CORE MATTERS

Despite higher inflation the Bank of Japan will stay accommodative – Key rates and JGB yields to move little

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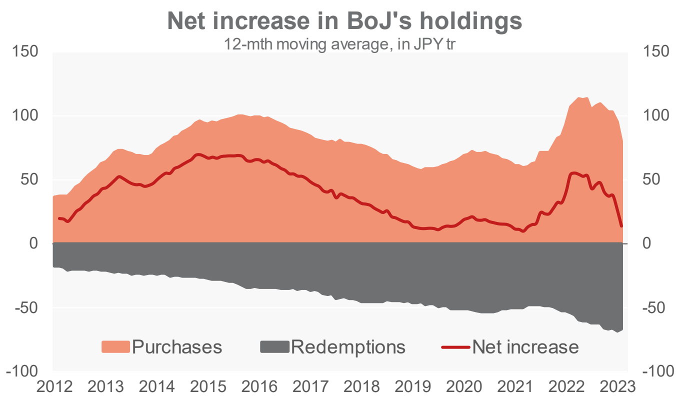
Our Core Matters series provides thematic research on macro, investment, and insurance topics

- The Bank of Japan (BoJ) has stressed that inflation is driven by a supply shock, which is no good basis to establish the much-wanted positive wage-price cycle. As real household income decreases, inflation tends to die out.
- However, the recent inflation bout has cut into traditional price stickiness and thus may contribute to more active price setting. For this to happen, the recent first round of higher inflation and wage needs to be nurtured, i.e. the first cost-push inflation needs to be transformed into a virtuous demand pull-driven cycle. This warrants – at least for some time – strong monetary accommodation. Thus, we forecast the BoJ to stick to very loose QQE as its main policy tool over the next years. Over the longer run, we remain sceptical that the BoJ will sustainably achieve its 2% inflation target.



Source: Datastream, GenAM

- One reason is the failure of the Kuroda BoJ's massive monetary easing to live up to expectations. The current Ueda BoJ has also to assess the results of previous policies, and the side effects of the Negative Interest Rate Policy (NIRP) and Yield Curve Control (YCC). Scrapping these policies needs good reasoning, for which we see – with high uncertainties - a good window of opportunity in April. In its more fundamental policy review, Ueda will stress that the operating environment of monetary policy has improved and thus will "only" simplify the structure of the monetary policy tools.
- Hopes of higher inflation have pushed up key rate expectations and on longer-dated Japanese government bond yields (JGBs). But, given the lack of significant increases in key rates, the further expansion of the BoJ's JGB portfolio, and the expected downtrend in global yields, we forecast that there will be no further sustained increase in JGB yields. Instead, we expect a slight decline in long-dated JGB yields in the medium term. This reduces the risk of Japanese investors massively withdrawing funds from higher-yielding overseas bond markets, which could disrupt global bond markets.
- Even if the BoJ's monetary tightening falls short of market expectations, the end of NIRP and YCC combined with the Fed's key rate cuts will be enough to trigger a moderate appreciation of the Yen.

CONTENT

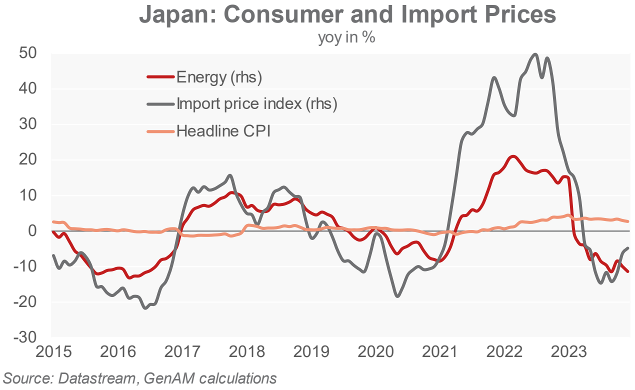
After years of ultra-loose monetary policy in an attempt to eradicate deflation, Japan recently experienced its highest inflation rate for decades, caused by the combined effects of the global energy crisis and the depreciation of the yen. Nevertheless, Japan has never reached the high inflation rates of its Western peers and inflation is now back on a downward trend. The Bank of Japan (BoJ) has repeatedly emphasised the supply-side nature of the inflationary impulse, which, given the risks of stagflation, is a shaky basis for establishing the desired virtuous wage-price cycle. The BoJ's task is thus different from that of other central banks. Hence, the BoJ has maintained a very loose monetary policy stance. In our view, to keep the wage-price cycle going, the BoJ needs to expand the money supply at least by the target rate of nominal potential growth (potential growth plus target inflation of 2%). Given the structure of the BoJ balance sheet, it has no choice, in our view, but to keep its Quantitative and Qualitative Easing (QQE) programme as its main policy tool. We advance this argument more fully in chapter 1.

