# Minutes of the Meeting of JGB Investors
# (89th Round)

• Date: Tuesday, October 25, 2022, 10:30 a.m. - 11:50 a.m.
• Place: Special Conference Room 3, Ministry of Finance
• Contents: JGB Issuance Plan for the second supplementary budget for FY2022

▶ The Financial Bureau gave the following explanation about the JGB Issuance Plan for the second supplementary budget of FY2022.

・According to the material, at the cabinet meeting held on September 30, the Prime Minister instructed that comprehensive economic measures be prepared by around the end of October, and the Cabinet is going to submit the second supplementary budget for FY2022 to the National Diet based on those contents.

・In response to this supplementary budget, we believe that it may be possible to maintain JGB Market Issuance (Calendar Base) by the government making internal adjustments to funds the same as with the first supplementary budget of FY2022.

・On the other hand, the scale of this supplementary budget and required government bond funding are unknown. Therefore, the possibility to increase JGB Market Issuance (Calendar Base) cannot be ruled out. Assuming this case, we would like to hear your opinions including about maturities where the size of issuance for JGBs can be increased along with the priority and reasons.

・Moreover, if it is decided that the JGB Market Issuance (Calendar Base) will increase, we are considering doing so in January 2023, and we believe it is necessary to keep in mind that the period until the end of the fiscal year is short. We would also like to hear your opinions on the timing for increasing the amount.

▶ Summarized below are the views and opinions from attendees:

・ Regarding the current capacity for purchasing JGBs, we still have ample deposits, and resources for purchasing JGBs, as evidenced by the fact that the ratio of loans to deposits has remained low throughout Japan. Basically, we purchase a fix amount from the perspective of ALM. However, it is difficult to purchase in the medium- to long-term zone, because they are highly suppressed by the yield curve control. In reality, we limit our purchases to a minimum, targeting the ultra-long-term zone.

・Regarding future purchasing in the medium- to long-term zone, assuming that the current yield curve control policy of the Bank of Japan (BOJ) will change, the demand for purchasing mainly in the medium- to long-term zone, which is basically a better match from an ALM perspective, will not change because the duration of deposits as liabilities is shorter.

・Therefore, if the monetary policy becomes normalized, we believe we will shift to make purchases mainly in the medium- to long-term zone, which includes, of course, 2-year bonds as well as 5-year bonds and 10-year bonds, in line with liabilities. It would be good to have a situation where it is possible to purchase considerable amounts of 5-year bonds and 10-year bonds similar to before negative interest rate policy was introduced.

・If monetary tightening occurs beyond the adjustment for monetary easing, first of all, the yield curve shape will change greatly once policy interest rates start to increase. Therefore, it will become difficult to decide to purchase JGBs, and we believe it will go back to being careful stance like now while continuing to purchase a fix amount of JGBs from the perspective of ALM. If only the yield curve control is lifted and negative interest rates are cancelled, the yield curve will continue to steepen. Therefore, we do not believe that we would be able to aggressively purchase. However, once the policy change is incorporated into the market to some extent, we believe there will be room for purchasing due to the balance with liabilities.

・We invested in foreign bonds with high yields and credit products for global diversified investment, and we have invested the small remaining portion in JGBs. If interest rates increase in the future, we believe we will have enough capacity for purchasing JGBs according to their increased attractiveness.

・We believe that we have enough capacity for purchasing JGBs with maturities of 10 years and less since they are a zone where purchase is possible according liabilities such as core deposits. However, the latest market trends have made it very difficult for us to buy aggressively, as we are carrying appraisal losses. We would like to respond to this situation by utilizing the held-to-maturity concept.

・The gap between deposits and loans has widened considerably due to negative interest rates since before the pandemic. As Outright Purchase of JGBs by the BOJ has progressed, currently, while the BOJ is holding about ¥500 trillion worth of JGBs, depositary financial institutions have sold bonds in response to the Outright Purchase of JGBs by the BOJ, and funds continue to remain in the BOJ Current Account. Therefore, the balance sheets of depositary financial institutions have expanded greatly, giving them much room for purchasing.

