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UOB Investment Insights

Thinking Ahead

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Fed nearing the end of rate hike cycle, BOJ slowly dismantling yield curve control

At the 1 November 2023 policy meeting, the US Federal Reserve (Fed) kept interest rates unchanged with the possibility of another hike if required. The Fed also suggested that the rate hike cycle is nearing the end. The day before, the Bank of Japan (BOJ) took another gradual step towards dismantling its yield curve control (YCC) policy. While bond markets have been volatile, this is an opportunity to lock in higher yields as most central banks are near the end of their rate hike cycles.

Takeaways from Federal Open Market Committee (FOMC) meeting

Fed kept options open, but suggested rate hike cycle nearing the end

- At the latest policy meeting, the Fed held interest rates unchanged at 5.25% - 5.50%.
- The Fed again mentioned that another rate hike may be required, and Fed Chair Jerome Powell said he is not yet confident that interest rates are sufficiently high to slow inflation down to the 2% target.
- That said, the Fed suggested the rate hike cycle is near the end.
  - Financial conditions have "tightened significantly" in recent months partly due to higher long-term bond yields, and this reduces the need to hike rates further.
  - The central bank is moving "carefully" as "tighter financial and credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation" and the full effects of prior rate hikes are yet to be felt.
  - Fed Chair Powell also downplayed the September dot plot that showed Fed officials are expecting one final 25 basis point (bps) rate hike, saying that is not a plan the Fed has to necessarily carry out and the usefulness of the projection decreases over time.

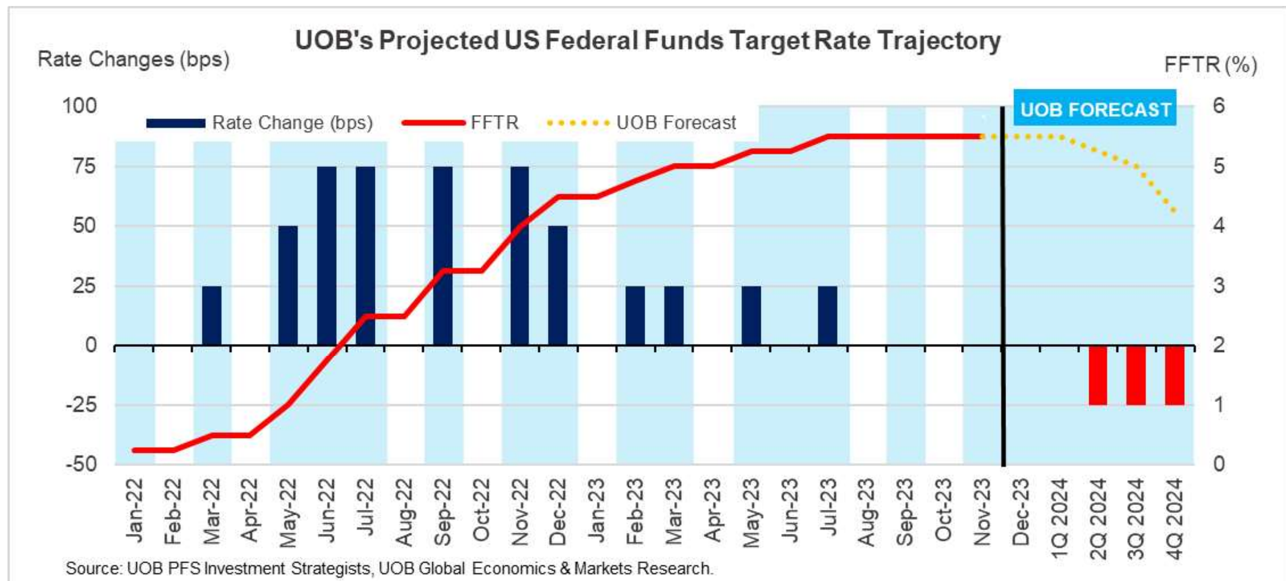
Factors that determine how much longer interest rates must stay high

- Though the Fed is close to the end of this rate hike cycle, interest rates are still expected to stay higher for longer.
- How much longer must interest rates stay high?
- Keep an eye on inflation, employment, and consumer spending trends, and whether current financial conditions lead to a sharper economic slowdown.
- If both the US jobs market and economic growth remain strong, higher inflation would mean higher interest rates for a longer period of time.
- If there are fewer jobs available and subsequently lower consumption, the Fed would be able to focus less on bringing inflation down and more on supporting economic growth.

UOB House View:

- We no longer expect a final 25bps rate hike this year.
- Instead, we expect the Fed to keep interest rates unchanged at 5.25% - 5.50% until the middle of 2024.