The next two chapters discuss the Ueda BoJ's analysis of the failure of the Kuroda BoJ's ultra-aggressive monetary expansion. We expect some "normalisation" of monetary policy tools and see the expected exit from the Yield-Curve-Control (YCC) policy and the Negative Interest Rate Policy (NIRP) less as steps of monetary tightening than "scrapping" some of the "excesses" of the Kuroda policy which were not worth their negative side effects. But the NIRP is a high-profile policy that needs careful reasoning and justification. The BoJ would want to make sure that the still infant stage of a possible virtuous wage-price cycle will not be cut off prematurely (chapter 2). Governor Ueda also announced in April 2023 to perform a broad review of monetary policy over the past 25 years within 1-1.5 years. This would invite a fundamental discussion of why the Kuroda BoJ policy could not live up to expectations. However, we expect its focus to be narrow, on the changing operating backdrop of monetary policy and the simplification of policy tools (chapter 3).

Finally, in chapter 4, we analyse the implications for financial markets. We show that market participants' expectations that the rise in yields that began in 2022 will continue are overdone, given the lack of support from the BoJ's policy rate hikes and the expected decline in global yields. While yields on short-dated bonds are likely to remain near current levels, we see yields on long-dated bonds declining slightly. Conversely, the JPY is likely to reverse its trend and appreciate moderately in the coming years.

1. The BoJ's monetary policy backdrop: Why QQE will be kept

Japan's current monetary policy under the helm of Governor Kazuo Ueda is still very much coined by the ultra-loose monetary policy stance introduced under his predecessor Haruhiko Kuroda, whose term ended after 10 years on April 8, 2023. We list the basic tools in Box 1. Its monetary thrust – as part of PM Shinzo Abe's "three arrow" concept – was the belief that a massive monetary impulse could eventually lift Japan out of deflation, which is why the Kuroda BoJ put monetary policy tools into extremes. Conceptually, the Kuroda BoJ built its policy on a demand-pull type of inflation. Stepping up money supply was intended to create rising demand via private consumption, investment, and exports (via c.p. yen depreciation), which would in turn increase inflation and generate higher (nominal) corporate profits. This then would lay the basis for rising wages, which again supports demand, the starting point for maintaining higher inflation and a virtuous cycle. (At least) over time, inflation expectation would adjust, lifting wage increases and inflation to a higher equilibrium.



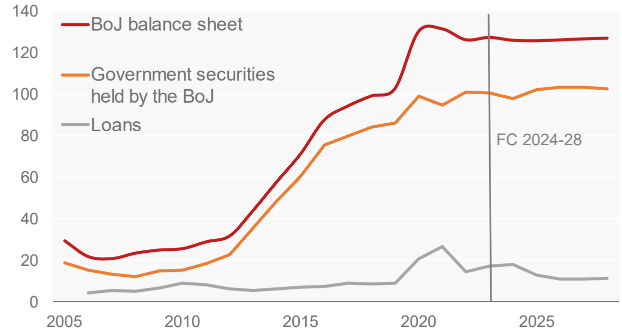
Source: Datastream, GenAM calculations

This policy approach has not lived up to expectations. The Ueda BoJ is not only tasked with reassessing the effectiveness of the policy but also faces a quite different starting point. The current inflationary impulse is not generated by a demand-pull but by a supply/cost shock (a point Gov. Ueda has always stressed). In 2023, wages already picked up, but workers' real compensation fell, torpedoing the necessary increase in real consumption needed for a rise in demand that would keep inflation going.

> *The BoJ balance sheet rose to 132% of GDP*

Nevertheless, current inflation is sometimes referred to as Japan's chance of a lifetime. The cost-push impulse could raise inflation expectations and wage growth to a higher equilibrium, with easy monetary policy preventing a pullback in inflation expectations as purely supply-side inflation (stagflation) dies out. Thus, monetary policy must at least "feed" the expansion of the targeted nominal GDP growth rate. In line with IMF data, we see real potential growth declining from currently around 0.9% to around 0.4% by 2028. We assume that the inflation target will be maintained at 2% so that the targeted nominal GDP growth rate will decline from 3% to around 2.5% by 2028.

