October 31, 2024

Bank Of Japan: A Hawk In Dove's Clothing

- The Bank of Japan left its policy rate unchanged but hinted that it may soon resume "normalizing" policy. We think this could be as soon as this December. With the U.S. and global economy resilient, we expect the BoJ to hike rates by 25 bps every 3- to 6-months until eventually reaching at least 1.75% (consistent with our estimate of the nominal neutral policy rate).
- The BoJ will continue to be sensitive to the yen as it has explicitly tied fluctuations to the inflation outlook. When the currency is weak, expect the BoJ move ahead with its tightening campaign by ramping up hawkishness and following through with rate hikes. Currency intervention is also more likely.
- We remain underweight Japanese duration and favor curve steepeners in 2s/10s and in the forward market.
- While FX-hedged yields have improved for Japanese investors, they still remain inferior to local 10-year JGB yields. This reduces the risk of investment away from JGBs.
- The Lower House General Election delivered a blow to the Liberal Democratic Party, but it is likely to remain the main party in a coalition. There are risks to this but such a scenario suggests for a more expansionary fiscal policy, which will ultimately reinforce the BoJ's tightening campaign.

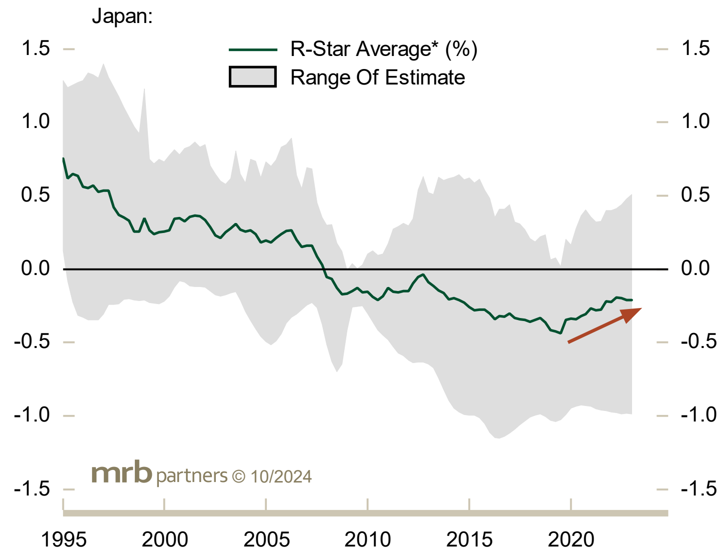
The Bank of Japan (BoJ) stood pat at its most recent decision and made very little change to its projection. Still, the tone of the meeting was hawkish. In his press conference, Governor Ueda signaled that the BoJ did not need "time to mull" whether a rate hike was needed and that fears over the U.S. economy were overblown. We think investors should expect a hike as early as this December. The yen has unwound its strength from the surprise July hike which alleviates it as a concern for the central bank. Indeed, Ueda emphasized that the exchange rate would significantly impact the outlook for inflation (the BoJ notes upside risks to inflation in its accompanying Outlook Report). Going forward, we expect the BoJ to sound more hawkish. This report analyzes the outlook for policy rates and underscores that the path of least resistance remains much higher for 10-year JGB yields.

The BoJ will have a hawkish tilt going forward. A hike at its next meeting is looking increasingly likely

1.75% Is A Reasonable Nominal Neutral Policy Rate

MRB's research has long-argued that the U.S.' nominal neutral rate (the rate that is neither stimulative nor restrictive for the economy and maintains an expansion around potential GDP growth) is much higher than the Fed and the bond market estimate. Part of the difficulty is that this is not directly observable and is reliant on the outlook for longer-term growth and inflation.

Chart 1 The BoJ's Real Neutral Policy Rate Estimates



* Average of 5 estimates; R-star is defined as real neutral rate of interest; source: Bank of Japan

Similarly, the BoJ has been conducting an ongoing *Review of Monetary Policy from a Broad Perspective* forum, which includes an update on several estimates of the ***real*** (or inflation-adjusted) neutral rate of interest. The main takeaway is that the real neutral rate (i.e. R-Star) has been in structural decline but appears to have bottomed out (**chart 1**). Averaging these estimates (which range from -1% to 0.5%) points to an R-Star of near zero (-0.2%). While a useful starting point, a key criticism is that the central bank's analysis is backward looking at a time when Japan has finally exited a prolonged period of secular stagnation.

