note: 1. The estimation sample spans from April 1996 to March 2017 and covers 56 regional banks. The estimated values are based on rolling samples of the last 1 year.
2. VaR in the middle chart is the difference between VaRs with the 95 and 50 percent confidence levels over a 1-year holding period.
3. β in the right-hand chart is estimated using a quantile regression where the change in market capitalization for the regional bank sector is regressed on that for individual regional banks. The TOPIX return is used as a control variable.

Source: BoJ Financial System Report (October 2017)

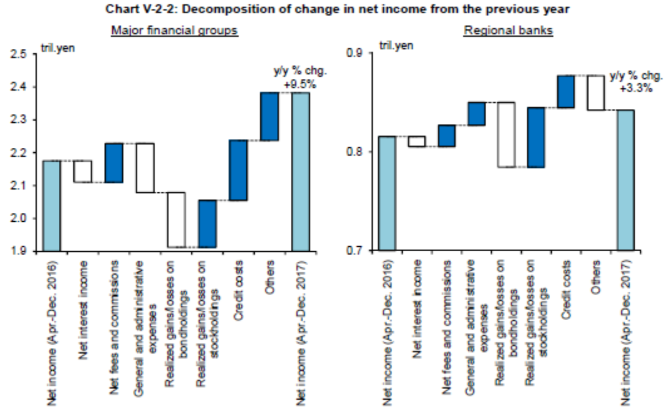
Chart V-2-5: Factors for reduction in deposit and lending margins among regional financial institutions



Note: 1. The chart indicates the decomposition of cumulative changes in deposit and lending margins from fiscal 2009, based on the panel estimation (covering the period from fiscal 2001 to 2016) for regional financial institutions.
2. In the estimation, financial institutions' deposit and lending margins are used as the dependent variable. The explanatory variables used are the population growth, the population aging, the number of branches in the business areas of each financial institution (representing "Structural factors"), the nonperforming loan ratio of each financial institution (representing "Credit cost factor"), and 5-year JGB yields (representing "Interest rate factor").
3. With regard to forecasting "Structural factors," the population growth and population aging forecasted by the National Institute of Population and Social Security Research are used. The number of branches in business areas is assumed to remain constant from fiscal 2016.

Source: BoJ Financial System Report (April 2018)

Chart V-2-2: Decomposition of change in net income from the previous year



Note: The left-hand chart covers Mizuho Financial Group, Mitsubishi UFJ Financial Group, Sumitomo Mitsui Financial Group, Resona Holdings, Sumitomo Mitsui Trust Holdings, Shinsei Bank, and Aozora Bank.
Source: Published accounts of each bank.

Source: BoJ Financial System Report (April 2018)

POSSIBILITY OF MITIGATING ACTIONS ON JGB MARKET LIQUIDITY — COULD BE ATTENUATED BY FINALLY ABANDONING THE ¥80 TRILLION A YEAR QUANTITY PURCHASE TARGET BUT PROBABLY NOT NOW DUE TO MONETARIST DOVES

Before jumping to the conclusion that in a marathon race to raise inflation costs that cumulate over time will require the BoJ to recalibrate the yield curve, the central bank will explore whether these costs can be mitigated without making changes to its rate target(s). Some part of that exercise will likely have been completed by the time of the July meeting raising the possibility of some mitigating actions being taken at this meeting, though Kuroda may simply announce that the BoJ staff will do further work on this topic and report back in the fall. Near term it is possible that the BoJ might give itself a little more flexibility on JGB purchases though tweaks of this kind come at the expense of predictability and may not make large differences to market functioning.

The BoJ could take the larger step of formally abandoning or scaling sharply back its notional commitment to by ¥80 trillion of JGBs a year, which is already qualified with the phrase "more or less" and has been subordinated to the yield / price target with actual purchases running more in the ¥50 trillion a year range. This would be clean from a policy perspective[2] and might lead to more private sector market activity even within an unchanged target rate and tolerance band at the ten year horizon. However, while we would not be at all amazed if the BoJ did take this step in July, we think it is unlikely because of adverse signaling risks and in particular because the three firm doves — Wakatabe, Harada and Kataoka — are strongly committed to the quantity target and to the associated target for increasing the money base.[3] With this option certain to face fierce resistance from one third of the Policy Board, we think it is more likely that the BoJ could de facto or de jure widen the tolerance zone around the target to promote market liquidity; more on this below.

