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Change on the Horizon for Japan

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Last year we wrote about [Japanese government bonds] (JGBs) and the potential for the Bank of Japan (BOJ) to tinker with its yield curve control (YCC) target range, extending the policy's sustainability, and to alter its dovish stance if the inflation trajectory shifted. Those predictions panned out last December with the BOJ increasing the target band to +/-0.5% from +/-0.25%. Now, inflation trends are up, but the BOJ has been resisting upward pressure on yields, which has led to a correction in the yen. A new BOJ governor is set to take the reins, and he will have to decide whether to tweak YCC or get rid of it all together. When this change happens, or even with the anticipation of its occurrence, the yen should see a boost. As always, timing will be critical. Here is what we will be watching.

Services Sector Growth

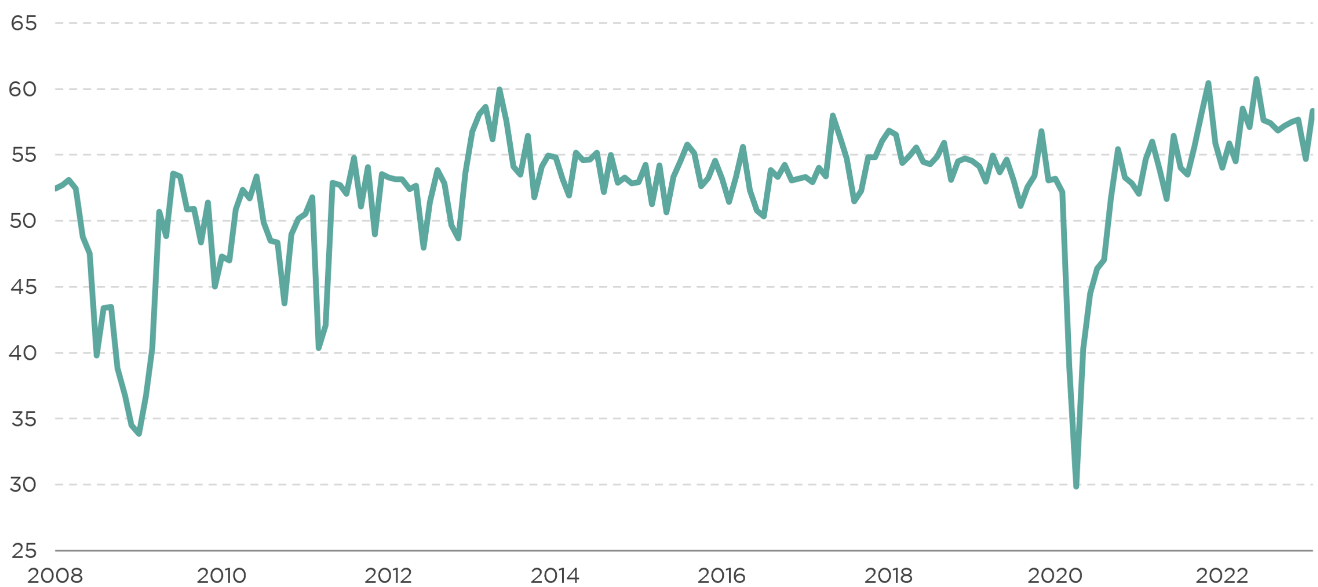
Japan only reopened to foreigners in October of last year, so consumption and services spending continue to ramp up. Department store sales remained high due to the demand for luxury goods, but duty-free sales also are back to 80% of pre-pandemic levels. Purchasing Manager Index (PMI) services remain resilient (see Chart 1).

Meanwhile, we have yet to see the return of Chinese tourists to Japan. We anticipate Chinese tourism numbers to pick up in the second half of the year as the ban on Chinese group travel to Japan is expected to be lifted. The level of the yen is still cheap, evidenced by the CNY/JPY exchange rate (see Chart 2), which should further encourage visitors. Chinese tourism contributes approximately 1% to Japan's gross domestic product (GDP). Given Japan's overall potential GDP may be less than 1% over the course of the year, the return of tourists could be a significant lift to services sector growth and demand.