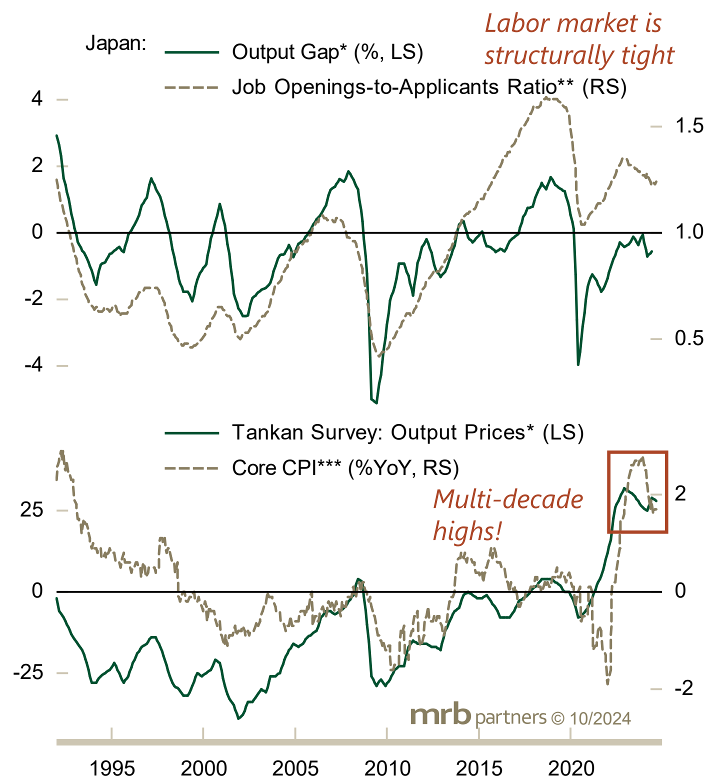
Japan's R-star has been in structural decline until recently

Our framework approach begins with an estimate of potential GDP growth, as the average cost of capital should be roughly in line with nominal economic growth over the long haul. As a starting point, population or workforce growth will present a mild -0.5% drag on Japan's potential GDP growth, whereas productivity will provide something like a 1.25% contribution (which is about 75 bps below our estimate for U.S. productivity and neither accounts for a potential positive contribution from AI down the road). Productivity is incredibly hard to estimate but we caution about underestimating its contribution based on the low estimates of recent history. The reason is that productivity is calculated as GDP per unit or labor or capital, and thus appears bleak when the numerator is stagnating (i.e. weak growth makes it hard to showcase true productivity in an economy). Taken together, this suggests that the long-run ***real*** potential GDP growth rate for Japan is about 0.75%.

Our assumptions for Japan's economy imply a much higher R-star estimate than most of the BoJ's estimates

Next, we need to add an inflation rate to estimate Japan's long-run ***nominal*** potential GDP growth. The BoJ has an inflation target of 2%, but this may be ambitious given that inflation has averaged near 0% during the decade preceding the pandemic. Japan's cyclical inflation dynamics have shifted positively and secular global disinflation drags have diminished/ended (including the rapid advancement of globalization and technology adoption, as well as deleveraging of the U.S. and euro area). However, our best estimate is that Japan will experience about 1.25% inflation (on average) in the decade ahead. Together this would imply long-run nominal GDP growth of 2%.