・However, because low return rate continued in Japan during that time, many investors made investments in foreign bonds, and since short-term interest rates increased more than 400bps in the US, investors are experiencing considerable latent losses. It will take time to dissolve such latent losses, and we believe that the purchasing capacity will not quickly recover.

・If negative interest rates policy is cancelled and interest rates are added in the future, the demand for medium-term zone centering on 2-year bonds and 5-year bonds will be very strong for depositary financial institutions. Since there is a restriction on how much interest rate risk can be held, if the environment allows for even some funds that are currently placed in the BOJ to be invested, there will be a greater demand to invest funds in the medium- to short-term zone instead of in longer zones.

・Although investors in Japan have little procurement costs for Yen, they invest in foreign bonds with dollar funding, which easily results in negative margin. Instead of interest rate level, we believe changes to the environment such as the procurement environment will help encourage a return from foreign bonds to domestic bonds.

・Demands have not been created for foreign investors because the BOJ keeps the interest rates for 2-,5-, and 10-Year Bonds low. Investors in Japan seem to mainly purchase issues that can be understood to be closer to the theoretical values where, basically, the yield curve has been steepened; that is, in the zones for 20 years and longer.

・As for the 20-year, 30-year, and 40-year zones, we honestly feel that liquidity has become quite thin.

・If the trading amount increases even slightly, offer bids will reduce considerably. We believe this is because the market is divided into the futures zone where interest rates are controlled by the BOJ, and ultra-long-term zone. As a result, the hedging function of futures has been reduced. Therefore, we believe that if the issuance amount for the ultra-long-term zone is increased, there is a risk that not enough responsive bids will be received at the time of auctions and results in a big tail.

・10-year bonds, 5-year bonds, and 2-year bonds are controlled by the BOJ and have a certain amount of liquidity. Therefore, it is not such an issue even when the issuance amount is increased by ¥100-200 billion per auction.

・We recognize that the current JGB market has been strongly influenced by the US bond market. Therefore, although we believe that the peak of Federal Funds rate hikes will be reached in the near future, we also recognize that there continues to be a high degree of uncertainty since it is not clear how much the economy needs to be slowed down in order to lower the US inflation rate to 2%, and not clear how much the Federal Funds rate needs to be raised for this.

・In Japan, while the BOJ's policy is to continue monetary easing, there is some movement related to Japan's unique characteristics and external factors such as preparation for incorporating policy revisions due to replacement of the BOJ's Governor and Deputy Governor.

・Regarding the outlook on the near future, there is much interest in whether the economy will go back to the disinflation seen prior to the pandemic after the pandemic ends, or inflation will continue. We believe that the discussion will come down to whether the Phillips curve has shifted upward or not, in regard to the inflation in the US, which is the origin of the current interest rate hikes.

・Recently, the economic outlook showed an unemployment rate of 4.4% corresponding to an inflation rate of 2.3% in 2024. However, if the Phillips curve is now shifting upward, further tightening will be necessary. We believe the reason why the Phillips curve seems to be shifting upward is related to excessive saving. If excessive saving can be dissolved to some degree, there would be a greater possibility of returning to the disinflation world prior to the pandemic. However, it is difficult to predict when this will happen.

・JGBs are positioned as one asset of a diversified investment, and when nominal yield and durations are considered, currently, investment is centered on 20-year bonds.

・However, trends with overseas interest rates, especially in the US, currently have a strong impact on the trend in JGB market, and we recognize that volatility is very high and it is extremely difficult to participate in the market. Therefore, we request the debt management office not to increase the issuance amount in the ultra-long-term zone and increase the issuance amount of bonds with the maturity of 10-years and less, especially in the 10-year zone, which is strongly supported by the yield curve control.

