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MACRO MORNING BRIEFING

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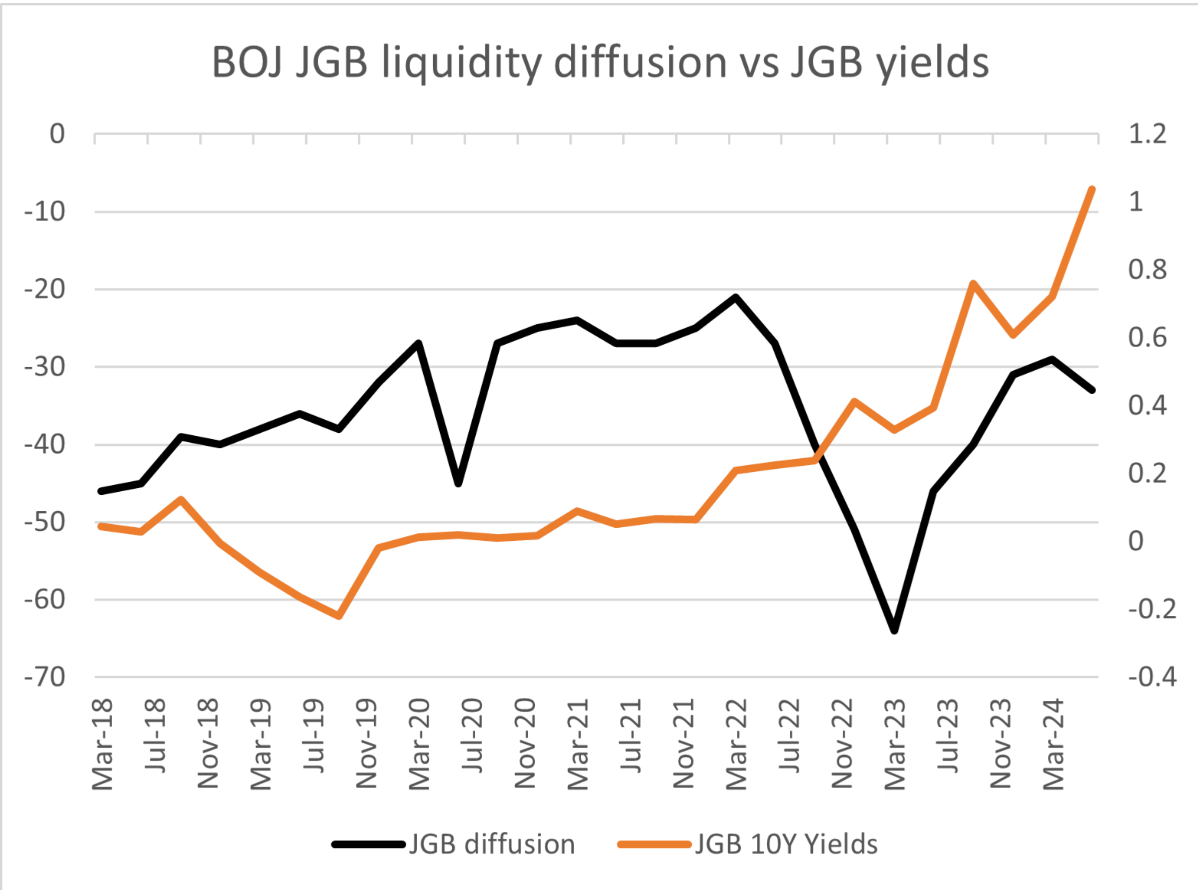
Japan, Its Central Bank And The Yen

Divergence in the paths of monetary policies has been a consistent theme across markets this year. The Bank of Japan's role in global markets has been muted since its policy moves in March. Viewed as more important because it helped cap US dollar strength against APAC currencies was further intervention by Japan's Ministry of Finance in early May, i.e., spending $62bn to hold USDJPY below 160. The role JPY weakness plays in global markets is a familiar discussion topic. The role Japanese bond yields play, not so much. We see a clear risk of disruption to European and US bond markets were 10y Japanese government bond yields to reach 1.5%. We suggest considering this into the BoJ's impending policy decision.

