OCT
03
2023

Around THE Curve

Holding Out for the Yen

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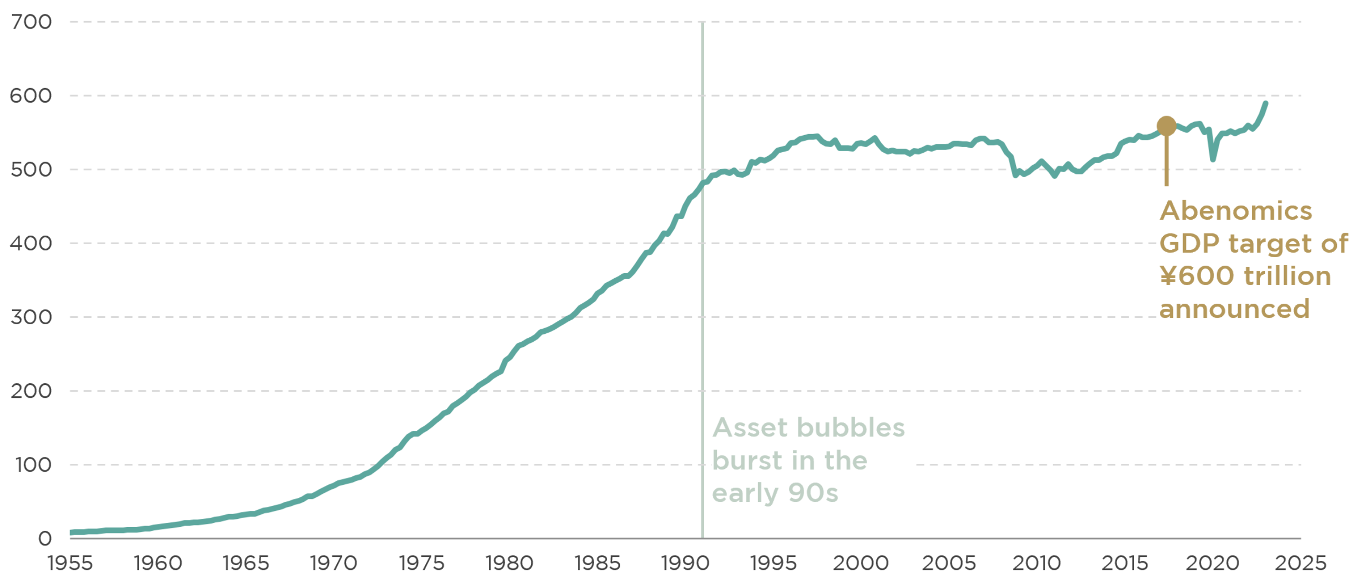
The pieces finally look to be falling into place for Japan's economy. From a broad macroeconomic perspective, recent Japanese growth has been encouraging. Future activity also looks robust for both manufacturing and services, which is particularly meaningful when one considers Japan's nominal Gross Domestic Product (GDP). For a long period of time—nearly 20 years—Japan has been in a low or no growth phase. Now, GDP is finally approaching the ¥600 trillion target set roughly eight years ago when Shinzo Abe was Japan's prime minister (see Exhibit 1). Reaching the target would be good news as it finally would allow Japan to exit its extremely easy monetary policy settings. The Japanese government is also planning economic stimulus measures to ease the sting of inflation. With these developments, Japan's economic recovery looks likely to continue.

1 Japan's Nominal GDP Is Approaching the Abenomics Target of 600 Trillion Yen
JPY, Trillion, As of 4/1/2023



Source: Macrobond, Cabinet Office (© 2023)

At its July meeting, the Bank of Japan (BOJ) adjusted its yield curve control (YCC) policy by expanding the trading band for 10-year Japanese government bonds (JGBs) to +/-1%. So far, 10-year JGB yields have not tested the new band, staying around 0.7%, perhaps due in part to early BOJ market activity aimed at keeping yields low during the initial days of the YCC widening (see Exhibit 2). This success in keeping 10-year JGB rates stable should give the BOJ confidence that YCC could be removed with little disruption to the financial system.