POSSIBILITY OF MITIGATING ACTIONS ON BANK COSTS — INCLUDING TWEAKS TO OPERATION OF NEGATIVE RATE, MORE CONCESSIONAL FINANCING AND ACTIVITIES-BASED REGULATORY RELIEF

We believe parallel efforts have likely taken place with regards to mitigating costs to the tier two regional and Shinkin banks, some of which might result in mitigating actions at the July meeting, though it is also quite likely that here too Kuroda may simply task the staff with conducting further analysis and reporting back in the fall. We highlight three possibilities. The BoJ may be able to tweak the incidence of the negative 10 bp overnight marginal rate on excess reserves, though this already falls on only a small fraction of reserves and we are skeptical there is much room for relief. More promising in our eyes, the BoJ could emulate the Bank of England's moves to shield banks from net interest margin compression when it cut policy rates further after Brexit[4] by providing offsetting concessional funding.

[2] It is awkward to maintain both a price and quantity target though in practice the BoJ has managed to live with this.
[3] Harada for instance is a monetarist for whom increasing the money base is a key channel for raising inflation and inflation expectations.
[4] Bank of England (August 4, 2016), Monetary Policy Summary.

BoJ measures to support strengthening the foundations of economic growth

	Main rules	Special rules for equity investments and asset-based lending	Special rules for small-lot investments and loans	Special rules for the U.S. dollar lending arrangement
Time of establishment	June 2010	June 2011	March 2012	April 2012
Total amount of loans	10 trillion yen	0.5 trillion yen	0.5 trillion yen	24 billion U.S. dollars
Eligible investments and loans	Those with the size of 10 million yen or more	Equity investments and ABL with the size of 1 million yen or more	Those with the size of 1 million yen or more but less than 10 million yen	Those denominated in foreign currencies with the size equivalent to 100 thousand U.S. dollars or more
Loan rates	Fixed at 0.0 percent per annum for 4 years			6-month U.S. dollar LIBOR
Duration of loans	4 years (each year, counterparties have an option to make a prepayment)			1 year (the maximum overall duration of loans, including rollovers, is 4 years)

Source: BoJ

The BoJ already provides four year bank funding at an interest rate of zero under multiple subdivisions of its loan support program. The term of these loans could be increased further, quantities and collateral broadened, and — in principle at least — the concessional funding rate could be reduced below zero for some types of loans and / or types of banks, restoring a wider spread on these loans. Providing negative rate funding would be challenging because of public opposition to subsidies for banks, but there might be ways to finesse such opposition.[5] Finally, we believe the BoJ will support activities-based regulatory relief for regional and Shinkin banks, in particular in the area of commercial real estate development, where they are currently under severe restrictions that for instance prevent them from converting surplus branches into shops or office space that they can then lease to local firms. Such relief however would have to come from the FSA.

POSSIBILITY OF MITIGATING ACTIONS ON EQUITY MARKET DISTORTIONS — INCLUDING REORIENTATION OF ETF PURCHASES FURTHER TOWARDS BROADER TOPIX INDEX

Mitigating actions may also come on the equity market front where the BoJ purchases ETFs at a pace of about ¥6 trillion a year and market participants complain about distortive effects. The BoJ views its ETF purchases as a non-core element of its policy stance, initially put in place to lean against an elevated equity risk premium. Changes could come in one or both of two dimensions with somewhat different likely timelines. We see a high likelihood that the BoJ will signal at the July meeting that it will tweak its ETF purchase program to reorient ETF purchases towards more liquid and broader-based underlying markets favoring TOPIX[6] over the narrower Nikkei.

We also think it is possible though less likely that the central bank could also in July assert more discretion / flexibility over the monthly ETF purchase amount — potentially with an asymmetric option to buy less in a given month in the event that market and financial conditions appear appropriate. This larger change might be more likely to materialize as part of a larger package of mitigating actions following additional staff work reporting into the Policy Board in the fall. There

[5] For instance, negative rate funding could be provided for socially desirable loans; one could even imagine a broader scheme under which, rather than receive a direct negative rate loan, banks making loans could receive a credit against the negative interest rate on excess reserves that might be tradeable.
[6] Helpfully, banks are also better represented in TOPIX.

are two reasons why we think the central bank may be cautious about taking such a step near term. First, the central bank would need to consider the risk that US-China trade conflict could lead to a renewed spike in the equity risk premium, though this could be addressed by moving ETF purchases into more of a “put” role. Second, the BoJ is appropriately sensitive to the signaling effects that reducing (or asserting the option to reduce) ETF purchases could have on expectations around the potential evolution of its yield curve target under YCC so any such changes would need to be carefully coordinated.