- **We see a need to act – if not this time, then guiding to action in July.** The BoJ on Friday (local, June 14) is widely expected to taper quantitative easing further, if not end bond buying altogether. There is a small chance of another rate hike – overnight indexed swaps (OIS) price a further 22bp of tightening to year-end, with a 50% chance of +15bp for September. A lack of rate action likely translates into a weaker currency. Our iFlow data shows clients short JPY and adding to those positions, just like in AUD and NZD. SEK and CHF buying, meanwhile, appears to be covering shorts.
- **The BoJ is expected to taper JGB buying with a more definitive plan to reduce its balance sheet**. The BoJ kept bond buying plans steady in April after the rate hike in March but has since cut back its purchases. The functioning of the JGB market is clearly not as much of a worry as it has been in the past. The long-term correlation of 10y JGBs to 10y US Treasuries or UK Gilts is 0.38%, while the recent rolling one-year correlation drops to 0.15 for the US and 0.2 for the UK. Europe is far less dependent on Japan flows: long-term Bund correlation is just 0.19 to JGBs.

- **Domestic banks are a key focus given their foreign bond buying and domestic lending**. The role of rates for banks in Japan is another concern for the BoJ decision, as the sharp rally in Japan bank shares in 2023 (up over 60%) has stalled in 2024. The US term risk premium along with the Japan basis and the shape of the Japan curve are also part of the equation for the BoJ. Foreign currency-denominated assets account for 35-40% of the megabanks' earnings. However, smaller banks in Japan may face deleveraging from US and UK bond holdings. Japan's holdings of Treasuries are a key part of the storyline on JPY risks ahead.
- **Implication: we see potential for a 20% JPY correction vs. USD, to USDJPY 130, in the next year.** The role of JPY in the BoJ decision is important, but JPY weakness has many drivers beyond BoJ rates and US bond buying. Gold and its relationship to JPY is also worth considering as it captures doubts around fiat currencies, along with geopolitical concerns. The Osaka exchange has 1y forward gold higher and JPY lower. The role of gold in global central bank reserves is one factor, and the push to diversify reserves to currencies other than EUR and USD is another – with AUD, CAD and CNY clearly on the rise. JPY and GBP holdings could also increase.

