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MORNING BRIEFING

BOB SAVAGE
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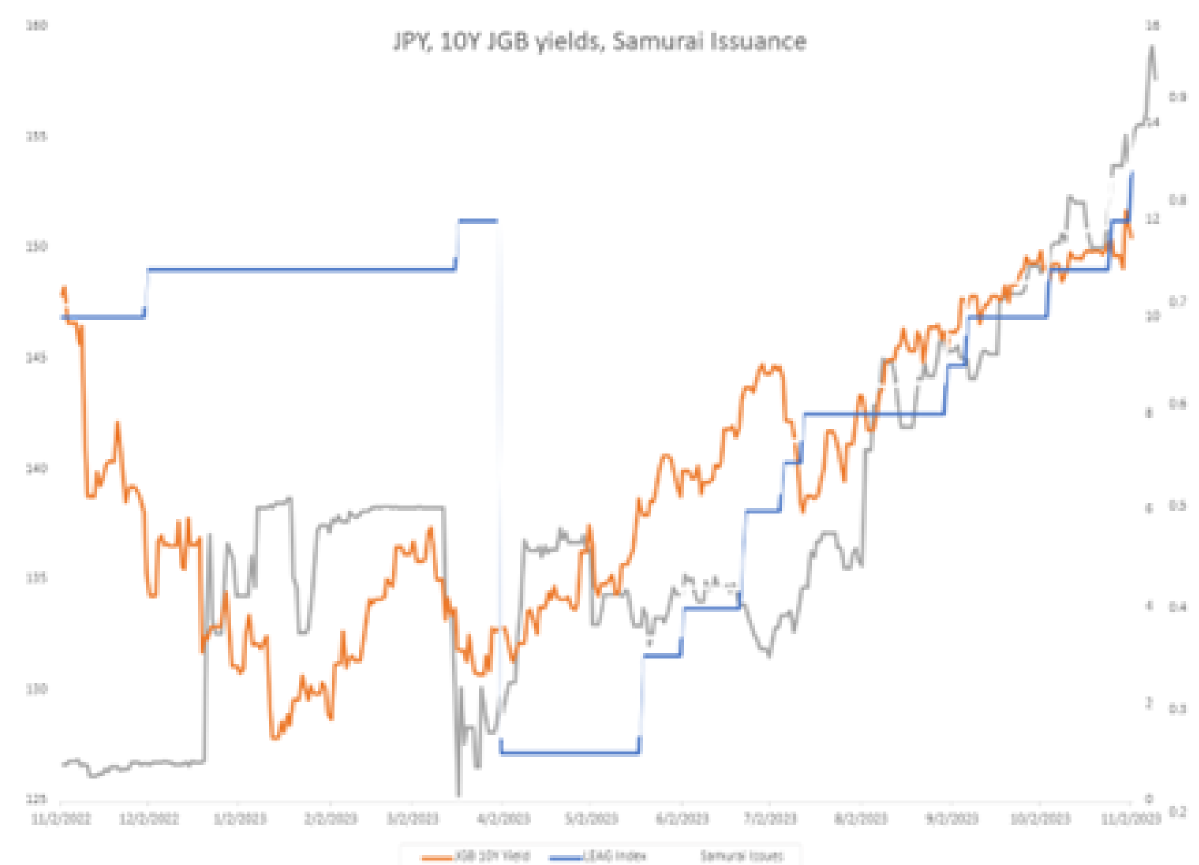
APAC And The Yen

The Bank of Japan surprised markets this week by doing less than expected with its yield-curve control, while raising CPI forecasts and apparently setting the stage for a larger policy move in coming months. Whether the BoJ hikes to 0% and ends YCC for good matters significantly, not just to the yen and Japanese government bonds and stocks, but also for the entirety of APAC. To global bond markets, as well.