2

10-year Japanese Government Bond Rates

%, As of 9/25/2023

Source: Bloomberg (© 2023, Bloomberg Finance LP)

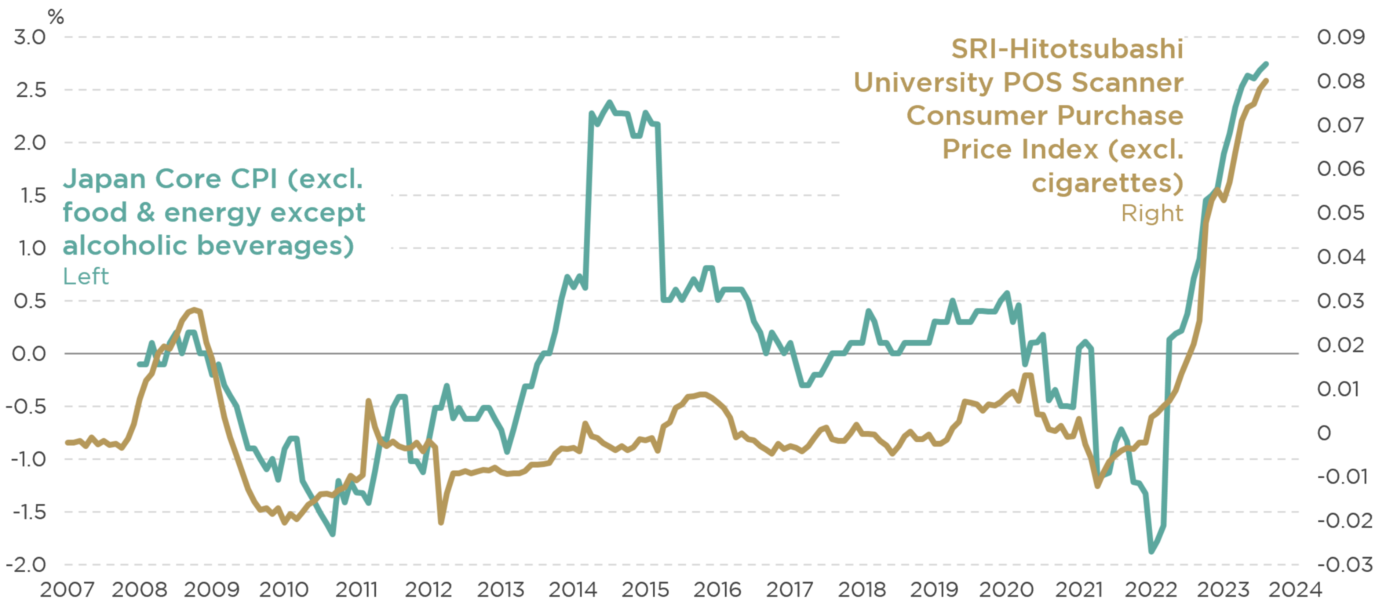
Positive Inflation and Growth Outlook

Looking at the inflation part of the equation, core CPI is still printing above 2% (see Exhibit 3). Furthermore, on a very basic level, the rate of change of the price gain of goods does not appear to be abating. The SRI-Hitotsubashi Point of Sale Consumer Purchase Price Index suggests that inflation could still be higher than expected and that Japan is likely at least six months away from peak inflation.

3

Japanese Inflation Continues to Rise

%, Year over year, As of 8/31/2023



Source: Brandywine Global, Macrobond (© 2023)

Monetary Policy Expected to Normalize

With inflation expected to continue in Japan, even as most developed market countries are showing definitive progress against price pressures, the question returns to YCC and what comes next. Recent public interviews by some BOJ members indicate increased discussion among Japan's central bankers to shift out of this easy monetary policy, perhaps even abandoning negative interest rate policy. Early next year, January to March, will likely be a critical time, giving a clearer outlook on inflation and determining future monetary policy. The removal of YCC could occur sometime in 2024, even in the first half of next year. Ultimately, the BOJ could move rates into positive territory and reduce its balance sheet, but this is a multiyear process.