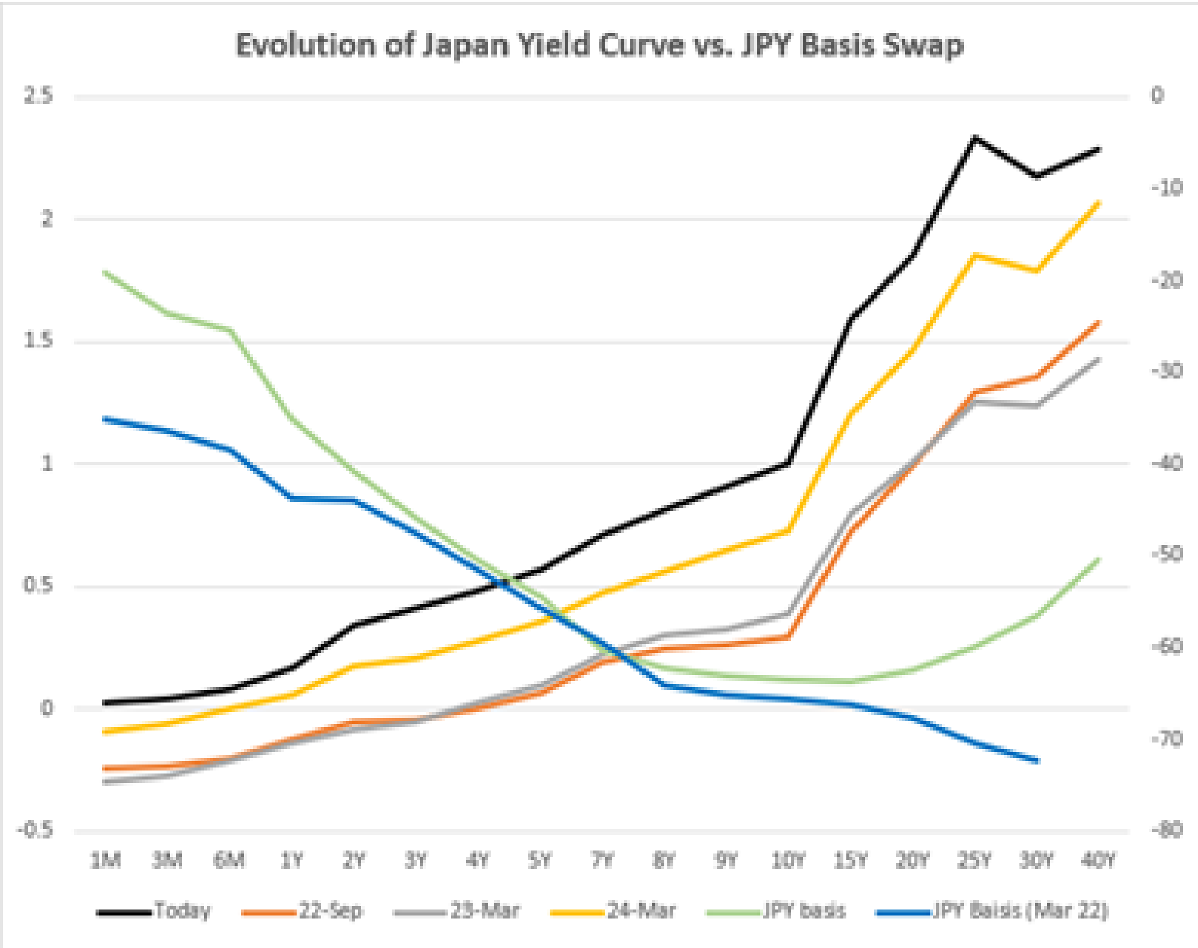
Exhibit #1: JGB Liquidity & Yields



Source: BOJ, Bloomberg, BNY

The BoJ bought only ¥4.5 trillion ($29 billion) of government bonds last month, the least since March 2013. The rolloff of bonds from the BoJ is key to the curve as the duration of the BoJ balance sheet is 8+ years. BoJ Governor Ueda clearly wants to have markets determine long-term rates. Speaking in parliament, Ueda said the BoJ has maintained its ¥6 trillion ($38.7 billion) April monthly pace of bond buying to avoid causing any market disruptions from the decision in March to exit its massive stimulus program, that shifted in May and its up for another shift in June. There will likely be debate on Friday about how to exit bond buying with a clear tapering process to avoid "discontinuity." Whether 10y JGBs yield 1.0% or 1.5% arguably matters less than the success of JGB auctions and volatility measures in the speed of change for bond purchases. The larger problems start with the rising cost of debt service for the government and continue with the negative earnings of the BoJ.