ASSUMING MITIGANTS ONLY HELP AT THE MARGIN, THE JULY MEETING EFFECTIVELY STARTS THE COUNTDOWN CLOCK ON A RECALIBRATION OF THE YIELD CURVE — BUT BOJ POLICYMAKERS DIFFER SUBSTANTIALLY AS TO HOW FAST THIS CLOCK RUNS DOWN

While we think the concept of mitigants is an important one, we think that in the end these are unlikely to make a very large difference. Consequently we view the July reset for Kuroda’s second term as essentially starting the countdown clock running on the current yield curve calibration. In effect we are now approaching the horizon over which the curve will likely need to be modestly recalibrated for sustainability purposes even if there is little further progress on inflation. However, we think BoJ policymakers differ quite considerably as to how fast this countdown clock runs down with some of the view that costs will become binding even in the absence of any inflation progress in 1-2 years, and others assessing that costs will not become absolutely binding for as many as 5 years though the cost-benefit balance might tip long before then.

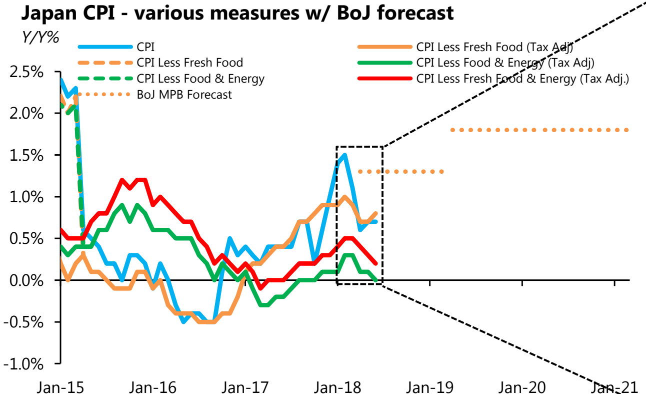
Note that we distinguish here between what the BoJ would try to present as a limited one-time recalibration for sustainability purposes that would involve a moderate steepening in the yield curve and the kind of ongoing hiking cycle that might take place upon substantial progress and ongoing progress on inflation. The latter would call for ongoing increases in the ten year target — or a steady pull-back in the tenor targeted by the BoJ under YCC — in order to keep real yields stable at a desired level. That still seems distant.

TIMING OF POTENTIAL RECALIBRATION IS NOT JUST DRIVEN BY COSTS — IT REFLECTS THE BALANCE OF THESE COSTS RELATIVE TO INFLATION PROGRESS, INFORMED BY CURRENT INFLATION DYNAMICS, FX MARKET CONDITIONS AND THE BROADER OUTLOOK / BALANCE OF RISKS

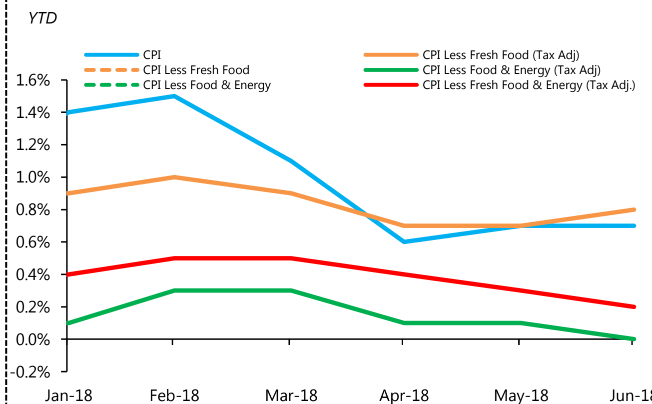
Even under a cost-benefit approach with costs that rise in time, the assessment of the cost-benefit balance and the point at which it may be appropriate to recalibrate the yield curve for sustainability purposes will be importantly influenced by economic and market conditions and the inflation outlook. We think it would be hard for the BoJ to take a step that might be read as a retreat from easing at a meeting right after a weak inflation print and at which its inflation projections come down hard. More broadly, we think the timing and extent of any recalibration of its policy settings will be driven by inflation dynamics, foreign exchange market conditions (because of the importance of the yen in driving imported inflation as well as the value of the equity market and companies’ willingness to raise base pay) and the broader economic outlook and balance of risks.

At present the strength of the dollar creates a favorable backdrop for policy adjustments — much more favorable than around the turn of the year when earlier hints of the debate about costs of easing and possible need to pare back accommodation contributed to yen strength that threatened to breach parity (¥100 to the dollar). However, in our view inflation dynamics are probably too weak — particularly after the June inflation print — and the economic outlook probably too uncertain with escalating US-China trade conflict that threatens Japan's exports of capital goods and high end components to China as well as its exports to other parts of the East Asia China supply chain for the BoJ to be comfortable making a material change today.

