Liquid Insight

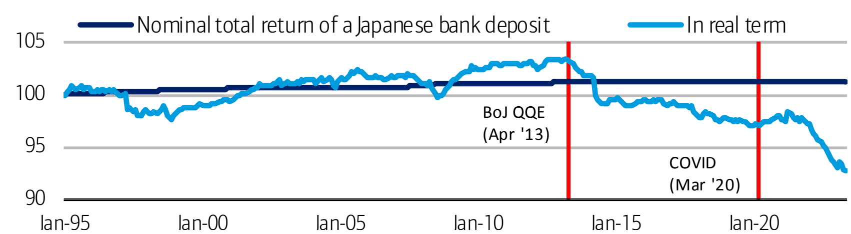
Phase 3 of JPY's structural decline in 2024?

Key takeaways

- We explore scenario B for USD/JPY. What if no rate cuts by Fed through 2024? This may lead to 3rd phase of JPY sell-off
- 1st phase = policy divergence (2022); 2nd phase = yen carry trade (2023); 3rd phase = households' rebalancing (2024)
- If households lose faith in JPY's value, offshore investment can accelerate, challenging policymakers.

By Shusuke Yamada and Izumi Devalier

Chart of the day: Total return of Japan's ordinary bank deposit in nominal and real terms
Yen deposit has loosing purchasing power since BoJ's QQE and after COVID



Source: BofA Global Research, Haver, Total return in real term is adjusted after CPI

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Risk of JPY's 3rd phase of weakening in 2024

We have been bearish on the yen and expect USD/JPY to stay high for long on carry-trade (147 by Sep vs 134 consensus; see report: JPY: no news is bad news 22 June 2023). That said, we agree with consensus on USD/JPY's correction in 2024 on policy convergence as our economists expect the Fed to start cutting rates in May 2024 and the BoJ to remove NIRP in mid-2024.

However, we think the yen's downside risk in 2024 cannot be ignored The market prices in around 170bp rate cut from the peak Fed policy rate in the fall 2023 to end-2024. At 3.7%, the Dec '24 OIS forward (1m) is notably lower than the Fed's dot (4.6%) and BofA's forecast (4.1%). Uncertainty remains high as to whether US inflation will slow sufficiently over the medium term, allowing the Fed to start cutting rates.

In particular, in a risk scenario where the Fed does not cut rates in 2024, (1) how would Japanese retail investors react? and (2) how would the BoJ's policy normalization proceed? We address these two questions in this note. Our conclusion is that the yen weakness can enter the third phase if the Fed does not cut rates in 2024: 1st phase = policy divergence (2022); 2nd phase = carry trade (2023); 3rd phase = households' rebalancing to offshore assets to protect purchasing power (2024).

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Japanese households have held cash, but their faith in the yen is not a given

An extended period of elevated global inflation and a wide US-JP interest rate gap could change Japanese households' behavior. Japanese households have allocated more than half of financial assets to cash in recent decades (Exhibit 1). Today, they hold ¥1,107tn in currency and deposits or 54% of total gross financial assets. This compares to 14% in the US and 35% in the Euro Area.

One key factor behind the difference between Japanese households and Americans may be purchasing power of cash. In Japan, due to the lack of inflation for most of the past 30 years, cash had been able to maintain purchasing power until the pandemic without efforts for yield-enhancement (Chart of the day). The strength in equity market may have also played a role. While the S&P500 index has returned 9.6% annually from 1992 to 2022, the TOPIX index has returned only 2.8%.

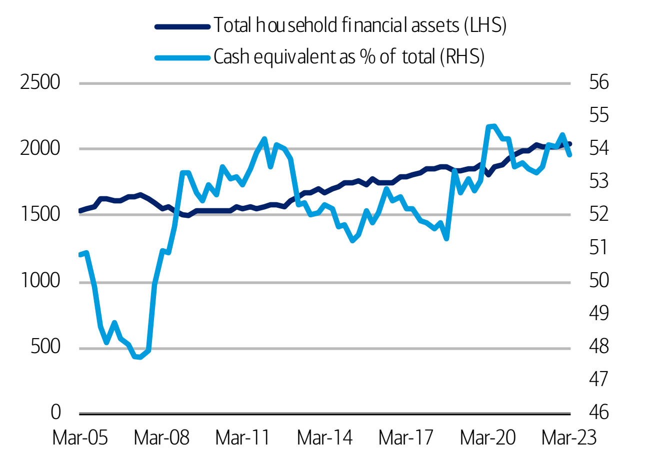
Now, as inflation has started to rise in Japan, bank deposits in Japan have lost 5.5% in real term over the last two years. The domestic equity market has also seen a notable rise in 2023. The hurdle may be high for most households to start investing in risk assets. But if inflation becomes the norm, there is significant scope for rebalancing out of cash/deposits to risk assets, including foreign assets. Our economists expect Japan's inflation to be stickier than the BoJ expects (see report: Japan Watch: May CPI: Acceleration eases, but high inflation to persist 26 May 2023).

