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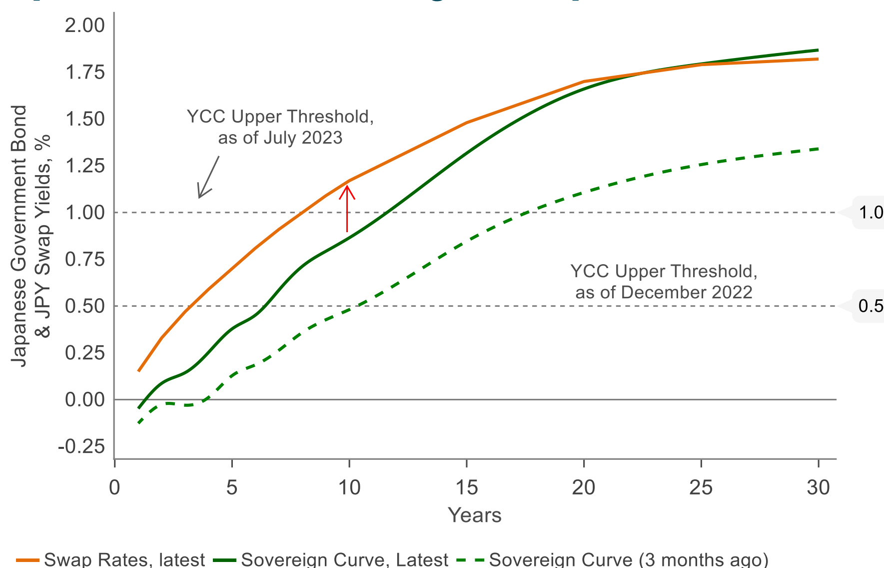
POINTS OF VIEW: JAPAN'S YIELD CURVE CONTROL – BIDDING A LONG GOODBYE

Global Economics & Investment Analysis, October 25, 2023

Summary of our main Points of View:

- **Underlying inflation in Japan is becoming more persistent** and yearly core inflation, at more than 4%y/y, is now running higher than in the U.S.
- **Not normalizing faster, is becoming riskier**. Wide policy and yield differentials are weighing on the yen and passing through to inflation faster than wage increases. The collapsing yen is also eroding the popularity of the government.
- **Any remaining monetary policy doubts about slow wage increases are likely to be surmounted** by domestic resilience in services, and more vociferous demands for higher wages which are increasingly backed by the Kishida administration.
- **We do not think the Bank of Japan is about to dismantle its Yield Curve Control (YCC) framework** just yet (no imminent goodbyes), **but further upward tweaks are likely before this year is out**.
- But **even an upward tweak in the YCC and an orderly rise in Japanese Government Bond (JGB) yields may not stabilize the USDJPY** (dollar-yen) exchange rate. A Fed pivot toward policy easing may also be needed.
- **Unpredictable near-term exchange rate dynamics also keep us tactically neutral on Japanese equities** (except for Japanese bank stocks), even though long-term fundamentals seem increasingly attractive.
- **Higher onshore Japanese yields are unlikely to drive a renewed exodus of Japanese fixed income investment abroad.**

Figure 1: Another hike in the YCC threshold is likely, but YCC won't be dismantled.



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Efforts to re-ignite inflation in Japan have been successful by most objective measures. But **The Bank of Japan's (BOJ's) inclination to patiently stay the course, to seek corroboration of the medium-term staying power of domestic price dynamics, have been upended** by global developments.

For instance, the spike in US Treasury yields since August has exceeded the orderly run-up in Japanese long rates. Moreover, crude oil prices have surged on supply constraints and, most recently, on heightened geo-political uncertainty in the mid-east.

These developments have resulted in a steep depreciation of **the USDJPY (dollar-yen) exchange rate which has slumped 14% in the YTD and 30% since the start of 2022**.

Currency weakness boosts corporate earnings. Larger Japanese conglomerates, with a global footprint, have reaped sizable translation gains from a cheaper yen. It also boosted the services sector, with global tourism drawn to one of the most attractive locales at rock-bottom prices.

But **large-scale yen depreciation is politically unpopular**. It is worth noting that Japan remains heavily dependent on imported commodities. It imports 80% of its energy requirements and 70% of its calories. Much more so than the US or even Europe.

In this backdrop, any commodity price spike -either through an increase in the price of the underlying commodity, or a depreciation of the yen- pushes up import costs and hurts the budgets of low-income households the most. Polling undertaken by Japan's NHK news shows Prime Minister Kishida's approval rating has ebbed to around 35% in September from around 60% when he took office in July 2022.

