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Private Bankers

Flash note
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Japan - Is it possible to stabilize the Yen without damaging the equity market?

The Japanese equity market is by far the best-performing market in 2023 with a +23.8% appreciation for the Nikkei 225, placing it well above the 15% in the Vietnamese VN, 13% in the S&P, +9% in the Indian Sensex, 6.7% in the Euro Stoxx, and of course, the -3.6% of the Chinese Shenzhen.

Nonetheless, the Japanese market remains the subject of numerous inquiries and uncertainties. These queries necessitate thorough responses. To this end, I have taken the initiative to address the array of questions posed by you, and to the best of my capacity, furnish comprehensive answers that facilitate informed decision-making regarding this market.

Kindly be reminded that in our discretionary mandates, a decision was made in 2022 to allocate a portion of our portfolios to this market. We continue to uphold this exposure in Japan, constituting 6% of the overall equity investments.

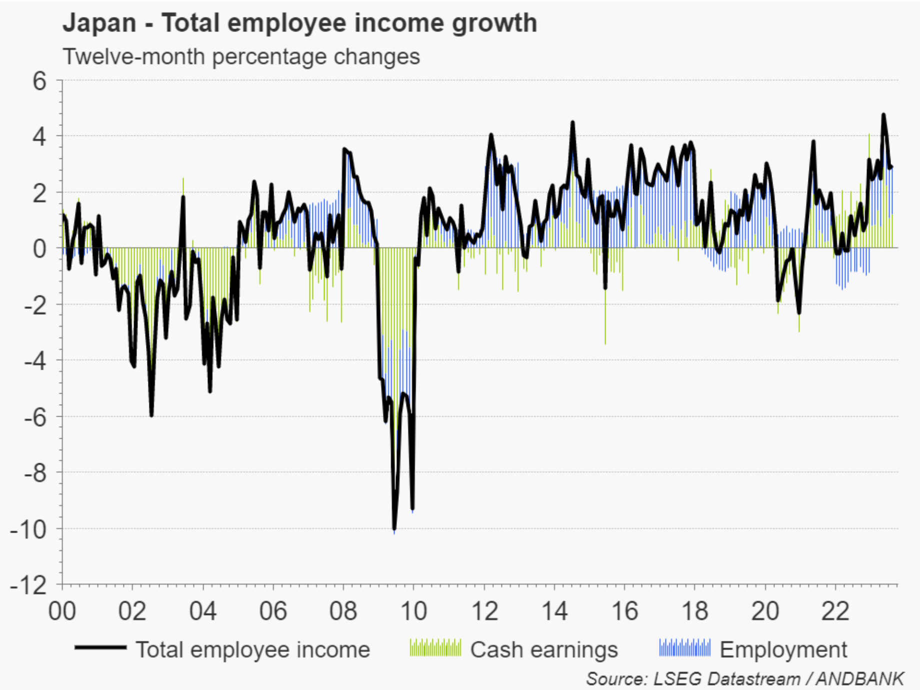
Now, let us address all of these questions and provide our responses.

BOJ decoupling: Tough times to be a central banker in Japan?

Before abandoning its ZIRP policy, Governor Kazuo Ueda insists that the Bank of Japan needs clear evidence of the right sort of inflation—demand-led inflation—before it scales back its monetary easing. The problem of a BoJ retaining its ultra-easy stance while the rest of central banks elsewhere are tightening is a depreciation of the JPY, which in turn leads to inflation of the wrong sort —imported inflation —, making the BoJ's policy goal even less attainable, as well as creates new imbalances. For example, Japan's Finance Ministry is criticizing the BoJ's policy because it says such a depreciated currency forces it to bear the fiscal burden of energy subsidies (to offset the effects of imported fuel cost inflation). The Minister of Finance wants the Bank of Japan to change course and reverse the weakness of the yen, generating a disinflationary effect on energy and a reduced need for subsidies.