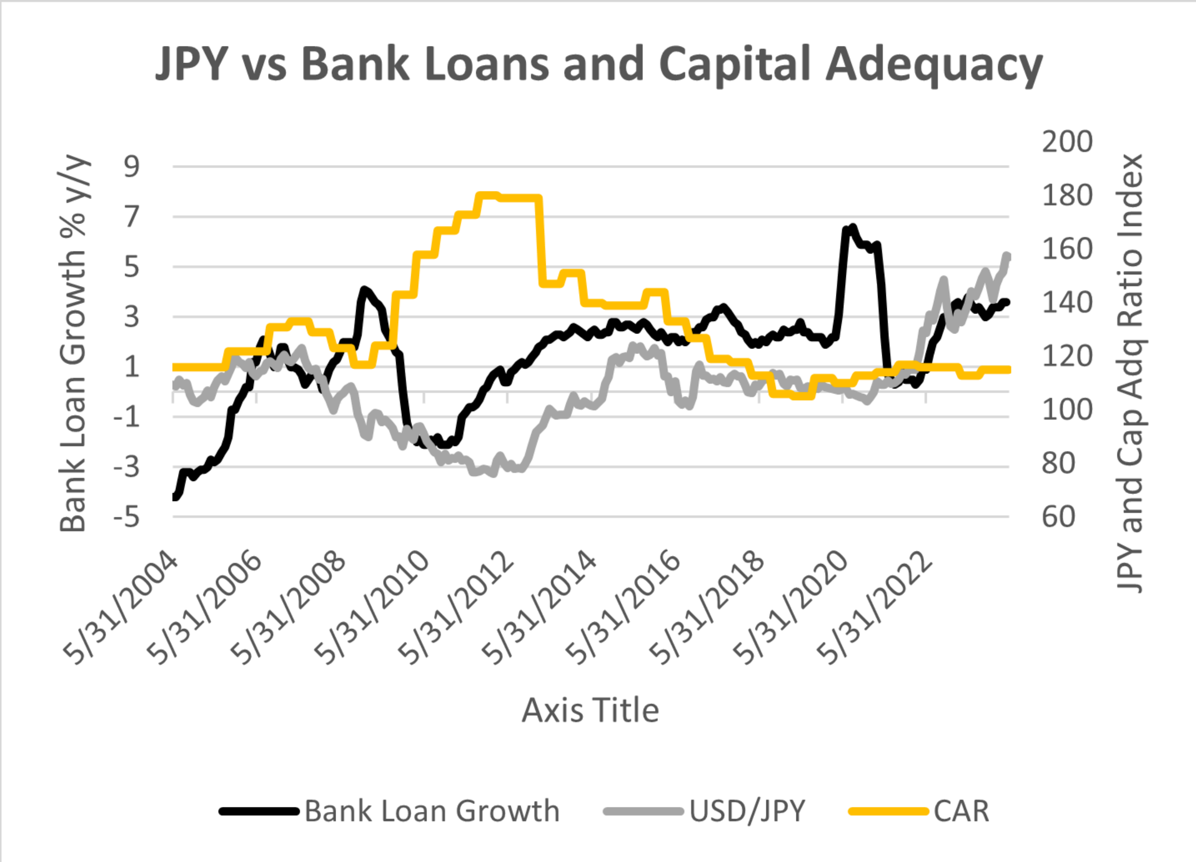
Exhibit #2: Japan Yield Curve & Basis Swaps



Source: BOJ, Bloomberg, BNY

The health of Japanese banks and the growth of Japan's economy also matter. Part of the BoJ decision hinges on financial conditions with equities up-JPY down linkages being questioned. Foreigners who have to decide on JPY hedges appear confused with the MoF intervention and the degree of JPY undervaluation. The Japan bank stock index was up 61% in 2023, beating the TOPIX, up 29%. The key question for USDJPY and for Japan assets revolves around the 'home bias' push from Japan and the government. Keeping banks healthy and encouraging them to lend at home rather than abroad might be the key for JPY gains into the future.