・The inflation trend in Japan goes without saying, and we expect trends with overseas interest rates to have a strong impact on the market. In particular, while the US continues to raise interest rates, we believe that inflation in the US and employment trends will continue to lead to repeated interest rate level adjustments in the level of the medium- to long-term zone, including revision to the outlook for the terminal rates for the US policy interest rates.

・Bond investors are still facing a difficult situation. However, compared to government bonds in other countries such as the US and Europe, JGBs seem to have continuous purchase support from the BOJ, and we believe that volatility is relatively low.

・In that sense, we believe that JGBs are assets that are easy to invest in, so we will carefully consider investment based on the market environment. However, yen-based balance sheets are expanding as a result of the current yen depreciation. In other words, there is an increasing demand for foreign currency funds necessary for investing in foreign currency assets and for yen funds for use in the exchange market. Also, as yen depreciation progresses, more yen will be needed for this even when no new investment is made. Therefore, we cannot say there is much capacity for purchasing JGBs.

・We continue to focus primarily on ALM-based investment management. In terms of investments against long liabilities, we continue to have investment demands for the ultra-long-term zone. Demand for insurance tends to change according to the interest rate, and we believe that the current level of premium income will continue for a while regardless of the situation with interest rates. Since interest rates have risen recently, we continue to purchase a certain amount of bonds in the ultra-long-term zone. However, our debt costs are higher than yen interest rate and we are still unable to secure an expected interest rates by yen interest rates only. We continue to invest in various overseas assets. We make investments based on the relative attractiveness of other overseas assets as we compare market outlooks. Although there is capability to invest in the ultra-long-term zone, due to recent fluctuations with interest rates, as investors, we want you to be cautious since the current market environment may respond negatively to hearing about increased JGB issuance.

・Regarding investment in foreign bonds, there are different ways to invest including open, short-term hedge rolling, and long-term yen-denominated investment. We use these according to the market outlook. In particular, for foreign corporate bonds, it is currently possible to earn higher yields by investing in assets that convert foreign corporate bonds to yen interest than in yen interest rates. We determine the investment amount in JGBs by comparing these.

・Over the past year or two, there has been a significant increase in the holding ratio of JGBs with securities portfolios. However, this does not mean that JGBs were purchased aggressively. Rather, these were simply purchased as a result. One reason is that the amount of loan did not increase while deposits increased considerably, which indicates there is a need to invest excess cash. On the other hand, JGB holdings were increased since there should not be a large amount in the BOJ Current Account. As a result, we have been purchasing in the medium- to long-term zone where there is positive yield. The second reason is that we had significant latent losses with foreign bonds due to overseas interest rate hikes, and we needed to dispose of some of these, and we chose JGB in the medium-term zone, etc., as an alternative investment for the disposal of foreign bonds. Furthermore, the third reason is that volatility has increased considerably. Balance has not increased while market risk has increased considerably. Therefore we cannot currently make purchases in the ultra-long-term zone.

・We regularly purchase a certain amount of Local Government Bonds. Primarily, we believe that regional bank portfolios are buy-and-hold types for ensuring stable profit. Currently, foreign bond yields are inverted and absolute yields from JGBs are insufficient. Therefore, we are increasing flexible trading in the foreign bonds and JGB market. Right now, it is difficult to buy and sell Local Government Bonds in a flexible manner. Therefore, from a liquidity perspective, JGBs are preferred. If we purchase Local Government Bonds instead of JGBs, we believe we will hold them in the portfolio, and depending on the situation, we may need to buy-and-hold.

・We hold JGBs because these are positioned as having high liquidity and are easy to sell when necessary. Since natural disasters occur often recently, profitability from fire insurance, which is a core product, has not improved. We are currently making efforts to improve profitability such as by raising prices, and we believe we will be able to generate funds. On the other hand, we are proceeding with shortening contract terms. In the past, we could purchase JGBs with long remaining maturities to match debt with a duration of 30 years. However, since contracts are being shortened, we expect to purchase JGB in the 5-year to 10-year zones.