Caught between a rock and a hard place, what next for the BoJ's monetary policy and the JPY?

The BoJ seems to be caught between a rock and a hard place, and instead of going out there, several reasons make us think that it could decide to stay there for a while. 1) Japan wants the Federal Reserve to do the heavy lifting for it, by sufficiently cool the North American economy and give rise to a sort global deflationary trend. 2) Having missed their inflation targets in the last 4 decades, the BoJ has been remarkably innovative over the years anchoring monetary policy to the nominal yield on the 10-year JGB (suppressing long-term rates) as the only way to ger out of its deflationary trap. The problem with this innovative policy is that it has seen real rates more and more negative, and the yen ever weaker. It is not being easy for the BoJ to abandon this “innovative” stance. However, the BoJ has tried to overcome this counterproductive effect of a weaker yen (and inflation of the wrong kind) by widening its target band for the 10-year yield to 1%. What we believe is that if authorities see wage increases accelerating at a pace consistent with its 2% inflation target, the BoJ will allow JGB yields to rise, and this would be a precursor to an increase in BoJ policy rates. The good news is that salaries are already growing at that rate of 2% (see the graph below) and total employee income (cash income plus employment income) is growing at 3%, which makes us think that Japan's decoupling in terms of monetary policy is close to its end, and sooner rather than later we could see the end of the policy facilitating monetary This should lead to a stabilization of the Yen, and who knows, even an appreciation. In such circumstances, Western central banks are most likely already at the end of their tightening cycle, while the BoJ would be at the beginning, which could result in (soft) support for the currency. We also do not expect the BoJ to turn its innovative nature 180 degrees, so we are not scared by a possible reversal in Japan's equity trend.



Is it possible to achieve stabilization of the Yen without damaging the debt and equity markets? Yes.

With more than a trillion dollars in foreign reserves, the Bank of Japan has a lot of intervention power to deploy and reverse the depreciation of the JPY. On the other hand, the BoJ is still willing to exert its influence over the half of the JGB market it doesn't already own (and continue with QE). Of course, doing both simultaneously could backfire and fuel further speculation. But it also means that the Bank of Japan could try to defend both lines in the sand (the yen and the 10-year JGB yield) in the near term, hoping that external developments will alter the market's risk-reward calculus.

Can the improvement in the economic outlook continue to support the market?

Recently, the IMF raised its 2023 GDP growth forecast for Japan from 1.4% to 2.0%. Given that the Japanese economy grew by 1.8% in the 2023 H1, this implies it should grow faster in the H2 (2.2%) than in the H1. This optimism have impacted sentiment at home, with the BoJ also expected to raise its assessment, which in turn is leading to higher bond yields in anticipation of an ending of ZIRP. Nevertheless, and according to high frequency data, optimism can be premature and difficult to materialize in the short term. September Economy Watchers Survey current conditions index was 49.9 vs consensus 53.2 and 53.6 in prior month. Outlook index was 49.5 vs consensus 51.3 and 51.4 in prior month.

Japanese government is set to extend gasoline, natural gas and power subsidies that were due to expire at end-2023. Subsidies are seen as urgent as Kishida government wants to reduce burden on firms to keep the momentum toward wage hikes at annual labor talks in March.

Japan's sale of USTs is driving up yields, putting pressure on the global equity market. Is this a case of a vicious cycle?

Treasuries face added selling pressure from Japan life insurers continuing to offload holdings, as rising hedging costs offset attractiveness of higher-yielding US sovereign bonds. Some major life insurers have flagged boosting exposure to JGBs with focus on long-dated securities. Life insurers sold further USD1.3B of foreign bonds in fiscal half-year ending 30-Sep following USD53.7B of sales in previous half.

Market outlook – Recommendations & Targets from fundamental analysis

Equities – N225: OVERWEIGHT

Bonds – Govies: UNDERWEIGHT (Target yield 1.00%)

Forex – USD-JPY: OVERWEIGHT JPY (Mid-term target 140)