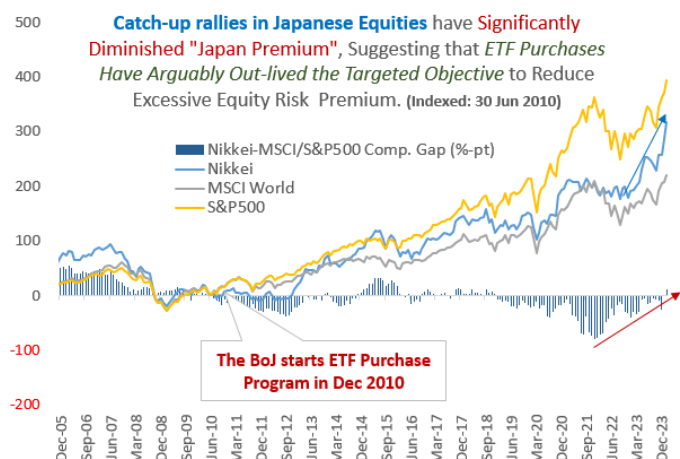
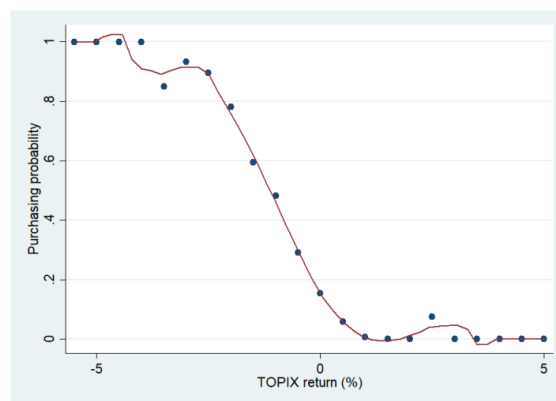


## Mid-Judging the BoJ's ETF Risks



Sources: Bloomberg, Mizuho Bank

Figure 1: Probability of ETF Purchases under the Program



Source: BIS

### 1. Not a Policy Turn Response

- If speculative whispers of **ETF purchase termination** comes to pass, it is **critical to recognize this is not a (hawkish) policy turn**.
- For one, catch-up rallies in Japanese equities have **dramatically diminished** the so-called **"Japan premium"** in equities.
- Arguably then, the **ETF purchase program has out-lived their policy purpose**, and need not consume balance sheet capacity. In particular, as ETF purchases was **never intended as a permanent feature** to eradicate "Japan premium".
- But merely a temporary mechanism to mitigate a self-reinforcing adverse spiral whilst conditions recover for a self-sustaining market backstop.
- Second, the **wider umbrella of QQE policy is still expansionary**. *Unwaveringly so*, as bond purchases as expected to persist.
- In concert, this ought to solidify the notion that **cessation of ETF purchase is not a departure from policy accommodation**. Instead, it **merely reflects a cost-sensitive reallocation, not retrenchment, of balance sheet capacity**.

\* short hand reference for the enduring relative global under-performance of Japanese equities

### 2. Nor (Necessarily) a Valuation Risk

- What's more, **unlike the case with JGB purchases, terminating ETF purchases need not jeopardize Japanese equity valuations**.
- Primarily because **ETF purchases have predominantly been in response to episodes of significant market sell-off**. In other words, ETF purchases have effectively been operated as a **counter-cyclical and temporary backstop**,

- And *not committed and continued buying that guarantees a sustained valuation lift that departs from underlying pricing forces.*
- Upshot being, the **first order effect of ETF purchases being terminated is not necessarily a valuation risk**. By extension, this underscores that it will **not amount to wider financial tightening** (that is set off by slipping equities) either.

### 3. But Instead a Volatility Threat

- *Nonetheless, revocation of ETF purchases*, even if fully compensated for by bond purchases, **can still upend risk appetite.**
- **But by blowing up volatility** rather than undermining value.
- Put simply, the **real threat is not that the BoJ is no longer a buyer but rather that the BoJ is no longer the dependable back-up buyer in bad times.**
- To be precise, the threat is derived from depriving markets of *an effective dampener of downside volatility*, which has been the *defacto function of ETF purchases*
- Notably, the recent surge in Japanese equities only accentuates the conspicuous absence of **asymmetric (downside) volatility dampening from ETF purchases.**
- Especially as the *"risk-reward" calculus will now turn more sobering without the inferred floor from the BoJ.*
- It is worth noting that the BoJ could actually deem such a dial-back in excessive risk-taking and attendant check on potential frothiness as desirable financial stabilizer.
- The knee-jerk is to proclaim that the volatility threat might walk and talk like a valuation dent initially; denting Japanese equities.
- But not just that. The volatility re-calibration (higher) will ripple further into wider asset market correlations, FX and options impact.
- At the most basic, arguably simplistic, levels the three distinct, and unintended, outcomes from this may be:
  - i) *diminished allure of Japanese equities as a hedge for global equity market pullback*
  - ii) *attendant JPY volatility*  
(mainly upside given typically, although not exclusively, negative Nikkei-JPY correlations)
  - iii) *pricier options for Japanese equities/assets* due to increased volatility

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