BofA survey hints at potential reallocation

Our proprietary monthly Japan Consumer Suvey also found that, of those who currently do not invest in risk assets, 37% intend to start investing in order to protect their incomes amidst a weak yen and rising inflation (see report: Japan Watch: Japan Consumer Survey (May 23): Are households losing faith in cash? 15 June 2023).

Exhibit 1: Japan's households' gross financial assets (¥tn) and cash %

Japanese households hold over ¥2000tn in financials assets 54% of which stays in cash equivalents



Source: BofA Global Research, Haver

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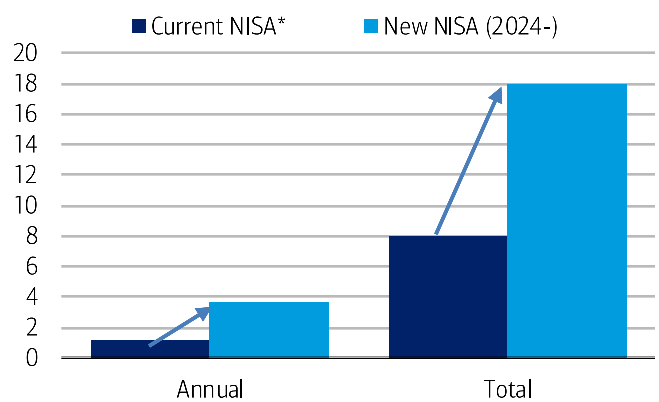
Exhibit 2: Max investable amount in current and new NISA accounts (¥mn) per year and total

Annual bracket would rise to ¥3.6mn (¥2.4 regular + ¥1.2 DCA) from current ¥1.2mn regular or ¥0.4mn DCA and maximum balance to ¥18mn (¥12mn regular + ¥6mn DCA) from current ¥6mn regular or ¥8mn DCA



Source: BofA Global Research

DCA: Dollar-Cost-Averaging (*Tsumitate* in Japanese)

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Expanded NISA to begin in 2024, likely boosting retail investors' risk-taking

We think the expansion of the NISA program (Nippon Individual Savigns Account), effective in January 2024, can also impact households' asset allocation. NISA's tax-exempt bracket will expand from ¥1.2mn (regular NISA) to ¥3.6mn per year and from ¥8mn (in case of DCA (Dollar-Cost-Averaging)-NISA) to ¥18mn total. The exemption period will also be made permanent. For the detail, see report: Japan's push for retail investments – risk or opportunity for JPY? 16 December 2022.

The existent NISA program has already had a noticeable impact on households' behavior. The number of brokerage account has risen since NISA started in 2014. There has also been a steady increase in households' investment in investment trusts since the pandemic started and a good portion of it may have been through or influenced by NISA's dollar-cost-averaging accounts (Exhibit 3).

For the FX market, it is important that Japan's investment trusts have been buying foreign equities and have not added Japanese equities in recent years. The expansion of NISA may lead to more offshore investments by households amidst signs that they are growing more worried about the diminishing purchasing power of yen cash.

Annual retail flow to risk assets via NISA can rise by at least a few trillion JPY

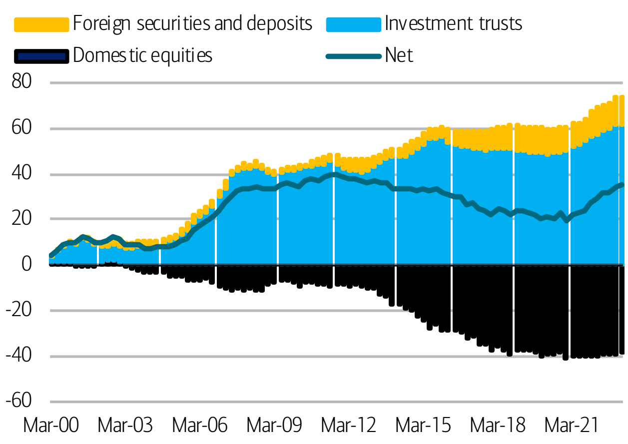
How much could the size of retail flow increase? In 2021, NISA accounts made ¥4.2tn purchases (¥3.3tn through regular NISA and ¥0.8tn through DCA NISA). There were 12.5mn regular NISA accounts of which 10.4mn still had not filled the maximum investable bracket and 5.2mn DCA NISA accounts.The simple average of purchase volume per account was ¥320K for regular NISA, 27% of the max investable amount, and ¥160K for DCA-NISA, 41% of the max investable amount.