Exhibit #3: JPY & Japanese Bank Loans

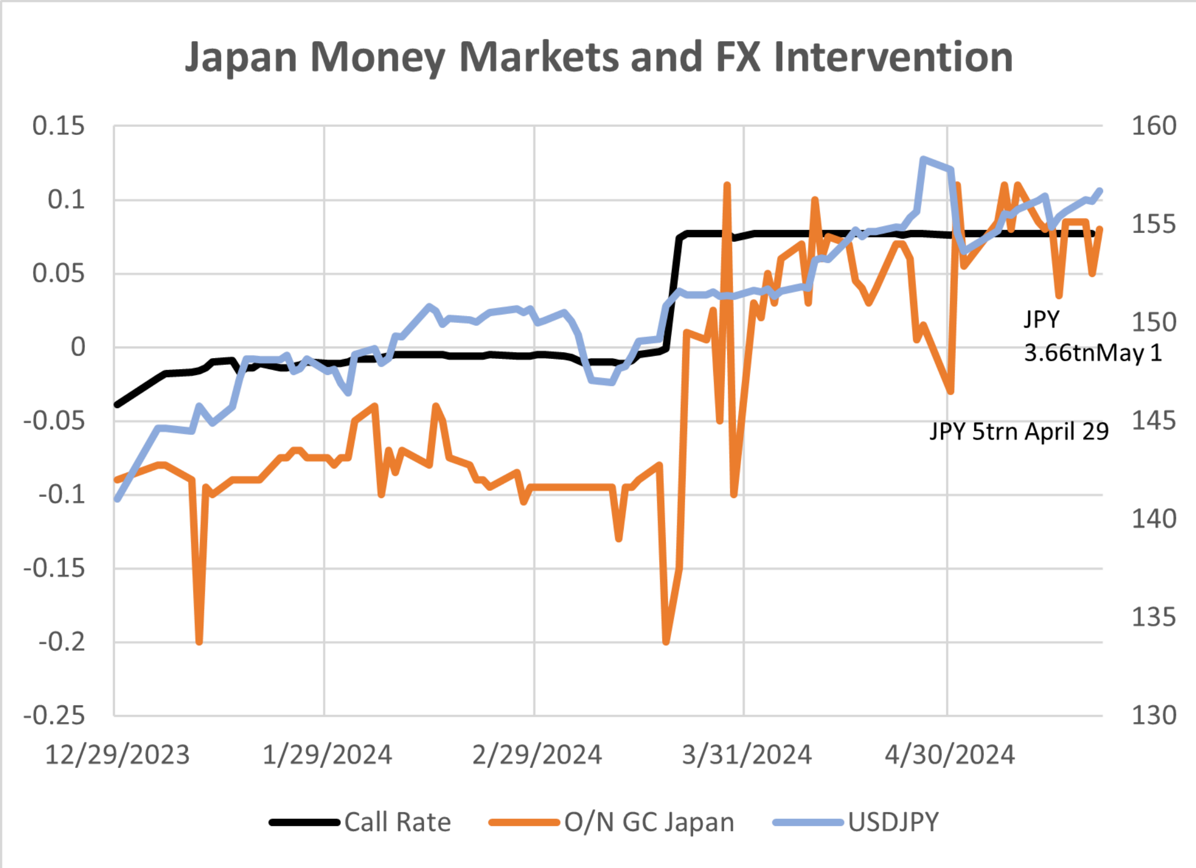


Source:BOJ, Bloomberg, BNY

Bottom Line: Historically, JPY hedging by foreigners for investments in Japan equities have had a 20% ratio. The correlation between USDJPY and the Nikkei has been significant, around 0.31, but in the last two years this drops to 0.11 and now matches US and Japan rate factors as a driver. The implication: the BoJ has less to worry about hurting the stock market or financing by hiking rates here. The baseline Taylor Rule for average rates in Japan over the last 30 years is 1.85%. The current rate is 4.5%. Given the higher wage agreements, the output gap closed and CPI over the 2% target, higher BoJ rates should be expected. Add in imported inflation from JPY weakness and the disruption it causes for domestic production and capital flows and the BoJ may have a more urgency to act than the market now prices.

The GC rate and intervention correlate – but clearly JPY moves now on Rinban (BoJ bond buying operations) and just how big those operations are. BoJ officials think they can rely on bonds that they hold maturing to gradually shrink the central bank’s vast portfolio. Annual maturities from the portfolio will run at about ¥70trn ($447bn) during the next few years. With the BoJ buying bonds at barely that pace, small adjustments to the purchase schedule could tip the portfolio into decline.

Exhibit #4: JPY Intervention Risk & Japan Money Markets



Source: BOJ, Bloomberg, BNY

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