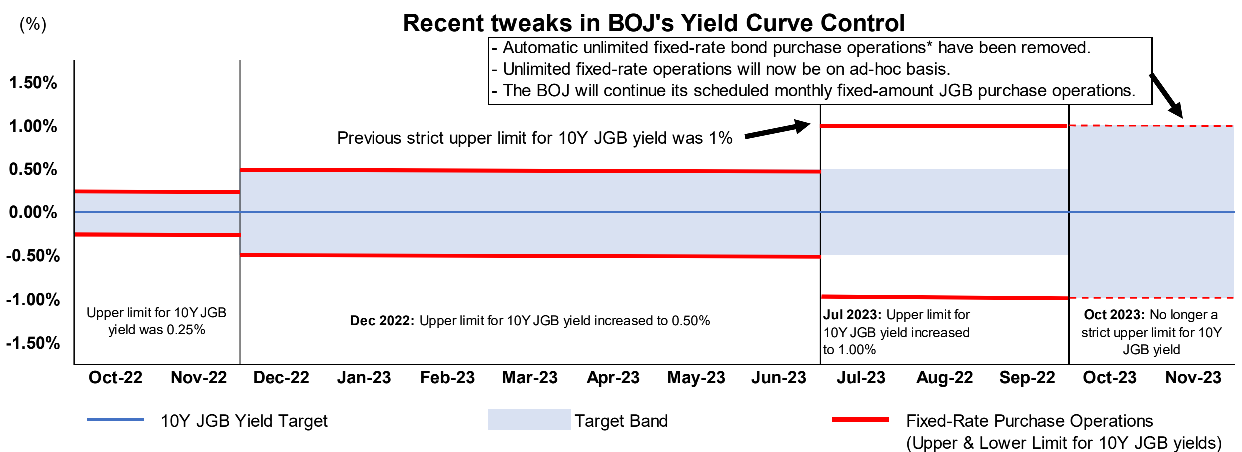
- Thereafter, we expect three separate 25bps rate cuts in June 2024, 3Q 2024 and 4Q 2024.



BOJ on a gradual path towards a change in policy

Another small step towards removing yield curve control (YCC)[1] policy

- The BOJ kept short-term interest rates unchanged at -0.10% and the 10Y Japanese government bond (JGB) yield target at "around 0%".
- The central bank also made no change to its outlook and stated that they would not hesitate to cut rates if required.
- However, it will now be more flexible with yield curve control "so that long-term interest rates will be formed smoothly in financial markets in response to future developments".



[1] Yield curve control policy aims to keep interest rates low to spur economic growth and ensure sustainable 2% inflation, by buying bonds to control 10Y Japanese government bond (JGB) yields.

1% is no longer a strict upper limit for 10Y JGB yields

- The BOJ mentioned that 1% is now a "reference" level for the upper limit of 10Y JGB yields rather than a strict cap.
- In addition, it removed its previous pledge to buy an unlimited amount of fixed-rate bonds whenever 10Y JGB yields rose above 1%, citing potentially large side effects to the economy.
- Instead, the BOJ will conduct yield curve control policy by buying a fixed amount of JGB monthly as well as via ad-hoc fixed-rate purchases.
- What this means is that the BOJ may now allow 10Y JGB yields to rise above 1% if this reflects economic fundamentals or if yields rise from the broader bond market.
- How high will the BOJ allow 10Y yields to climb? We will need to wait and see at what yield level the central bank steps in to intervene in JGB markets.

Third step towards abolishing YCC, policy changes expected early 2024

- This latest change in YCC policy is the BOJ's third step since December 2022 towards eventually abolishing YCC, and is one way to relieve pressure on the policy framework since bond yields have been rising globally.
- While YCC policy removal can only be gradual, it is inevitable that the BOJ would have to let yields rise given that inflation is now well above 2%, and the Japanese Yen (JPY) is depreciating sharply as well.
- UOB holds the view that recent YCC tweaks are adjustments to prepare markets for an eventual change in policy.
    - From here, we expect Japan's negative interest rate policy to be scrapped in January 2024 and the YCC framework to be fully abolished in March 2024.
- Should that happen next year, global financial markets could be impacted if Japanese investors sell foreign bonds to buy Japanese bonds as JPY rebounds.

What you can do

- Central bank action could lead to bouts of volatility in both global stock and bond markets in the near term.
- There is however a limit to how high bond yields can rise as global inflation is expected to continue to come down in 2024, and central banks are near the end of their rate hike cycles.
- This represents an opportunity for you to lock in higher yields via bond funds and investment grade (IG) bonds as economic conditions are expected to turn in favour of bonds in 2024.
- Build a defensive and diversified portfolio that can withstand sudden selldowns in any one asset class or sector. Multi-asset strategies can help you lower portfolio volatility and capture a broad range of opportunities at the same time.
- If you are able and willing to take risk, take advantage of market corrections to accumulate quality global stocks for the medium to long term. Our global healthcare Top Idea currently offers both defensive characteristics and growth opportunities.
- Speak to a UOB Advisor on how to position your portfolio according to your risk appetite and goals.

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