Waiting for wages to be over 3% in 2024 may be too costly given that markets view Japan far behind the credibility curve in fighting inflation, which is above the 2% target. There's also the potential mark-to-market hit to the BoJ's balance sheet given its large holdings of government debt. The ability of the BoJ to effectively cap JGB yields has a limit. The forces driving JPY weakness are interconnected to inflation, confidence and politics, leaving time not on the BoJ's side.

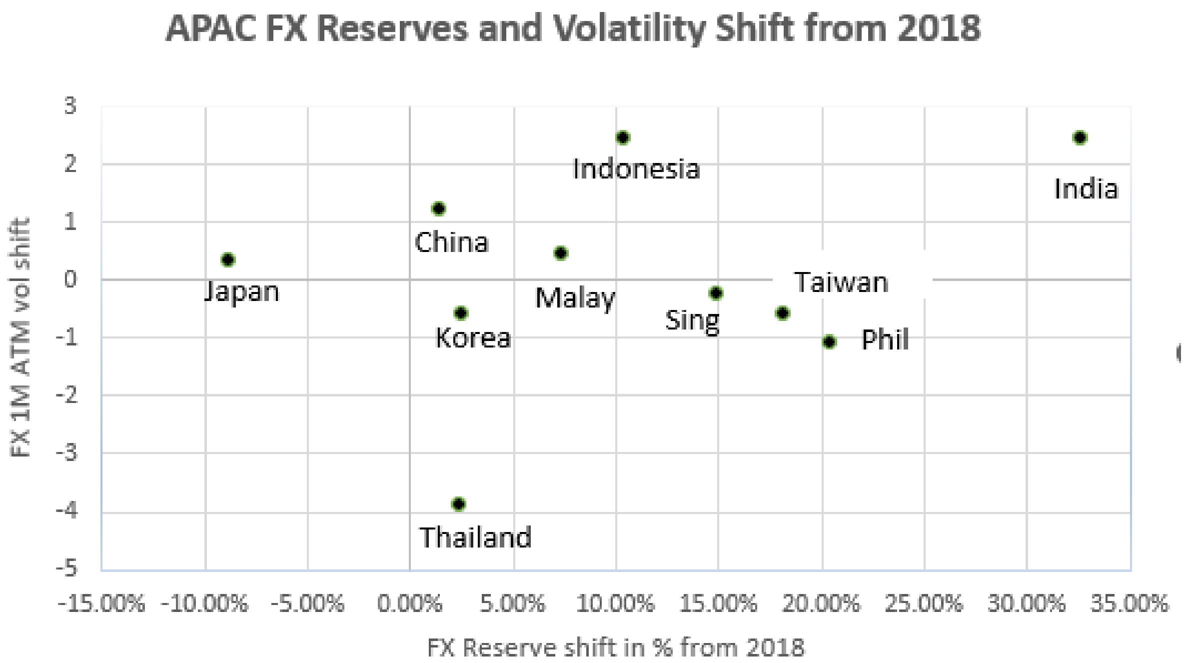
- **The ability of Japan's Ministry of Finance to cap USDJPY at 152 is in doubt**. Markets are setting up for 160 or higher as the real yield differential between the US and Japan widens. The new stimulus package to fight inflation pain on households adds to debt monetization fears.
- **The ability of the BoJ to cap 10y JGB yields at 1.0% is in doubt**. The BoJ's balance sheet and the functioning of the bond market remain market concerns, and intervention in the market has diminishing returns.
- **Japan's stock market has seen a declining benefit from a weaker JPY** driving up exports and the overall economy, as it has been counterbalanced by inflation concerns and falling consumer demand.
- **JPY weakness and negative real rates are attracting renewed interest in Samurai bonds, e.g., Egypt's issue**; 2023 issuance exceeds pre-pandemic highs. This sets up a larger risk-reversal moment in JPY over the next year.