To be sure, **nominal wage increases have helped but they have not been sufficient**. Wages have risen the most for part-time (gig) workers. But the benefits for full-time workers have been slow in coming. For instance, monthly wage increases so far this year have averaged 1.4%y/y a fair bit slower than the BOJ's 2% inflation target and well below the 2.5% to 3% wage hike agreements reached, between business and labor, this past spring.

What all this implies is that real wage growth, for full-time workers, has taken a knock. Negative real wage growth has made the government nervous. **Amidst the risk of a 'cost of living' crisis, Japan's government has become understandably anxious** about additional sources of inflation shocks.

In particular, **the Japanese ministry of finance (MOF) has become more vocal about the sinking yen**. They have threatened to intervene in foreign exchange (FX) markets as the yen hovered around the psychologically important 150/USD threshold. **Government officials have also put together a supplementary budget -containing personal income tax cuts, and extensions of energy subsidies-** to defray households' mounting cost of living burden.

However, we believe FX intervention or fiscal handouts are ultimately not a panacea. They only address the symptoms of a fundamentally weak FX rate. Or they could even prove counterproductive. For instance, supplemental fiscal spending could force the BOJ to step up purchases of additional Japanese Government Bonds (JGBs). That would further expand its balance sheet and -amidst quantitative tightening at other major central banks- could end up weakening the yen even further.

But the need for Japanese officials to be seen as "doing something" has grown. Many market participants also now realize this, and calls have risen for the BOJ to move further and faster in tweaking the YCC and narrowing the 10-year yield gap with US Treasury yields.

Our own view is that **there is scope for the BOJ to deliver additional upward tweaks to its yield curve cap**, but likely not end the yield-curve targeting altogether. This is for four crucial reasons.

First, underlying wage increases are still ongoing. Cash wage increases have slowed in recent months on account of a fallback in bonuses and special payments, especially in the manufacturing sector, where activity has softened a bit in recent months. But contractual wages across services are still rising.

Second, corporate profits have risen to near-record levels (see figure 2, below). Alongside business (Tankan) surveys showing tight labor market conditions, this has risen to louder demands for -and promises of- further labor wage increases. Indeed, country-wide minimum wage growth has picked up to around 4.5%y/y, its fastest pace in decades. Moreover, according to reports from the Yomiuri newspaper last week, the Japanese Trade Union Confederation, or Rengo, is laying the groundwork for demanding a wage hike of "5 % or more" in the 2024 "Shunto" labor-management wage negotiations. The language around wage demands is hardening and is increasingly backed by the government.

Third, underlying inflation has remained sticky with core inflation running above 4% without a let-up in the momentum. Recent news articles from Bloomberg also highlight that the BOJ may be considering raising its 2024 inflation forecasts (of core and headline) to above 2%y/y, signaling greater faith in the durability of higher inflation.

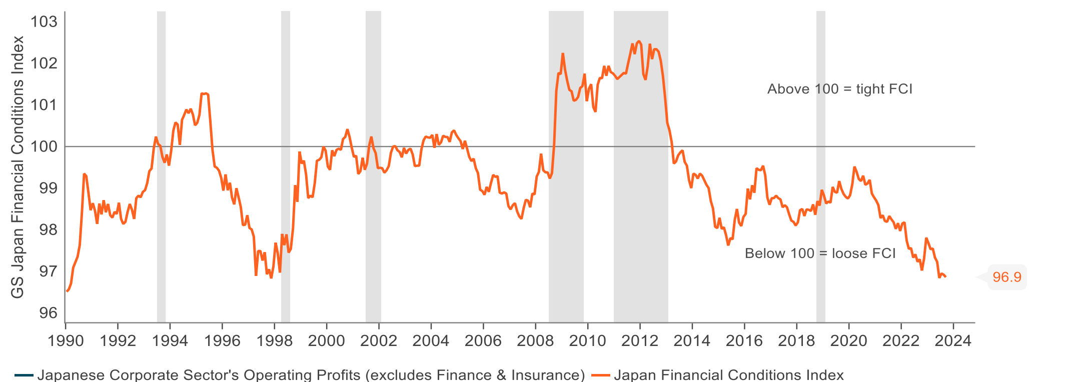
Fourth, overall "loose" financial conditions have not changed very much at all since the BOJ's last YCC tweak at the end of July (see figure 2, below). Real (ex-post) rates, adjusted for realized inflation, have turned more negative; stock market buoyancy has come off, but Japanese equities have outperformed most major bourses; and the currency has cheapened further. Moreover, financial buffers have not eroded. For instance, Japan's bank-deposits-to-GDP ratio is running relatively higher, since the onset of the pandemic, than other major advanced economies --highlighting a deeper pool of economy-wide 'excess savings.'