・Compared to the past, profitability with automobile insurance is stable and we are able to achieve a certain level of profit. We use such income for international diversification of investment including investments for overseas public and corporate bonds instead of JGBs, as well as alternative investments. We predict that if yen interest rates normalize, it is conceivable that a certain amount of funds will be returned to the domestic market.

・Investment demand for surplus funds will always exist based on excess deposits. We also have collateral demands, and we continue to purchase a certain amount of JGBs. From the ALM perspective, the medium- to long-term zones are supposed to be the main investment target. However, since investment in these zones is difficult due to the current interest rate situation, etc., we have been making some investments in the 20-year zone. In the future, when negative interest rates are lifted, we believe that the investment stance will go back to centering on the medium- to long-term zones from the ALM perspective.

・Since, we have ultra-long-term liabilities related to insurance, we regularly need to reduce the duration risk and invest the newly earned cash flow. That is why we purchase 30-year bonds and 40-year bonds every year. The trend with contracts is stable. Also, as durations become shorter, we have a demand for new assets to match those ultra-long-term liabilities with durations of 40 years or more that have not been matched with assets. Therefore, we believe there is a stable demand for the ultra-long-term zone. Although the funding is based on long-term liabilities in yen, we have been investing abroad, because the low interest rates have continued up to now. However, due to increasing hedge costs and other factors, we have shifted our weight to domestic investments. Regarding yield curve movement, it seems that the ultra-long-term zone has started to increase first due to monetary tightening, etc., and we believe that it will gradually become a bear flattener when the yield curve control is cancelled. If the interest rate increases and we can get the yield levels that we need, we believe that it is possible for us to buy JGBs in the short- to medium-term zones in addition to continued purchases in the ultra-long-term zone.

・First of all, it seems that recently, many investors in the same business are worried about expanding interest rate risk based on the possibility of revisions to the yield curve control after the next fiscal year. In addition, many are saying that they are hesitating to take risks with interest rates due to increased risk related to higher interest rate volatility. While some of them invest with prudent timing decisions, most investors seem not to be actively taking interest rate risk. As for immediate investment prospects, we will avoid purchasing overpriced bonds and will purchase a limited number of bonds in the ultra-long-term zone with higher yields when interest rate rise at an accelerated pace like now by considering the possibility of revisions to the yield curve control in the next fiscal year. As for capacity to increase the issuance of JGBs, we feel it would be easier to purchase in the 2-year and 5-year zones where yield has become positive based on the perspective of duration for liability.

・Currently, there is high volatility. The decrease in liquidity and latent losses due to interest rate hikes makes domestic investors to lose their ability to take risks.
・If we want to hedge 10-year and longer assets, we have to sell other 10 year and longer assets to do so. Since the interest rate on the 10-year on-the-run issue does not change, it is not a hedge tool, and our hedging options are becoming limited. In zones of 10 years and less as well, the adjudicatory function for futures was lost in the middle of June, and since then, participants in basis trading have decreased. At the end of last week, Implied Repo Rate (IRR) nearly reached -4% again because of decreased liquidity and lowered ability to take risk, which has not been seen in recently years.
・We are considering examining risk-restricted investment in zones longer than 10 years. Since futures are obviously skewed, we want to pursue relative value in zones of 10 years and less.
・Futures are exchanged for physical bonds by actual receipt and actual delivery on the final day of trading. For example, Futures December contract will be replaced by the 357th issue on December 20, and if the current BOJ policy continues, the BOJ will purchase 357th issued bonds at 0.25%. Therefore, there is no doubt that it will converge toward by that time. Generally, if future delivery yield is 0.25% or higher, some people will make outright purchase, which prevents large selling and prevents the IRR expanding. However, this is not possible in the current situation, which indicates that market participants have lost their ability to take risks.
・Basis fluctuations will stabilize as we get closer to the time until contract month rollover. In November, we believe the adjudicatory function of futures will recover as a calendar spread market is established and people start to think more about contract month rollover. However, after contract month rollover, there will be at least three months until the next final trading day of futures. Therefore, if liquidity is reduced at the end of the year, we feel the situation may be even worse than in June.