Samurai Issuance Even As JGB Yields Ascend



Source: BNY Mellon and Bloomberg Data

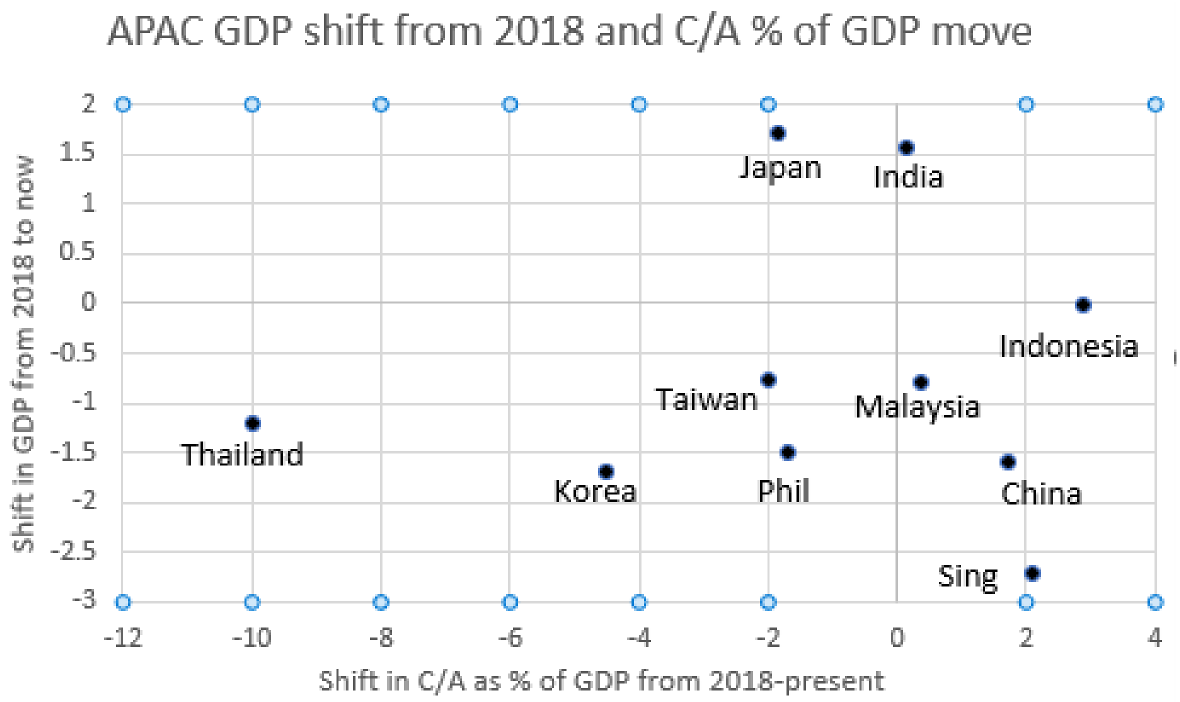
The cost of JPY intervention for Japan's Ministry of Finance is notable when compared to the rest of APAC. FX reserves in Japan are down 10% since 2018. Reserves in the rest of the region have grown modestly, and in some places, like India, the build has been aggressive. The relationship of FX volatility to reserves is an important part of the story this year and next. Reserves that aren't used wisely can lead to a more volatile FX market – Indonesia and India stand out, as inflows into their bonds and stocks have been notable, but so too is their risk of outflows, particularly in a global risk-off situation. Most notable for Japan and its reserve use has been that it didn't help JPY performance, and that hot money buying of Japan stocks related to JPY weakness stalled in the last few months. Smoothing asset flows and calming FX and other volatility are legitimate reasons to use reserves. However, both fiscal and monetary policy must support such efforts.



Source: BNY Mellon and Bloomberg Data

Japan's balance-of-payments story has less to do with foreign interest in Japan assets and more to do with what happens at home. The role of hedging foreign bond holdings and the JPY is one part of the FX story. Notably, life insurers' asset management of such hedging has pushed back on the new cost of hedging. The US bond market is still attractive, but they see hedging back to JPY as not worth the cost – something that we think sets up the market for a more dramatic USD drop in the months ahead. The timing for any pivot in JPY is complicated by many factors, including Fed policy, US fiscal policy, and how the APAC region performs. Japan's ability to grow faster and have nominal GDP over 4% appears to be linked to its own fiscal progress, which most see as unsustainable. The IMF projects Japan 2023 GDP at 2% and CPI at 3.2%, with GDP slowing to 1% in 2024 and to 0.4% in 2025, while inflation slows to 2.9% in 2024 and 1.6% in 2025. The implications for the nation and the policy mix ahead are clear.