1

Japan Services PMI Future Activity Index

Index, As of 2/1/2023



Source: Brandywine Global, Macrobond (© 2023)

2

Chinese Yuan (CNY) vs. Japanese Yen (JPY) Exchange Rate

CNY/JPY, Last Price, As of 1/31/2023

Source: Bloomberg (© 2023, Bloomberg Finance LP)

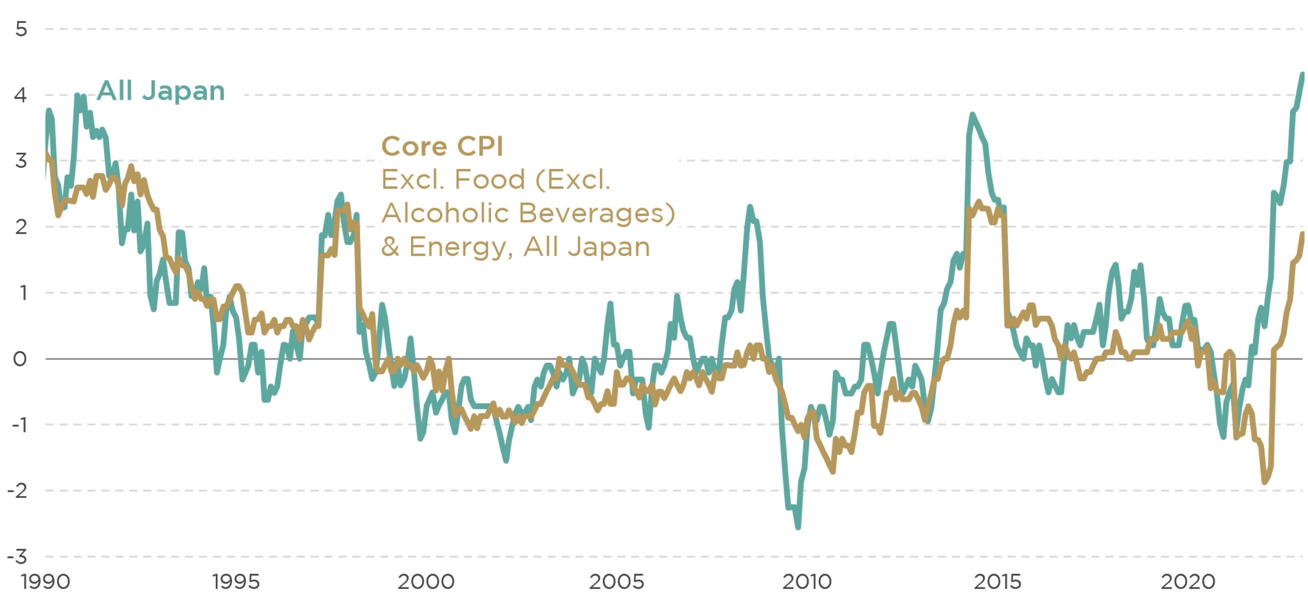
Inflation and Wage Growth

Energy costs have pushed headline inflation higher, leading to a pass-through to core inflation as well. Headline inflation should abate in coming months due to energy subsidies from the government. However, certain input costs are still far below prevailing global levels. Therefore, there will continue to be upward adjustments to input costs that will push up core inflation (see Chart 3).

However, the key factor is wage growth, which is estimated to reach 3% to sustain inflation over the medium term. With the Shunto wage negotiations ongoing—the annual wage negotiations between Japanese unions and employers—the good news is that this year has seen the highest number of firms surveyed over the past 25 years indicating wages will increase. The overall impact may be more muted though. While large firms have raised wages by 5% on average, the small-to-medium enterprises whose labor share is high have been unable to pass on their higher input costs. Therefore, these smaller employers may be reluctant to raise wages by 3%. Lastly, despite the somewhat tight labor market, job openings in Japan are still trailing the levels seen in Western countries after reopening occurred, which could put the sustainability of higher wages in question as well (see Chart 4).