Yen Poised to Appreciate

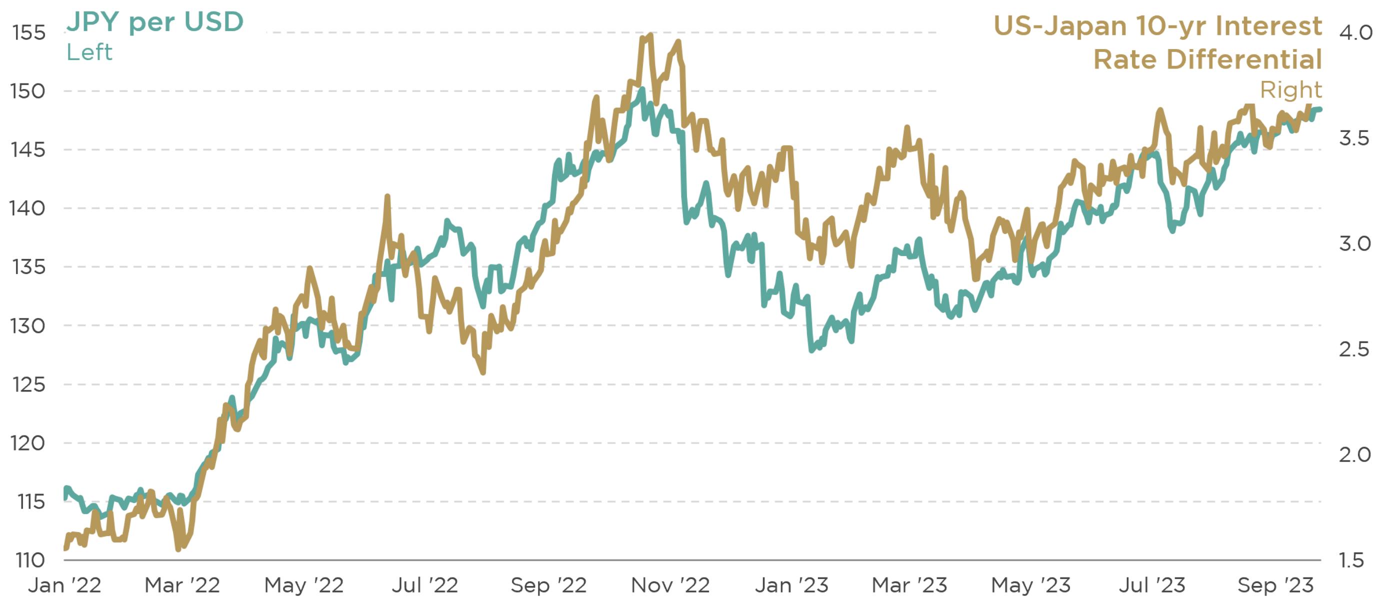
The dominoes, set out nearly a year ago with Abenomics, finally appear to be lining up for Japan. The growth outlook is favorable, which could lead to further relaxation in YCC and ultimately normalization of monetary policy. So, why is the yen so weak? Even after the BOJ's latest tweak to YCC, the yen failed to stage a follow-through rally.

We believe much of the yen's underperformance is due largely to the meteoric rise in US interest rates, which have overshadowed the BOJ's YCC maneuvers. Looking at the 10-year interest rate differential, the correlation, which has not broken down, stands out (see Exhibit 4). It appears the yen is being driven more by what is happening on the US side rather than simply what is happening on the Japanese side; the US moves have been influencing the exchange rate and preventing the yen from appreciating. We believe this situation is similar to what is happening with other low-yielding Asian currencies and the euro to some extent.

4

US-Japan 10-Year Yield Differential

Yen (Left), % (Right), As of 9/8/2023



Source: Brandywine Global, Macrobond (© 2023)

We remain positive on the Japanese yen for several reasons. Given Japan's high inflation, the Japanese government prefers a strong yen. They have already engaged in interventions to support the currency, and we would anticipate they could intervene around 150 USD/JPY as this level would not be in line with the correlation that we are seeing in yield differentials. Two other factors are likely to work in the yen's favor going forward. One would be the Federal Reserve's rate hike cycle nearing a peak, which would allow Japanese fundamentals to drive this currency pair lower. The second would be continued normalization by the BOJ, which we would expect would eventually buoy the yen.

Index Definitions

The SRI-Hitotsubashi Point of Sale (POS) Consumer Purchase Price Index is calculated based on the POS data of about 6000 stores, such as supermarkets, convenience stores, drug stores, and grocery discount stores, to see the change in the price of consumer purchases.

In Japan, the Global Core Consumer Price Index (CPI) tracks changes in prices that consumers pay for a basket of goods which excludes prices of food (except alcoholic beverages) and energy.

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