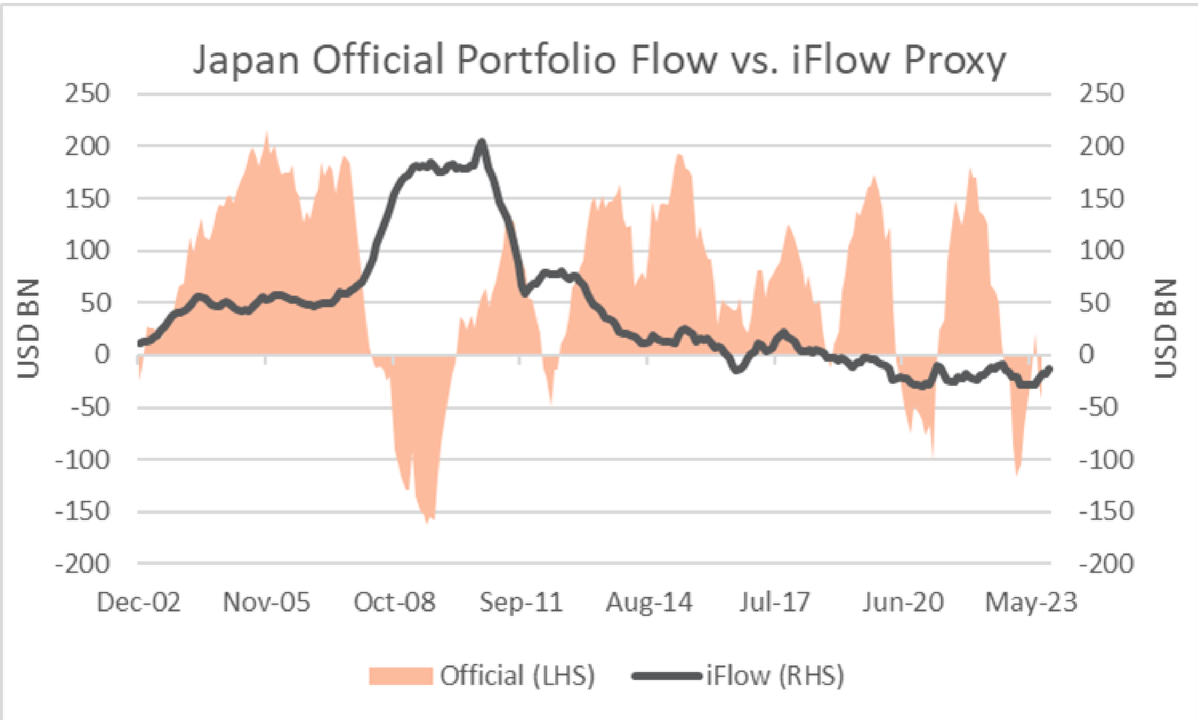
Japan Has Grown The Most In 5 years, But C/A Negative



Source: BNY Mellon, Bloomberg Data

Aside from in Japan and India, growth elsewhere in APAC has struggled. The demographic contrast of India versus Japan stands out in that growth surprises and the current account swing lower in Japan. This should be worrisome to policymakers as it suggests JPY weakness has a limit. Similarly, SGD, CNY and IDR look overvalued. The chart below – iFlow bond and equity flows (mostly cross-border) vs. Japan balance of payments – makes clear that foreigners are not interested in Japan assets despite the weaker JPY. This leaves open questions about the current account, the government deficit, and the inflation risks ahead.

Japan Cross-Border Flows Are Negative



Source: BNY Mellon, Macrobond

Please direct questions or comments to: iFlow@BNYMellon.com

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