・Regarding excess buying power in the medium- to long-term zone, over the last 10 years, there has been an outflow of cash.
・There are few opportunities to purchase new JGBs. From the perspective of relative valuation, significant premiums have become required for the ultra-long-term, 15-year, 20-year, and 30-year zones. Viewed globally, finance premiums and premiums for volatility are required. Therefore, our investment stance is that we carefully make purchases in the ultra-long-term zone when we see an opportunity.

・As for our response to when the monetary policy is normalized by the BOJ, etc., in the future, it is principally the same because the policy asset mix has been determined. Basically, we will gradually make investments in undervalued zones. However, since there is a cash outflow, instead of purchasing, we may sell according to the situation such as when interest rates drop.

・Based on the situation with the current market, we will continue investing in yen interest assets in the ultra-long-term zone. Among these, ultra-long-term JGBs will become the main portfolio. Over half of our investment portfolio is in JGBs, and we have purchased JGBs in longer zones for many years, and it has become the core of our investment portfolio.
・Insurance contracts are liabilities with a long duration, and long-term investment demands continue to exist. In particular, in over 10-years zone, we have established a portfolio centered on JGBs.
・Recently, since payment of insurance claims such as for COVID-19 have increased, we will continue to invest in a mixture of long and short term assets to ensure a certain amount of liquidity.
・In addition to JGBs, we have diversified asset management using foreign bonds, corporate bonds, stocks, and alternatives, etc., for the remaining half. As a result of increased hedging costs, we have sold some foreign bonds and transferred them to new ones.
・Since there is high volatility in the current market, market participants have become cautious. Therefore, if the debt management office increases the issuance because of this supplemental budget, from the perspectives of liquidity and stable procurement, we believe it should be increased in zones with shorter maturities such as 2-year, 5-year, and 10-year where a certain liquidity can be ensured.

・When reviewing the dizzying FOMC dot chart changes over the past nearly six months, the peak policy interest rate was 2.75% at the March FOMC and 4.875% at the September FOMC. Also, the Longer-Run neutral rate increased from 2.375% to 2.5% in the September FOMC. Furthermore, regarding recent market trends, the peak policy interest rate seen in OIS futures was a little over 5% last week, and BEI for the 5-year, 5-year forward rate was 2.4%, which was almost the same as six months ago. The policy interest rate seems to be rising three times faster than before, for responding to current price increases, and it can be viewed as being raised to stabilize long-term inflationary expectations or to incorporate the stabilized expectations into the market.
・As for the dollar-yen situation, the dollar quickly became strong, 10-year bonds stayed at the Fixed-Rate Purchase Operation level, and days without trading have increased. We are very concerned about JGB liquidity. When we look at the interest rates for each maturity for one-month OIS, the peak will be around 5% next May. Based on this, we believe that interest rates will continue to increase three times faster until the end of the year.
・According to the policy assessment by the BOJ last March, the impact from the yield curve control interest rate cuts was around 1%. Therefore, if the monetary policy of the BOJ changes, overseas

investors who expect yen appreciation will purchase JGBs, resulting in a strong yen, and we can foresee this suppressing a major increase with long-term interest rates.