BoJ balance sheet
in % of GDP



Source: IMF, GenAM calculations

The BoJ's balance sheet (broadly speaking, the monetary base) expanded under Kuroda from around 32% of nominal GDP in 2012 to about 100% pre-Covid and just under 132% in 2021 but lost 4 pp until recently due to the end of special Covid measures. More than 92% of the BoJ's balance sheet consists of just two items, government securities (~80%) and loans. The latter increased due to the Covid "funding for lending" programme. Therefore, to ensure an appropriate expansion of the money supply, the BoJ has no choice but to expand the most important item of its balance sheet, i.e. government securities. This is why we expect QQE to be maintained as the basic policy tool and why (more substantial) monetary tightening still seems a long way off, in our opinion.

The BoJ's main policy tools

• QQE was introduced in this form in 2013, combined with the change in the policy target from the uncollateralised overnight call rate to the monetary base. Its key aim was to achieve 2% inflation with a time horizon of about two years. JGB buying was increased to up to ¥80 tr in 2014 (worth about 15% of Japan's GDP at that time) but changed to "flexible" buying in 2018 and any explicit target was given up in 2020.

• In early 2016, the BoJ announced NIRP, but de facto only for a smaller fraction of banks' deposits within a three-tier system with different interest rates (Basic Balance +0.1%, Macro-Add-on Balance: 0%, Policy Rate Balance -0.1%). The motivation was to keep the abundance of liquidity created by QQE outside the BoJ.

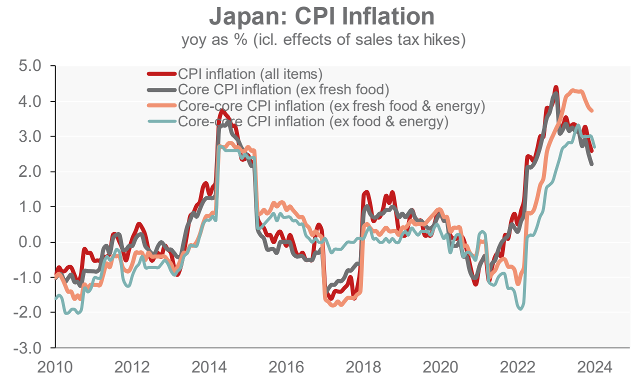
• Only eight months after NIRP, the BoJ introduced the Yield Curve Control (YCC) policy, setting the yield for 10-year JGBs at zero percent. The move defined the yield curve from -0.1% overnight to 0% on 10y yields. The move surprised, as the BoJ seemed to aim at controlling "quantity" and "price" at the same time.

• In March 2020, the BoJ launched a de-facto "funding-for-lending" programme as a main anti-Covid measure. It had favourable terms so that the credit component of the BoJ balance sheet has increased significantly. The tool is still in place but is a temporary measure.

Given our assumptions, the ratio of the BoJ's balance sheet and the ratio of government bonds in the BoJ's balance sheet to nominal GDP will stabilise at the current levels. In absolute terms, we expect the BoJ's sum of net purchases 2024-2028 of JGBs to be 20% lower than in the last five years 2019-2023 (which already dropped by 56% compared to 2014-2018), while the issuance of government bonds will shrink by 57% as the net deficit returns to pre-Covid levels.

2. The chances for a sustainable, virtuous wage-price cycle

Japan reports a range of core inflation measures, differentiating between food and fresh (!) food as well as core resp. core-core, additionally excluding energy. Headline inflation has stayed much below the inflation levels of Western peers (the peak was 4.3% yoy in January 2023). Inflation has peaked by every measure for now. In January 2024, headline CPI inflation dropped from 2.6% yoy to 2.2% yoy, still staying above the BoJ inflation target. Over the next months, inflation readings will remain noisy. Energy price subsidies caused in February last year month-on-month (mom) inflation to decline by 0.6%. Thus, headline inflation will rise in February 2024 again, likely back to 2.8% yoy. Moreover, last October PM Kishida announced as part of the fiscal package the extension of subsidies to the end of April, and of late – given that Japan dropped into recession in Q4 – the government is reported to mull extending fuel subsidies until summer. Hence, in May or after summer mom inflation will jump up on the end of subsidies and keep yoy headline inflation higher. However, despite all the noise, we see inflation recede as a trend.