Chart 2 The Japanese Economy Is Likely Operating In Excess Demand



* Source: Bank of Japan
** Japanese Ministry of Health, Labour & Welfare
*** Core excludes food, alcoholic beverages, energy and tax effects
source: Japanese Statistics Bureau

Finally, it is average interest rates (rather than policy rates) that should be in line with the 2% nominal GDP growth over the long haul. We expect a positive term premium over the long-run of possibly 50 bps, which implies that the BoJ's nominal neutral rate should be at least 1.75% (and the 10-year JGB yield will eventually rise to as much as 2.25%). Our R-Star (or inflation-adjusted estimate) is therefore 50 bps, which is the top end of the BoJ's range of forecasts (**chart 1**). There are two-sided risks to this estimate. On the downside, Japan has not achieved sustainable inflation just yet, although we think this will change. On the upside, a higher nominal neutral policy rate (and R-Star estimate) in the U.S. would also suggest some upward drift in Japan. Nonetheless, we believe 1.75% is a reasonable nominal neutral estimate of the BoJ policy rate.

The Slow Road To Normalization

Little to no slack and a structurally tight labor market should continue to support activity and real wages

Against this backdrop, the BoJ is operating in very easy territory with the policy rate at a mere +25bps. We expect the BoJ to continue to normalize, given the economy is more vibrant than it has been in recent decades and is operating with little to no slack. While the output gap is slightly negative, this is prone to conservative assumptions around potential growth by the BoJ. Moreover, the labor market is structurally tight (**chart 2**). Note that the output gap tends to feed through into the core CPI inflation with a 2-4 quarter lag, suggesting that private services inflation excluding rents (a key measure for the BoJ) will likely start to soon base at a solid 1.8% rate (**chart 3**). Moreover, early rumblings of the upcoming Shunto (spring wage talks) suggest elevated employment costs pressures: large labor unions are reportedly asking for a hefty 5% raise. This should help support real wages and consumption trends (**chart 4**).

Chart 3 **Lag Structure Of Output Gap Should Support Inflation Still**

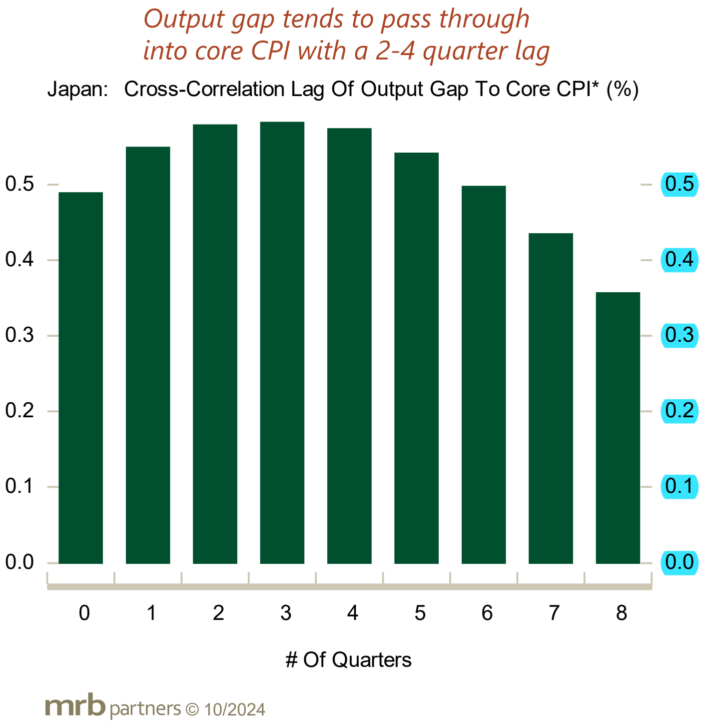
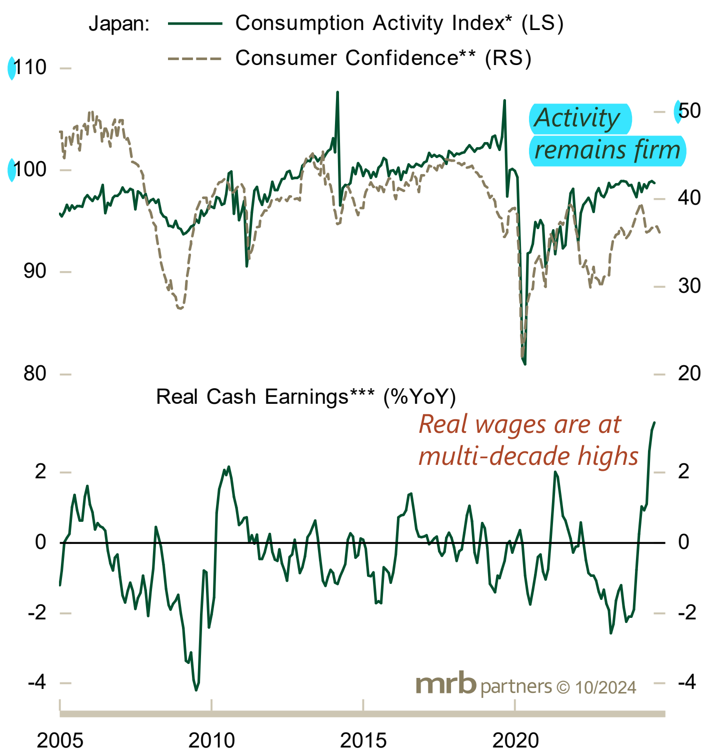