Japan CPI - various measures w/ BoJ forecast

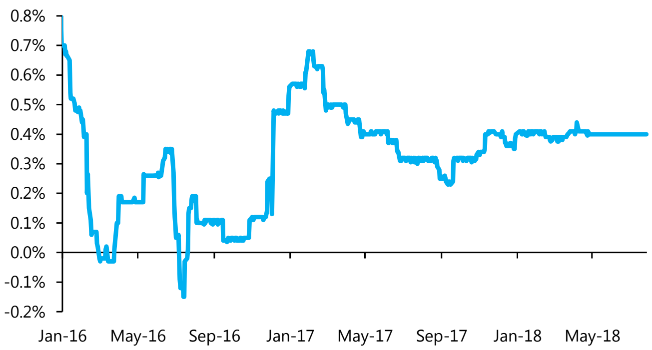


Source: Ministry of Internal Affairs and Communications, BoJ



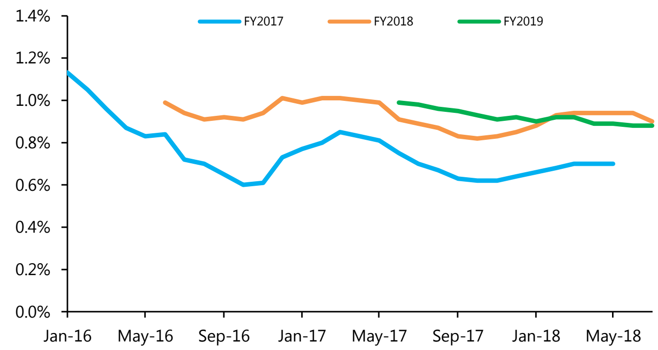
Source: Ministry of Internal Affairs and Communications

Japan 5y5y inflation swap



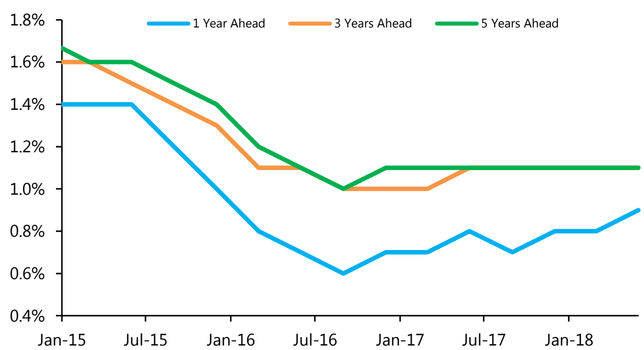
Source: Bloomberg, Evercore ISI

JCER ESP Forecast - prof. forecasters consensus expectations for CPI less fresh food *Annual average %*