3 Japan Headline Inflation vs. Core CPI

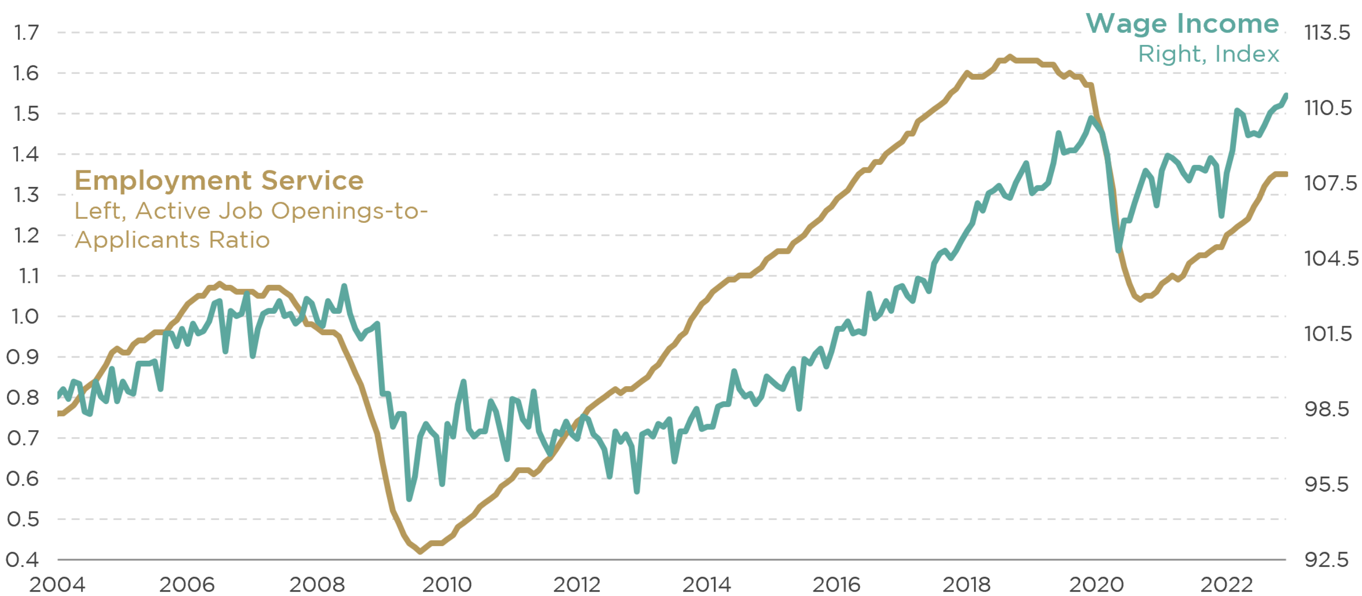
%, Consumer Price Index, Total, As of 1/1/2023



Source: Brandywine Global, Macrobond, Japanese Statistics Bureau, Ministry of Internal Affairs & Communications (© 2023)

4 **Ratio of Active Job Openings to Applications vs. Nominal Wage Income**

Nominal, Seasonally Adjusted, Index, As of 12/1/2022



Source: Brandywine Global, Macrobond, Japanese Ministry of Health, Labour & Welfare (© 2023)

BOJ Governor

The news of Mr. Kazuo Ueda's nomination was unexpected by the market. However, Ueda is well respected within the BOJ circle, boasting a strong academic background in macroeconomics, including studying under Stanley Fisher, an Israeli-American economist, former Vice Chair of the Federal Reserve, and former governor of the Bank of Israel, while at the Massachusetts Institute of Technology. Ueda was on the BOJ monetary policy committee in the late 1990s to early 2000s. This experience in setting monetary policy pre-negative interest rate policy (NIRP) and YCC may give him a more balanced view. If anyone has the capabilities to guide the BOJ into a more normal monetary setting, he is likely one of the best candidates.

That said, Ueda may be in no rush to tighten monetary policy from here. He was cautious in 2000 when the BOJ raised rates even as the Taylor rule, a formula equating the policy rate to inflation and economic growth, suggested rates should still be kept low and as the U.S. was entering the dot-com bust. He is likely to be more data dependent, taking into account global factors and the domestic inflation trajectory. Ueda is, however, likely to further tweak YCC due to its adverse side effects on bank profitability and the ongoing deterioration in JGB market functioning.

JGBs and USD/JPY

It is highly possible that this year will see further changes in the BOJ's policy framework via increasing flexibility in YCC, either a further widening in the 10-year trading band or shortening the YCC target from the 10-year to the 5-year. Despite the market pricing in a removal of NIRP by the second half of this year, the removal of YCC and NIRP could more likely be a story for 2024. The BOJ will want to see an entrenched inflation trajectory, beyond energy, and a stronger domestic economy before removing YCC. However, the market

pressure on the BOJ continues with the 10-year swap rate at 0.8% and the swap spread still trading wider than its long-term average (see Chart 5). Still, investors are unlikely to see tremendous weakness in JGBs as long as credit is weak since commercial banks have few alternatives. One needs to be cautious as Japanese banks, with nowhere to put their money, may be buyers of the long end of the bond curve, thereby capping 10-year rates between 0.7% to 1%. Ultimately for the longer end of the curve to steepen, there needs to be stronger bank credit growth and investment opportunities in Japan. The recent loan growth trend is promising but the question remains: How high must credit growth go and how sustainable will it be (see Chart 6)?