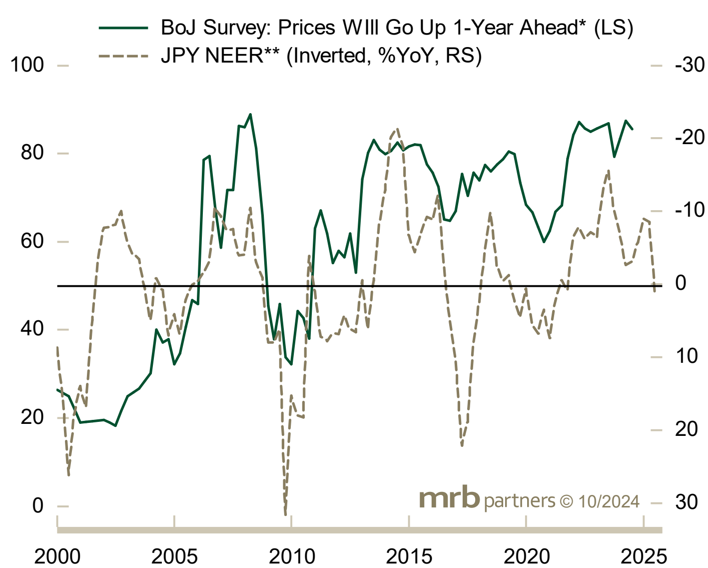
Chart 4 **Japanese Consumers Are In Better Shape**



* Source: Bank of Japan
** Source: Japanese Cabinet Office
*** Deflated by headline CPI; smoothed; source: Japanese Ministry of Health, Labour & Welfare

Moreover, the BoJ "weaponized" a weak currency in 2022 to help lift inflation expectations by falling behind the curve relative to other central banks (**chart 5**). To this end, the BoJ now views stability in the currency at these levels as a necessary pre-condition to achieving "sustainable" inflation. Earlier this year, Japanese authorities intervened in currency markets to prop up the yen, while in July the central bank cited a weak currency, which introduced upside risks to the inflation outlook and was the reason for a surprise hike. This subsequently triggered a sharp "carry" unwind of yen shorts and forced the central bank to announce a pause to its tightening campaign to calm the currency market. Since July, the currency has nearly reversed the entire gain, which should encourage the BoJ to return to its normalization path. Indeed, we believe the BoJ will likely sound hawkish and continue to lift policy rates on a go-forward basis, especially when the currency weakens.