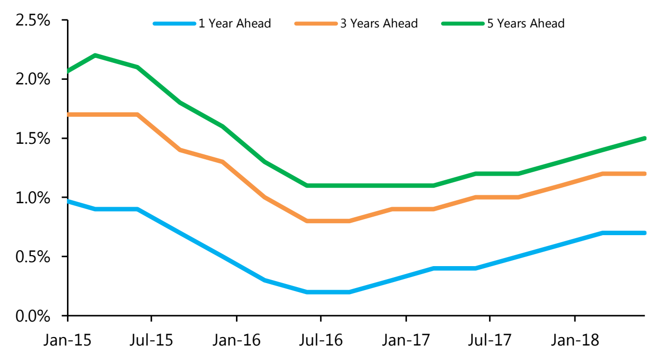
Source: JCER

***Tankan* survey - firms inflation expectations, general prices** *All enterprises, all industries*

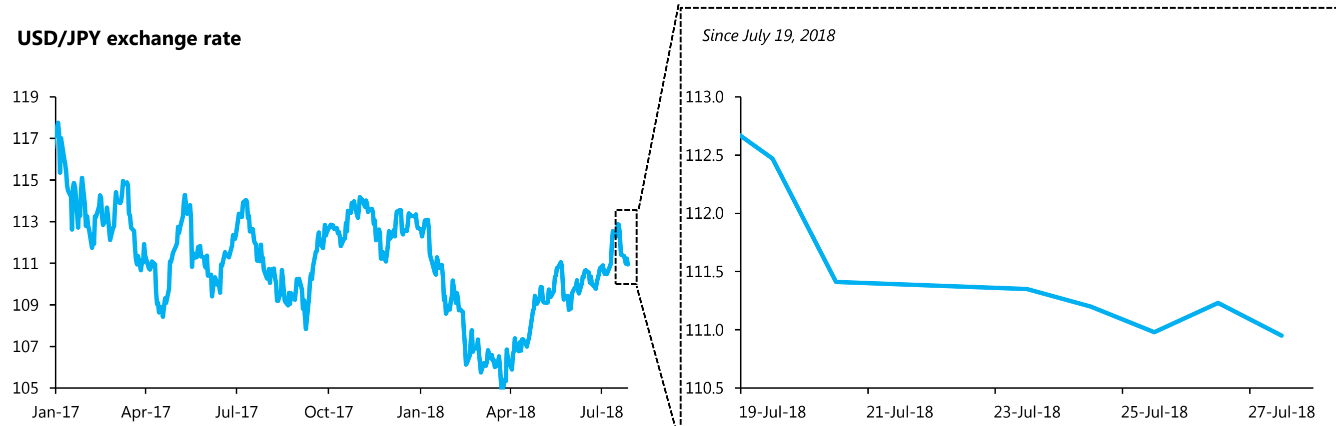


Source: BoJ

***Tankan* survey - firms inflation expectations, output prices** *All enterprises, all industries*

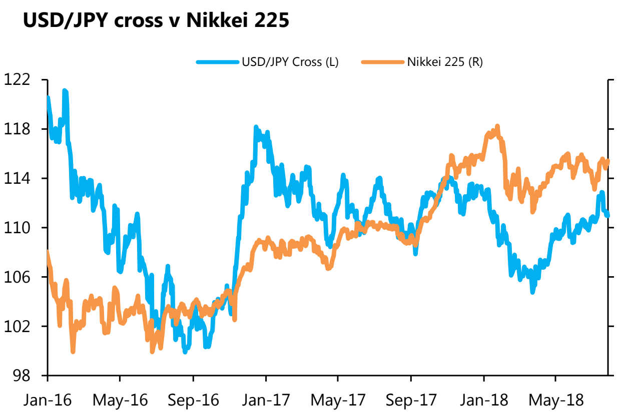


Source: BoJ



Source: Bloomberg

Source: Bloomberg



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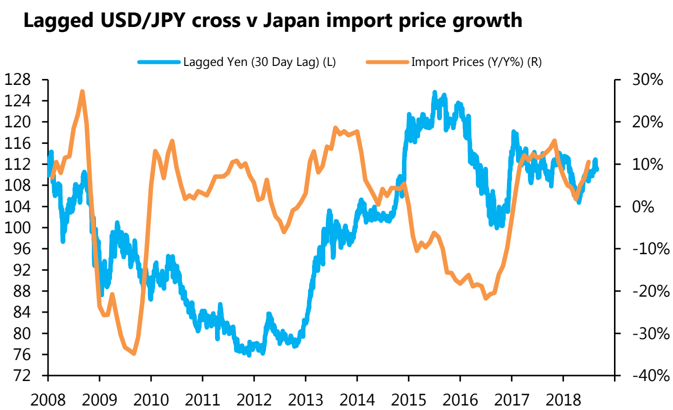


Source: Bloomberg, BoJ, Evercore ISI

BASE CASE JULY BOJ MEETING SETS THE DIRECTION OF TRAVEL WITH BIAS TO RECALIBRATE LATE THIS YEAR / EARLY NEXT, AFTER THE LDP ELECTION AND BEFORE THE CONSUMPTION TAX HIKE

In the baseline case we think the shifts underway at the July meeting will set a direction of travel and lay the foundation for a recalibration of the yield curve for sustainability purposes likely in the October to March period (September is possible and would have the benefit of preempting the US currency manipulation report but is right ahead of the LDP leadership election which is problematic at home so this seems feasible only if Abe is strongly favored to win and supports a preemptive move to ward off US pressure). Our best guess is that this would take place at the end of the year or early next, though this will depend on economic and market conditions. We think Kuroda personally will be wary of an earlier shift for fear that his and the BoJ's inflation-promoting credibility would be damaged by acting under current circumstances.

More broadly we see a twin peaks distribution — the BoJ will either recalibrate and move rates a bit higher / steeper in the October - March window noted above ahead of the planned consumption tax increase, or it will have to wait for a second window of opportunity in early 2020 after the economy has digested that tax hike. We previously viewed the second window as the more likely of the two though we viewed the two probability humps as fairly close; we now view the first as the more likely, though there remains a material chance the recalibration could be delayed to January 2020. The choice of which window to take is not set in stone and will reflect in part the economic outlook, inflation progress and balance of risks at the time: the weight on inflation has not gone from 1 to zero in the cost-benefit calculation.