The annual bracket will triple in 2024 but we do not think investment volumes will rise by the full amount of the expansion, as many accounts' utilization rates have been low. However, it is not unreasonable to expect a doubling of the investment volume from current levels since some wealthy accounts' have already filled up the tax-exempt bracket. The attractive tax benefit of the newly-expanded NISA program is also likely to attract new investors. In such a scenario, we can assume an increase of at least a few trillion yen in risk asset investments by retail investors just through NISA accounts.

Longer-term, the expansion of NISA can broaden the retail investor base and lead to households rebalancing away from cash-equivalent to risk assets. Note that a 1% change in asset reallocation among Japanese households, away from cash, amounts to ¥20tn ($138bn). In 2022, Japan's Ministry of Finance (MoF) spent ¥9.2tn to shore up JPY and it currently has $1.3tn (¥183tn) in foreign reserves.

Exhibit 3: Cumulative flow to risk assets by households (flow of funds statistics, ¥tn)

Households have increased investment in investment trusts and stopped selling Japanese equities since 2021



Source: BofA Global Research, Haver

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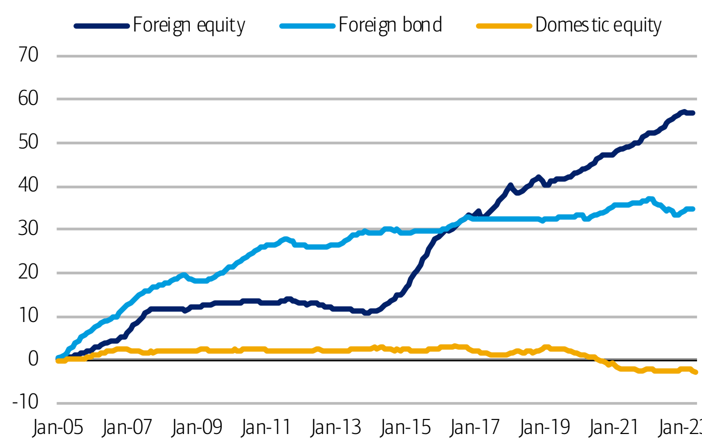
Exhibit 4: Cumulative flow by Japanese investment trusts by asset class (¥tn)

Japanese investment trusts have been buying foreign equities



Source: BofA Global Research, Haver

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BoJ dovishness risks fuelling yen sell-off

The BoJ's slow response to rising inflation may also add to pressures for the yen to weaken.

The Bank of Japan already stands as a dovish outlier among major DM central banks: it is the only central bank still sticking to negative interest rate policy (NIRP) and continues to engage in active bond purchases (via yield curve control).

This stance was understandable when inflation was running low. However, underlying inflation has been rising steadily over the past year. We believe the inflation on the cusp of a structural regime shift, and expect Japan's inflation to be sticky and persistent, with ex-energy core BoJ-style core inflation remaining above 3% for the rest of 2023, and at or above 2% through 2024/25 (see report: Global Economic Weekly: Mid-year review: Incomplete 15 June 2023).

We think that the BoJ is also growing more atune to the risk of a persistent inflaton overshoot, despite its on-going communications that the current inflation pick-up is transtitory (see report: Liquid Insight: BoJ preview: The clock is ticking 14 June 2023). But the BoJ seems much more willing to face the risk of falling behind the curve as it seeks to reanchor inflation expectations after years of static prices and wages.

Increased prospects for an on hold Fed in 2024 will likely increase the incentives for the BoJ to loosen yield curve control sooner, or even abolish it in 2023 (our base case is for some modest adjustments at the 28 July MPM). It also raises the risks that the BoJ may need to raise the short-term policy rate into slightly positive territory in 2024, instead of merely returning to zero, as we currently expect. However, we think the BoJ will remain cautious and behind the curve with respect to front-end hikes, leaving real interest rates in firmly negative territory.

How far can JPY fall?

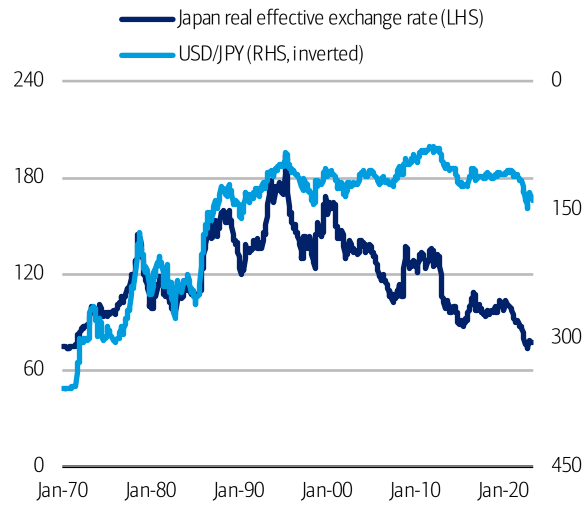
Given the yen's sell-off from 2022 up until now, JPY appears undervalued in many models. For example, the Economist's Big Mac index puts the JPY as 41% undervalued vs USD in January 2023 and USD/JPY has risen around 10% since then.