Chart 5 **A Weak Yen Has Helped To Drive Inflation Perceptions Higher**

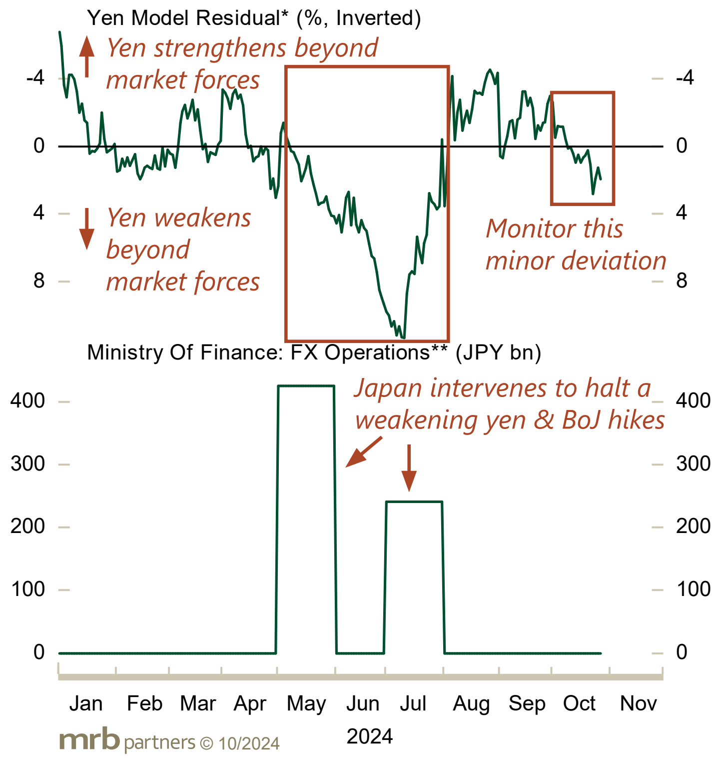


* Sum of prices going up slightly and significantly; source: Bank of Japan
** Nominal Effective Exchange Rate; advanced 1 year; source: Bank of Japan

Recent weakness in the yen has moved alongside the upward revision to U.S. economic growth and Fed policy expectations, as well as the back-up in Treasury yields. As such, recent yen depreciation is explained by relative growth and interest rate differentials, suggesting it has less to do with speculative carry trades. There has been a minor deviation from "fair value", though a far cry from the discrepancy observed early in the summer that triggered intervention (**chart 6**). This suggests more leeway for the BoJ to hike rates without triggering another major spike in the currency.

With the U.S. economy in the midst of a solid and durable expansion, the BoJ will be able to comfortably normalize policy. A U.S. recession outcome would have hijacked the tightening cycle for the BoJ as it could reintroduce a disinflationary shock and lead to significant yen appreciation. However, this is not currently a risk and MRB's view is that Fed rate cuts reinforce the "no landing" (or above potential growth) environment for the U.S. economy.

Chart 6 An Overly Weak Yen Risks Intervention



* Based on a regression of USD/JPY and market variables including Treasury yields, terms of trade, equities, inflation expectations and more; source: Bloomberg
** Source: Japan Ministry of Finance

The BoJ has a long way to normalize given our estimate of the nominal neutral policy rate (see above). However, the central bank has preferred to operate in a manner that is least disruptive to financial markets given that the economy has been mired in negative to very low rates for decades and had a failed attempt to normalize in 2006. We believe the BoJ will move forward in a measured way but will be able to deliver hikes on 3- to 6-month intervals, and we would not discount the possibility for a rate hike in December.

The BoJ will hike in 3- to 6-month intervals

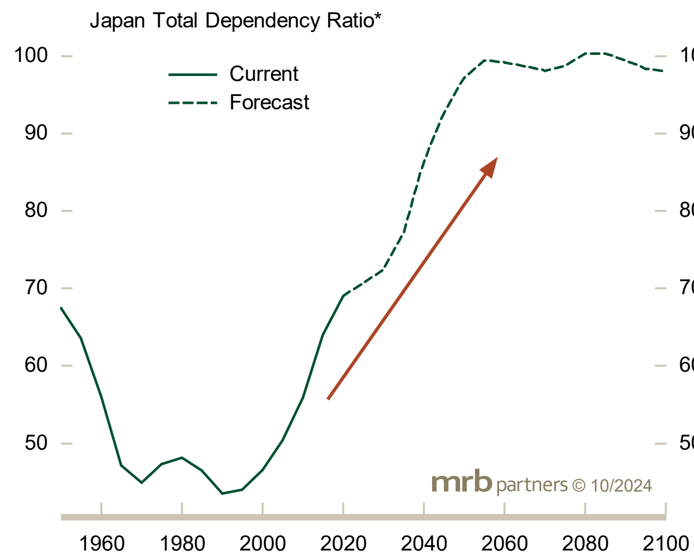
A Natural Exit Strategy

JGB yields are a more attractive investment compared to regionally hedged bond yields