BIG CHANGES AT THE JULY MEETING VERY UNLIKELY THOUGH WE CANNOT COMPLETELY RULE OUT A RIP-THE-BAND-AID DECISION

Consistent with this view, we are not expecting any major changes to actual core monetary policy settings in July. Within these options we would rank the likelihoods as follows:

- Low risk that the BoJ pulls back to target the five year yield rather than the ten
- Even lower risk that the BoJ increases the ten year yield target
- Still lower risk that the BoJ increases in the minus 10 bp overnight rate is even lower (because the BoJ believes that the slope of the yield curve rather than the level of rates is most important for the profitability of the stressed regional and Shinkin banks.)

But we cannot completely rule out a more decisive rip-the-band-aid outcome that involves one or more of the changes listed above. This is because a central bank that operates a yield cap today would presumably try to keep news of an increase in the target yield or retreat to a shorter tenor secret right until the moment at which it takes place in order to avoid having to buy very large quantities of bonds at the old capped rate. There are analogies here with the Swiss National Bank exit from its currency ceiling relative to the euro. However, our assessment is that the BoJ is not at present engaged in a highly disciplined Machiavellian operation to spring a surprise hike on the markets. If we are wrong, we would expect any early big move to be accompanied by forward guidance that would commit the BoJ to maintain the new policy settings for a period of time.

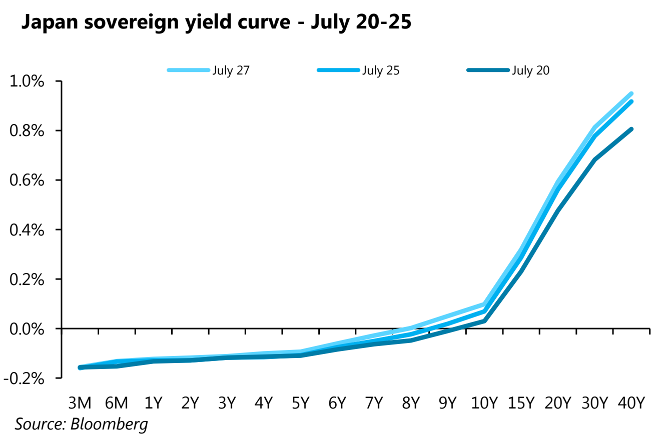
MATERIAL RISK OF A DE FACTO OR DE JURE WIDENING OF THE TOLERANCE ZONE WITH THE REMOVAL OF THE HARD CAP ON YIELDS AT +10 BP

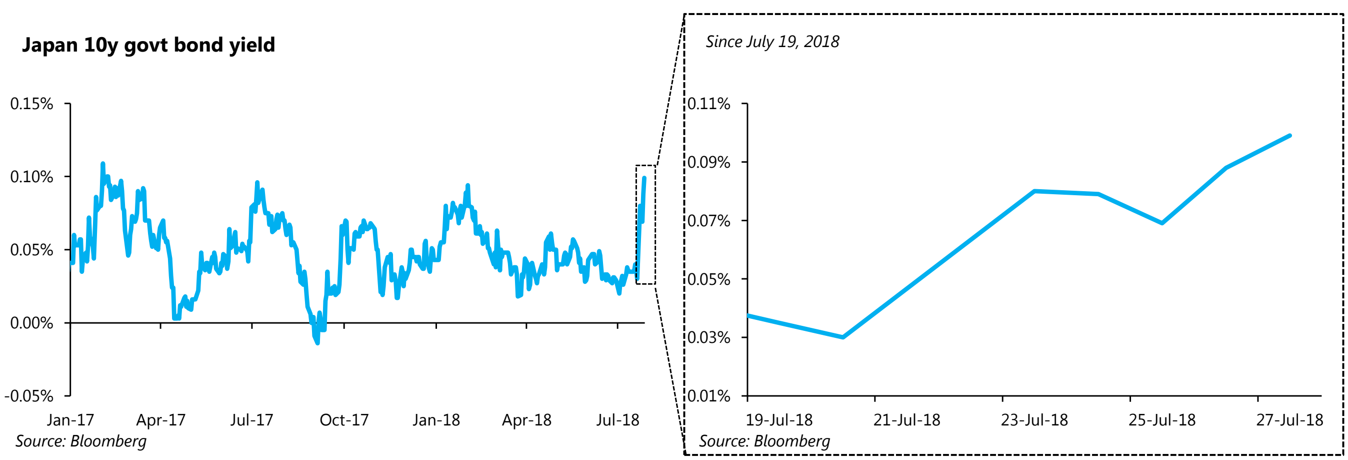
We think a much more likely outcome — not in our base case for the July meeting but in our view quite a close call — is that the BoJ will either formally or informally widen the tolerance zone around the zero yield target say to +/-20 bp. This would have the benefit of allowing market price formation within a wider range — promoting JGB market liquidity — and allowing the ten year yield on average to trade a bit higher than can be permitted under the current hard cap approach — providing a bit more relief to the troubled regional and Shinkin banks than could be achieved within the current zone. The BoJ could decide to seize the opportunity provided by the strong dollar that mitigates the risk of an excessive yen move and its leadership might even judge that widening the tolerance zone, allowing a bit more market price formation and accepting a bit of yen strength could help ward off the risk of being branded a currency manipulator by the Trump administration. Strangely, the monetarist BoJ doves might not be wholly opposed to this as a softer cap would make it easier to buy larger quantities of JGBs and meet the quantity / money base targets.