However, in the past two decades, JPY has structurally fallen in the real effective terms (Exhibit 5). We find three factors behind the yen's structural decline, especially over the last 10 years: (1) structural outward FDI due to demographic constraints (see report: Liquid Insight: Japan's outward FDI behind yen's sticky weakness 22 May 2023); (2) the BoJ's dovish monetary policy; and more recently, (3) higher interest rates abroad.

The longer the weak yen trend persists, USD/JPY at 140 may not be perceived as expensive and may be justified by the structural changes. If we focus on USD/JPY's recent relationship with the US-JP interest rate gap, USD/JPY currently appears fair (Exhibit 6).

The longer the Fed holds, USD/JPY can stabilize at a high level and is likely to exceed the level implied by the interest rate spread, as carry-trade accelerates and households increase offshore investments. The 2-year swap rate spread implies USD/JPY at around 150 in Exhibit 6. The interest rate gap could widen further if the Fed does not cut rates in 2024 and USD/JPY can overshoot that interest rate gap on carry trade, eyeing 160.

Exhibit 5: Japan's real effective exchange rate and USD/JPY
JPY-REER in a structural decline



Source: BofA Global Research, Haver

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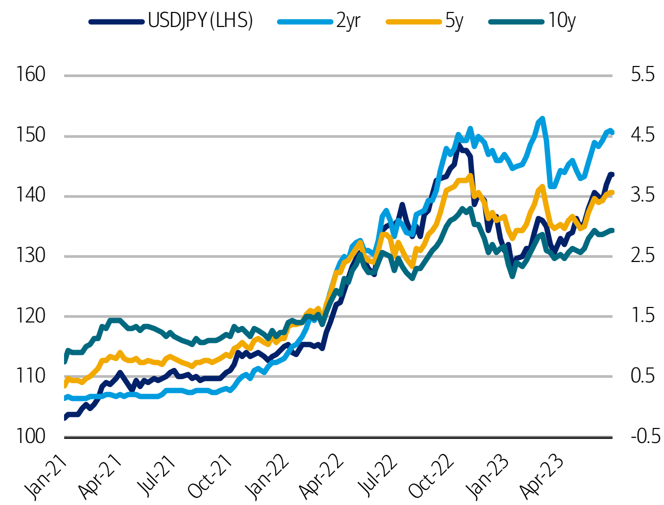
Exhibit 6: USD/JPY vs US-JP swap rate spreads
USD/JPY is not expensive relative to interest rate differences



Source: BofA Global Research, Bloomberg

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Ultimate risk of capital flight

The ultimate risk for policymakers is the weak JPY trend lowers the faith of households in the yen, which could lead to more rapid reallocation of their assets from yen deposits to risk assets and in particular, foreign assets.

If a rotation takes the form of capital flight, the risk of a sell-off in JGBs, JPY, and Japanese equities increases as banks lose deposits, which have historically been funnelled into JGBs. This is not our base case, but a prolonged hold by the Fed amidst structurally elevated US inflation may increase the probabilities of such a tail risk if JPY's structural headwinds are left unsolved.

Market implications

- Beware of JPY's further decline if the Fed does not cut rate in 2024 as it will coincide with the expansion of NISA program, which could encourage households to diversify their investments away from yen deposits and into foreign assets, in order to protect purchasing power.
- In that scenario, the MoF FX intervention may be necessary to slow the yen's decline as BoJ policy normalization is likely to be gradual and measured. But intervention may not be enough to stabilize JPY as long as the Fed does not cut rates. USD/JPY could reach 160 in 1H24 if the market comes to assume the Fed will not cut rates in 2024.
- Halting JPY's long-term decline requires policy reform and initiatives to promote domestic investment, raise productivity, and attract inward investment.
- Considering uncertainties around the US' inflation outlook, JPY's medium-term risk appears more balanced than priced by the options market (USD/JPY 1y risk reversal at -1.26).

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The curious case of r** **Global FX Weekly**, 23 June 2023
- High hurdles **Global Rates Weekly**, 23 June 2023
- USD under pressure again, **Liquid Cross Border Flows**, 19 June 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: The curious case of r** 23 June 2023

Global Rates Weekly: High hurdles 23 June 2023

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