Japan's investor base is a key factor in the BoJ's normalization plans. The era of Abenomics and easy money policy in Japan led to greater reliance on external income to offset Japan's unfavorable demographic profile (the dependency ratio is rising, **chart 7**). Japanese pensions and life insurance companies had to offset domestic liabilities by seeking much better FX-hedged yields abroad compared to local JGB yields. Indeed, the Government Pension Investment Fund's (one of the largest retirement funds in the world) domestic holdings of JGBs dramatically shrunk while its foreign bond holdings rose sharply. Moreover, the BoJ acquired a large share of the JGBs through its quantitative easing and yield curve control policies that led to reduced liquidity and prevented hopes of higher yields locally.

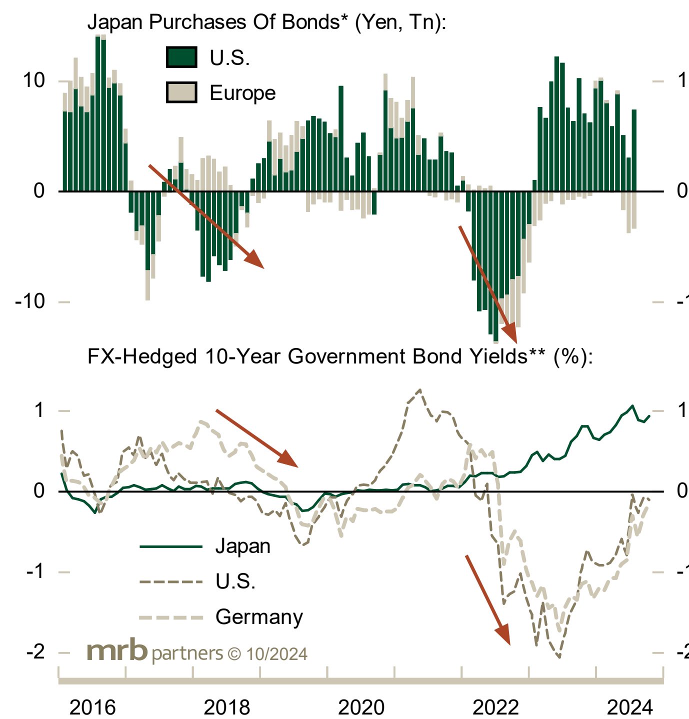
Since the global interest rate environment has changed significantly over the post-pandemic period, it became punitive for local investors to seek these foreign bonds on an FX-hedged yield basis (dramatic shifts in hedging costs have shifted foreign portfolio flows, **chart 8**). JGB yields became more attractive by comparison and underscored the importance for Japanese policymakers to exit an excessively easy monetary stance to allow for local yields to rise. Since the Fed and global central banks have started easing more recently, these FX-hedged yields are starting to improve although they remain inferior to JGB yields. This reduces the risk of an investment away from JGBs. That said, it emphasizes the importance for BoJ policy to continue to normalize to allow for a gradual updrift in JGB yields.

Chart 7 Japan's Aging Population Increases Demand For Yen-Denominated Assets



* Ratio of population aged 0-14 & 65+ per 100 population 15-64, medium fertility; source: UNDESA