There are three ways the BoJ could signal a wider tolerance zone along a spectrum of formal to informal or de jure to de facto. The Policy Board could formally amend the directive in its policy statement that the markets group should conduct operations to keep the ten year yield “around zero per cent.” However, it may be disinclined to do so and could take the view that the current directive nowhere commits to a +/-10 bp tolerance zone and allows for sufficient flexibility. Alternatively, the BoJ could leave the formal directive alone and leave it to Kuroda to say in the press conference that the BoJ will soften the existing hard cap on yields in order to allow more market price formation and improve JGB market liquidity. Finally, there could be no official signal at all, but the pattern of market operations following the meeting could simply allow this to happen. The cost in all cases is that a widening in the tolerance zone would be read by many as a stealth tightening at a moment in which inflation dynamics and the balance of risks ought in principle to call for more easing — weakening the BoJ's inflation credibility over and above the mechanical effect of a somewhat higher yen on import prices.

SUBTLE SHIFT COULD BE CEMENTED EVEN WITHIN THE EXISTING RATE CALIBRATION WITH NO CHANGES TO POLICY OR TO THE TOLERANCE ZONE EVEN DE FACTO

In our base case in which there is no actual change to core policy settings at the July meeting we nonetheless see scope for the BoJ to maintain a slightly steeper yield curve than prevailed before the latest media speculation about a shift in policy thinking in July. Indeed we think the central bank would be very comfortable with ten year yields settling in the higher end of the existing +/- 10 bp tolerance zone around the zero yield target — perhaps averaging 5 bp or higher in the months ahead — and may operate its regular quantity purchases of JGBs in a manner that is consistent with this. This benefit to the banks in this interim phase would be small but not quite trivial: with a very slightly steeper curve net interest margins on loans would improve a little while the yield available on risk-free securities would also increase[7] (most tier two regional and Shinkin banks have low loan-to-deposit ratios in the 50-70 per cent range so yields on securities do matter[8]).





[7] These banks do not have to mark to market or hold capital against their JGB portfolios.
[8] In particular now that higher dollar funding costs associated with a flattening yield curve in the US and regulatory pressure from the FSA has led many of these banks to pull back from currency hedged investments in US Treasury bonds.

The BoJ might regard this as helping to pave the way for a later move. If JGB yields were to de facto average 5-10 bp over the next few months, a subsequent formal decision some months later to raise the target to say 10 bp and / or to widen the tolerance band to +/-20 bp might not be too disruptive. We also think the BoJ will be inclined to shape its purchases in a manner that allows the yield curve beyond ten years to sustain a steeper slope than prevailed before the latest speculation on policy shifts. This might well require the purchase pace to slip further behind the notional ¥80 trillion a year quantity target; we think the BoJ could live with that.

CHOICE BETWEEN TWO-STEP APPROACH VS AT LEAST WIDENING THE TOLERANCE ZONE UP FRONT INFORMED BY JUDGEMENT HOW FEASIBLE IT WILL BE TO MAINTAIN CONTROL OF MARKETS DURING ANY INTERIM PERIOD BETWEEN THE STRATEGIC ANALYSIS AND RECALIBRATION

A key consideration in whether to take at least some upfront step such as widening the tolerance zone around the zero ten year yield target at the July meeting or follow a two-step process in which the July meeting lays out the analytical foundations of a likely recalibration of the curve late in the year or early next is whether the BoJ judges that it would be feasible to maintain control of the yield curve during the period following the reframing of policy thinking in the cost-benefit spirit but before policy changes were actually made. In the abstract this would look to be a dangerous play. If investors in the JGB market became convinced that the BoJ would either raise the yield target or widen the band and guide yields above +10 bp within a few months the market could put intense pressure on the existing +10 bp cap. To defend it the BoJ might have to make repeated fixed rate full allotment offers — and at some point investors might actually tender very large quantities of bonds[9] swelling the BoJ balance sheet in the limit case to the point at which the central bank buckles and gives up defending the cap. This is why we think it is a close call as to whether the band could be widened at the July meeting.