5

Japan 10-Year Rate Swap Spread

Last Price, Local Currency, As of 2/24/2023

Source: Bloomberg (© 2023, Bloomberg Finance LP)

6

Japan's Bank Loan Growth

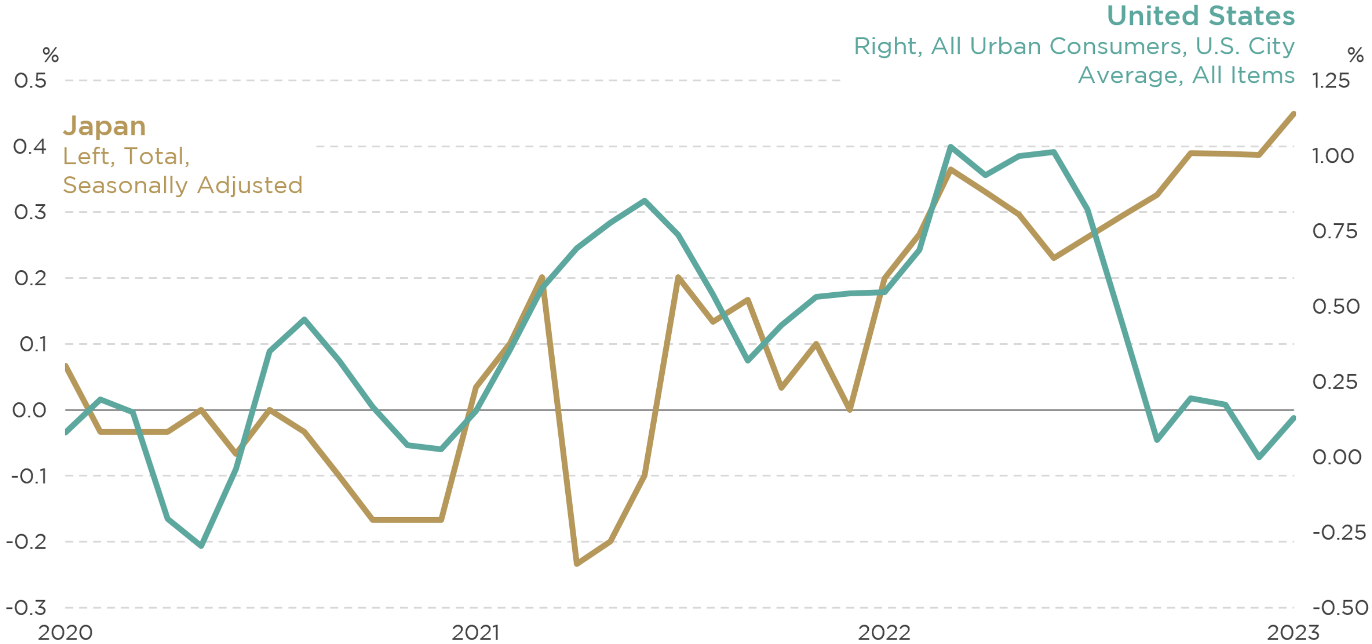
%, Loans Outstanding, All Banks, JPY, As of 1/1/2023

Source: Brandywine Global, Macrobond, Japanese Statistics Bureau, Ministry of Internal Affairs & Communications (© 2023)

For the Japanese yen, despite the near 10% appreciation since the currency hit roughly 150 yen to the U.S. dollar in the fourth quarter of 2022, valuations remain cheap. Recent bumps in U.S. inflation and growth data have shown that the yen is still beholden to U.S. yields. Medium term, the trends in Japanese and U.S. inflation trajectories remain important factors driving the yen. Since September last year, the divergence between Japan's month-on-month headline inflation and that of the U.S. has been stark, with Japan's growing at 0.4% at the U.S.'s at 0.1% (see Chart 7). If Japan's higher inflation trajectory continues while the U.S.'s continues to disinflate, the yen is poised to appreciate. What can potentially turbo-charge that appreciation are further tweaks to YCC or, in the best-case scenario, its removal altogether.

7 Japan vs. U.S. Headline CPI Month-on-Month Growth Rate

%, Consumer Price Index, As of 1/1/2022



Source: Brandywine Global, Macrobond, Bureau of Labor Statistics, Japanese Statistics Bureau, Ministry of Internal Affairs & Communications (© 2023)

Last year, JGB yields and the yen began to show signs of awakening from their slumber. Rising inflation along with a recent adjustment to the target band for YCC and a new incoming governor for the BOJ suggest further changes could be on the horizon. Those changes could trigger appreciation in the yen. Bond yields will rise but yields at the long end of the curve could remain range-bound until credit growth takes off.

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