Chart 8 JGB Yields Remain More attractive



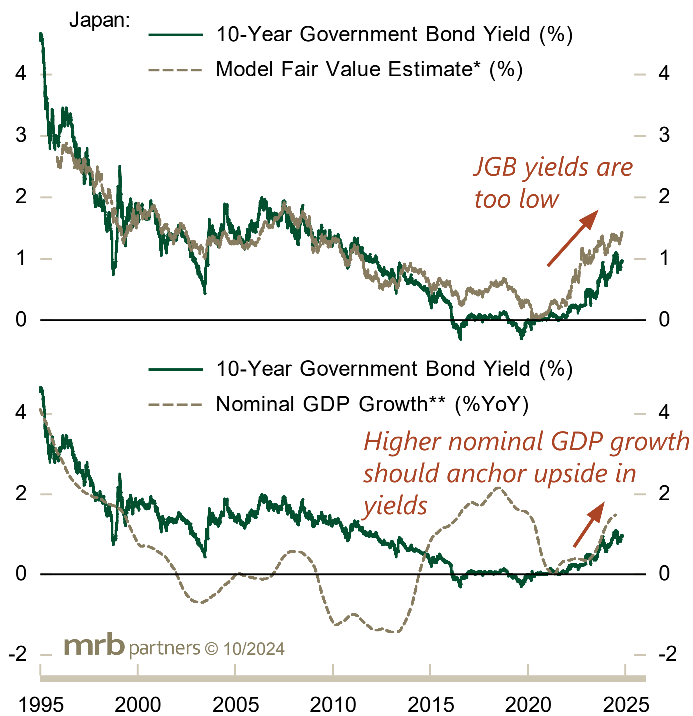
* 6-month moving sum; source: Japan Ministry of Finance
** Based on 1-year rolling hedges; source: Bloomberg

Japan Elections Raise Fiscal Uncertainty

In the recent national elections the ruling coalition parties - Liberal Democratic Party (LDP) and Komeito - fell short of the 233 seats required to form a majority. Meanwhile, the Constitutional Democratic Party (CDP) made significant gains and now represents the major opposition party. This result was not entirely surprising as the LDP have been plagued by scandals all year, causing its approval rating to sagged and leading former PM Kishida to step down.

It is possible that the LDP forms a majority coalition with additional parties, but doing so would likely raise the risk of more fiscal expansion given the policy bias of some of these parties. Since the LDP still holds the most seats, it is a fair bet that it will try to form a majority government, but it is possible that a minority government persists whereby the ruling parties pass bills on a case-by-case basis. One cannot rule out the possibility that the CDP will form a government either, but it is more likely that the LDP is part of its own ruling coalition in some shape or form, which makes it more likely that PM Ishiba remains in office.

Chart 9 Japan Yields Have An Asymmetric Tilt To The Upside



* Based on financial market variables
** 5-year moving average; source: Japan Cabinet Office

The bottom line is that the Bank of Japan will likely be sympathetic in the near-term to these developments and opt to wait for clarity before proceeding with its tightening campaign. That said, we would not rule out a resumption of BoJ normalization in December; by then a government should be formed, and (on the margin) may result in greater fiscal stimulus, which provides a greater need for monetary normalization. There is also likely to be an increased bond term premium associated with policy uncertainty and increased fiscal spending.

More fiscal spending is likely

Investment Strategy

The BoJ will push forward in normalizing policy rates at a pace of 25 bps every 3- or 6-months until reaching at least 1.75% (consistent with our estimate of nominal neutral). If we use this to derive a "fair value" estimate for 10-year JGB yields, it implies an ongoing upward adjustment in bond yields (even without assigning a positive term premium). Indeed, the "fair value" is currently around 1.5% and will drift higher over the next couple of years as the BoJ normalizes policy rates (**chart 9**). In short, the asymmetry in JGB yields is to the upside and remain underweight JGBs within a global (currency hedged) government bond portfolio. We favor Japanese curve steepeners (2s/10s) and in 1-year/1-year forward versus the 2-year/1-year forward.

10-year JGB yield has a lot more upside from here. Remain underweight

Mazen Issa I Strategist, Fixed Income

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London
24 Old Bond Street, 3rd Floor,
London, W1S 4AP, United Kingdom
Tel (+)44 (0) 20 3523 9618

Montreal
1275 Ave. des Canadiens-de-Montréal, Suite 500
Montreal, Quebec H3B 0G4, Canada
Tel +1 514 558 1515

New York
1345 Avenue of the Americas, FL 2
New York, NY, 10105, United States
Tel +1 212 390 1148

For more information, please contact:
Client Relations
clientrelations@mrbpartners.com

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