However, it is also very possible that in the strange particular circumstances of the JGB market the BoJ may judge that the risk of coming under pressure following a decision to reframe the policy outlook but not actually change any aspect of its core monetary policy at this meeting is manageable, while an interim step such as widening the de facto band that might not be the final adjustment for now could also invite market pressure. The BoJ is a massively dominant player in the JGB market with scope to greatly increase the quantity of regular purchases if needed, and the overwhelming share of the remaining bonds are in the hands of domestic long term investors whose portfolio allocations — whether for regulatory or for preference reasons — are extremely sticky and price-insensitive. Consistent with this, take-up at the last fixed rate operation a few days ago was not particularly large in spite of heightened speculation of potential policy changes at the July meeting. Moreover, the prospect of a wider tolerance zone in the future would not be as destabilizing as the prospect of a higher target itself would be, as given Japan's stalled inflation, trade risks and the capacity of the BoJ to guide yields within any given zone through regular QE purchases, a wider zone could still be accompanied by flat or lower ten year yields in the future relative to today's 10 bp. This is why we think the BoJ may be willing to set out its logic in July but wait for more opportune economic conditions before it decides that the cost-benefit balance favors a limited recalibration of the curve.

[9] The central bank can fix prices or fix the quantities it buys but not both.

ASSET MARKET IMPLICATIONS, SPILLOVERS INTO GLOBAL MARKETS AND THE CONCEPT OF A SHADOW JGB YIELD TARGET / RANGE

The policy developments underway — including the search for ways to mitigate costs to the financial system — ultimately favor Japanese financials even if actual policy changes follow later. They similarly make it harder for the yen to depreciate a lot further, which given Trump's attention to FX may be viewed as a good thing by Japanese officials. Near term the risks to yields in Japan itself may still be skewed a bit to the upside, though much less so than when we published our initial report two Fridays back warning of a potential strategic shift in a less dovish direction at the July BoJ meeting (FLASH NOTE — WEIGHING THE RISK BOJ WIDENS ITS YIELD TARGET BAND). It is less clear though that risks to global yields going into this meeting are still clearly to the upside as was the case when we commented in that first report.

Mapping the implications of any given BoJ policy outcome in July for global bond yields is challenging for several reasons. The statistical evidence of the last half decade or so suggests a relatively weak coefficient between JGB yields and yields on other core risk-free bonds such as US Treasuries and German Bunds. This might be particularly the case if any tweak in the direction of a higher cap on yields was read as driven by cost considerations unique to Japan rather than a stronger economic outlook that might have a read-across globally. However, the past half-decade's statistical evidence includes few observations in which JGB yields were rising because of a policy shift by the BoJ (even at the margin) away from easing[10] and market developments in recent days underline the potential for large spillovers globally given the importance of Japanese investors in global bond markets and the even partial influence of arbitrage conditions relating Japanese yields to US and other yields adjusted for the cost of FX swaps.

We can observe that global yields increased materially more than JGB yields in the last ten days. A large component of that likely relates to easing tension over US-EU trade but by no means all — with yields rising early last week on BoJ speculation in spite of then heightened concern about US-EU trade. To date the coefficient looks to have been more than one to one. That makes sense as global yields can move further in anticipation of a potential BoJ policy move than JGB yields can as long as the BoJ enforces the +/-10 bp cap as it did last week. By the same token however global yields have likely already discounted more than we see in JGB yields and may not need to move very substantially and durably higher if even if there is a modest change in BoJ policy — for instance a widening of the tolerance zone / softening of the de facto cap — this week. A gentle upward bias however will remain, reflecting the BoJ's orientation towards a little less rather than a little more easing. Looking further afield, if the BoJ does continue to cap yields as the current +/-10 bp but policy communications continue to point to a likely recalibration of the target / target range for yields late this year or early next a gap may emerge between the actual JGB yield and a "shadow" JGB yield that may be expressed to some degree in swaps prices. Global yields may be as much influenced by the shadow yield as the actual yield.

[10] The introduction of YCC is one example

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