Figure 2: Rapid recovery in corporate profits amid loose financial conditions

Japan: Corporate Profits & Financial Conditions

Corporate profits recover much faster after the pandemic, than it did after the GFC

Financial conditions remain extremely loose despite recent YCC tweaks in Dec'22 and July'23



Source: Macrobond, BNY Mellon Investment Management
Data as of Tuesday, October 24, 2023

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Despite all these reasons, **the BOJ would undoubtedly like more time to ascertain the materialization of higher wages**. So, it makes sense to retain a vestige of control over the sovereign bond yield curve.

But we doubt if it has the luxury of waiting interminably. This is because of manifestly higher political and financial pressure on it for anchoring the value of the yen, and considering the policy space, which we think it does have, for such an undertaking. As such, we do not rule out the possibility of one more upward YCC tweak before the year is out.

A shift higher in the current yield-curve cap could also be justified by considering a modified Fisher hypothesis, which states that nominal rates should equal the real rate plus expected inflation. BOJ officials often explain that an approximately 0 percent "neutral (or natural) rate," plus their 2 percent inflation target, minus 1 percent for YCC, should equal about 1 percent: that's precisely where they've set the yield curve cap, since July this year. But the global neutral rate itself may be on the way higher, led by U.S. rates, as we point out in our work on r* (forthcoming). In such an event, there is room, in our view, for greater flexibility and upward adjustments to the YCC threshold.

Whether and to what extent another upward YCC tweak actually stabilizes USDJPY exchange rate also depends on what happens with U.S. interest rates. The main driver of the USDJPY exchange rate, since Fed policy began tightening in March 2022, has been the US Treasury (UST) – Japanese Government Bond (JGB) 10-year yield differential.

Assuming other influences to be constant, or less impactful, **we estimate that every 1% widening (or compression) of the 10-year JGB-UST yield differential results in a 14-yen depreciation (appreciation) of the bilateral exchange rate.** Table 1 below summarizes various plausible permutations of UST and JGB rates, and the resulting USDJPY outcomes. For instance, if 10-year UST yields were to rise to 5.5%, from its current level of 5%, and similar tenor JGB yields rose to only 1%, from 0.75%, then the USDJPY exchange rate would weaken to 154 from its current level of around 151.

Table 1: Plausible USDJPY Outcomes

10-Year JGB Yields, %	10-Year U.S. Treasury Yields, %								
	3.50	3.75	4.00	4.25	4.50	4.75	5.00	5.25	5.50
0.00	141	144	148	151	154	158	161	165	168
0.25	137	141	144	148	151	154	158	161	165
0.50	134	137	141	144	148	151	154	158	161
0.75	131	134	137	141	144	148	151	154	158
1.00	127	131	134	137	141	144	148	151	154
1.25	124	127	131	134	137	141	144	148	151
1.50	120	124	127	131	134	137	141	144	148

Source: BNY Mellon Investment Management, author's calculations, October 23, 2023

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In the remainder of this year, we think higher for longer U.S. rates amidst American macro exceptionalism, imply the yen probably gets a bit weaker before getting stronger. But small-scale and un-announced FX intervention by the Japanese MOF may slow any big directional movements.

As such, **precisely timing a turning-point in the path of the USDJPY exchange rate, or its magnitude, has grown exceedingly difficult**, though, we still believe that a peak in Fed policy (or a pivot to easing) by mid-2024 coupled with a higher JGB yield-cap will strengthen the yen in the

second half of next year. But for now, we would stay away from suggesting yen-funded carry trades or going long the yen right away even though it screens as an oversold currency.

The unpredictability in the near-term outlook for the yen has also kept us tactically neutral Japanese equities. Large-cap companies have clearly benefited from yen weakening, and Japanese indices have outperformed the S&P in the YTD, as well as most other developed market equities. But much of the outperformance, of MSCI Japan (& Nikkei), in our view, has rested increasingly on yen underperformance. That could be about to turn in coming months. What is more, the correlation between a weaker yen and rising profits and equity prices also suggests an ability of the corporate sector to pass on higher import costs to the retail level. In other words, the FX-wage-price spiral is in full swing.

However, as we highlight in our Q4'23 Vantage Point asset allocation section --**we do, like Japanese equities on a strategic basis** on improved governance, widening income streams, share buy-backs, and long-term benefits from re-shoring and automation. We will have more to say on these topics in coming months as we await clearer fundamental catalysts and better entry points.

For now, the one area of the Japanese equity market we clearly prefer are the local banks which are poised to continue reaping the benefits of higher long rates and a steepening yield curve. Wider interest margins and cheap valuations keep us tactically and strategically bullish. We doubt if the BOJ will alter its negative interest rate policy (NIRP) anytime soon. Not while they remain skittish about the medium-term sustainability of wages and inflation, even though 1-year JPY swaps have begun pricing an end to NIRP in the year ahead (see Figure 1, again) and which will raise the banks' funding costs.