・We believe that the resignation of the British Prime Minister Truss was the result of an evaluation made calmly by the market for her trying to achieve her promise including the growth strategy based on tax cuts and measures for dealing with the drastic rise in energy costs in the midst of soaring prices and trade deficit. Up to here, the Fiscal risks and sustainability report by the Office for Budget Responsibility on July 7th stated that if the status quo continues, the ratio of outstanding Public Debt to GDP in the UK would reach 320% in 50 years. To return to the pre-pandemic ratio of 75%, taxes would have to be raised or expenditures would have to be cut by 1.5% of the GDP every 10 years. In addition, in the US, Biden's expenditure plan for 2021 was reduced by half, and became the "Build back better" bill. Expenditures were scaled back on August 16th of this year and were established as the "Inflation Reduction Act of 2022". These movements showed the major contrast between the US and UK. In the UK, Prime Minister Truss introduced her growth strategy on September 23, the day after policy interest rates were raised, which lead to a triple sell-off that attracted much attention. Around the time the Inflation Reduction Act was established in the US, raising of policy interest rates in the UK lead to long-term interest rate hikes and a weakening of the pound, which was a similar situation to a developing country.

・On July 29th, Economic and Fiscal Projections for Medium to Long Term Analysis were announced by Japanese Government. The goal is to achieve a primary balance surplus by FY2025. However, when this estimate is compared to estimates made four years ago when the goal was established, the deficit with the 2025 balance was reduced. This is because the economic climate worsened after October 2018, and even after the pandemic started, tax revenue has remained higher than expected four years earlier, and expenditures have been in line with estimates in the initial budget. If expenditures remain in line with estimates and obligations for ensuring financial resources are fulfilled for supplementary budgets and new financial resource demands, it will be possible for the primary balance to become positive by 2025. If large-scale economic measures and a secondary supplementary budget are implemented with the terms "Price policy" and "Growth strategy," we would be making the same mistake as the UK. Therefore, we believe it is necessary to implement fiscal soundness.

・As far as room for increasing the issuance, if the yield curve control continues for the next few months, medium- to long-term zones up to 10 years are an attractive candidate since they have liquidity and are eventually sold. However, the extent of the burden that inflation, i.e., decreased cash value, has on people in general if salaries do not increase must be considered. The Corporate Goods Price Index, which is the leading price index, has increased considerably, and the CPI cannot be viewed optimistically. Therefore, there needs to be a careful discussion about how much of a burden is being placed on each individual. Wealthy people can choose where to invest and can hire investment advisors, a low-income individuals can receive aid by means of cash and benefits. However, the middle class, who need to have cash assets, will be left behind. In this case, the middle class will face even more financial difficulties, which makes it necessary to carefully consider how people in general will be affected if the yield curve control continues.

・Interest rates for US Series I savings bonds (I bonds) are linked to the CPI every six month (interest rate as of October 2022 was 9.62%), and the government provides a way for protecting the value of cash owned by the middle class such as by providing certain favored taxation when expenses are paid for education. We believe there is high risk of making full investment in child education funds, down-payments for housing, and retirement savings. Therefore, it is important to have a solid discussion on whether to consider the middle class who must have cash, while not being in a high-inflation status like the US and Europe.

・The interest rate situation will change when the yield curve control ends. Therefore, to prevent major confusion, people need to immediately be informed that each individual should conduct a stress test by carefully considering the risk of fixed rates and floating rates for housing loans, etc.

・The situation in the UK also shows the need to maintain fiscal discipline in order to gain market confidence. Regarding Reconstruction Bonds for the Great East Japan Earthquake, it was explained to the market that redemption financial resources for the medium to long term were ensured in the form of Special Taxes for Reconstruction. Learning from what happened in the UK, we need to maintain firm fiscal discipline in regards to increasing government bonds for the supplementary budget this time and increasing government bonds in response to the pandemic that was done up to now, and we need to show the outlook for fiscal soundness in the medium to long term, and financial sustainability. We should learn from the situation in the UK. If we face a similar situation, each person in Japan will be greatly affected.

・Personally, I believe that a net carbon tax would be the best way to reduce the strain on portfolios. I thought that Inflation-Indexed Bonds were a great idea. However, since these can also be purchased by those of high income, it is necessary to consider implementing this via income transfer.

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