One question we often get asked is whether higher onshore Japanese yields will result in a large drawdown by Japanese investors of their holdings of U.S. Treasuries? The short answer is not necessarily. Exorbitant foreign-exchange hedging costs and higher JGB yields will undoubtedly attract larger hold-to-maturity inflows into JGBs from life insurance companies and local financial institutions.

Our view on this is that these need to be weighed against Japanese investors' return expectations on U.S. Treasuries and other foreign bonds, adjusted for hedging costs. We have been tracking net fixed income flows (into and out of Japan) closely, and we find that net JPY outflows are picking up gradually as Japanese investors themselves see a peak in global rates in the months ahead. This is also corroborated by data from the U.S. Treasury (Treasury International Capital, or TIC data) which show a slow recovery in Japanese holdings after a steep drop in 2022. See figure 3 below.

High hedge-costs are undoubtedly an inhibiting factor. **However, we think that -if 10Y JGB yields settle around 1%- a reasonable (duration) return requirement, for Japanese investors, on U.S. Treasuries, could be around 3% to 3.5% in the months ahead** to justify rebuilding positions in USTs. This comprises:

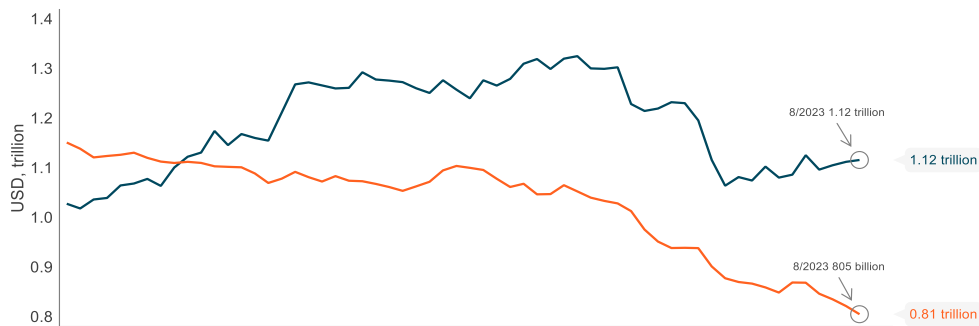
- An FX hedge cost of around -5% (entirely attributable to higher short-term US deposit rates over their Japanese equivalent).
- Higher bond carry of around 4% (the difference between 10-year UST and 10-year JGB yields).
- Required UST duration gains of at least around 3% to 3.5% (or 40-50bps rally in UST10-year yields with a duration of around 8) –to offset the negative FX carry and onshore opportunity cost of an assured 1% hold-to-maturity return on long JGBs.

We don’t think a 40-50bps duration rally, in the year ahead, in U.S. rates is out of the pale, after Fed rates have peaked and if the U.S. economy eventually slows. **As such, we doubt the plausibility of a renewed large-scale sell off in USTs by Japanese investors.**

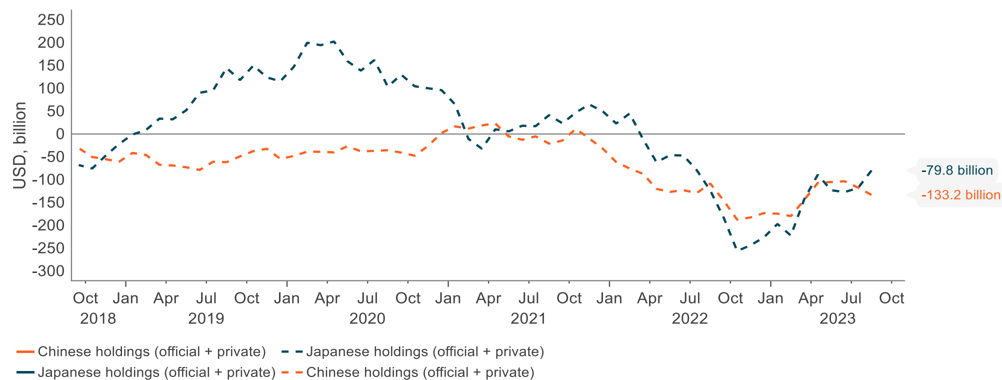
Figure 3: Japanese flows into USTs slowly recovering, peaking US rates unlikely to set off a renewed sell-off.

Holdings of US Treasuries by China & Japan

Total holdings of US Treasuries



One year change in holdings of US Treasuries



Source: Macrobond, Treasury International Capital (TIC) System
Data as of Monday, October 23, 2023

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