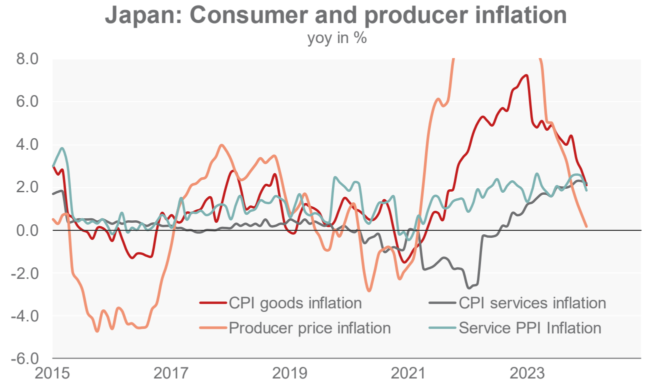


Source: Datastream, GenAM calculations

For the wage-price cycle to be maintained, higher inflation needs to prompt higher wage demands (which would be another cost-push impulse). In Japan, wage increases have to be separated into base pay rises and seniority pay. The latter quasi automatically takes place every year with employees getting older. What matters, is the base pay rise. The 2023 Japanese Trade Union Confederation (Rengō) data show that average wages (for companies with more than 100 employees) advanced in 2023 by 3.69%, including 2.16% for the base pay component. Concerning the wage outlook, some large enterprises showed willingness for another round of decent wage rises, but SMEs looked more reluctant. Overall, it is widely expected (and we agree) that this year's wage negotiations will bring results similar to last year.

Higher wages should lead to higher prices rather than being offset by productivity gains or lower profits, with the responsibility falling on services inflation. In January, consumer service inflation slowed slightly to 2.1% yoy. Service PPI has fallen again. The BoJ has repeatedly pointed out that the rise in service prices has not yet been driven by wage increases but by special factors (base effects due to the end of travel subsidies, material costs, etc). Nevertheless, it is hoped that in a labour-intensive sector like services, another year of high wage increases exceed the absorption capacity and prices need to rise. The BoJ stresses that the transfer mechanism is far from guaranteed.

For the virtuous wage-price cycle to work, not only nominal wages but also real disposable income needs to rise. **Real compensation of employees fell by 1.8% in 2023.** That was the third year of negative growth, but the expected decent 2024 nominal wage growth combined with lower inflation as well as fiscal support will lead to a positive turnaround (about 1.4% yoy). Fiscally, households will benefit from an income tax refund and cash payments (about 0.8% of GDP). The package also extends various energy price subsidies. Together, wages, fiscal subsidies, and lower inflation should provide the basis for a positive consumption trend, after three quarters of negative real consumption growth. In 2024 real private consumption is expected to grow by 0.6%, slightly lower than in 2023, but no longer for the "wrong" reasons (Q1 2023 boost of post Covid pent-up demand).

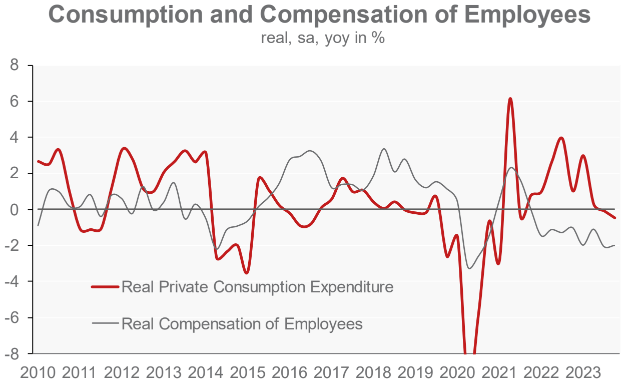


Source: Datastream, GenAM calculations

In sum, the BoJ looks to be in the position to (cautiously) drop the NIRP. We see inflation at 1.9% in 2024 and 1.6% in 2025 while growth should come in a bit below potential. Consensus forecast sees 2025 inflation at 1.5%. Regarding the question of when the BoJ could drop NIRP, we see a convincing argument in the availability of firms' wage negotiation outcomes. This typically starts with large, high-profile companies, then smaller enterprises follow. Around 50% of results will be available by about mid-April. Thus**, we expect the BoJ to wait until its April meeting the exit NIRP**: We first see only the negative interest rate to be lifted to zero, while the fate of the other policy tranches (see Box 1) might be better placed in the broad review. We stress again the high uncertainty around this timing (esp. in case GDP would not turn positive in Q1) and the risks tilted towards later exit from NIRP.

As far as the YCC is concerned, the BoJ has taken steps away. Currently, 10y JGB yields are significantly below the de-facto upper bound of 1% and the outlook for US Treasury yields of the same tenor is to fall this year. While markets could temporarily test the BoJ's resolution, we see no point in widening the tolerance band again. But it will be tempting to abolish the ceiling when it stays unbinding for some time.

Timing is uncertain. Given some surprisingly hawkish comments in the Summary of Opinions at the Monetary Policy Meetings in January 2024, the BoJ may move quicker than we thought. However, it could also wait for the market response to abolishing the NIRP, keeping the YCC as reassurance against excessive long-term yield volatility. Market views are very diverse. We see the BoJ will handle both issues in one move, a clear-cut to the Kuroda BoJ.



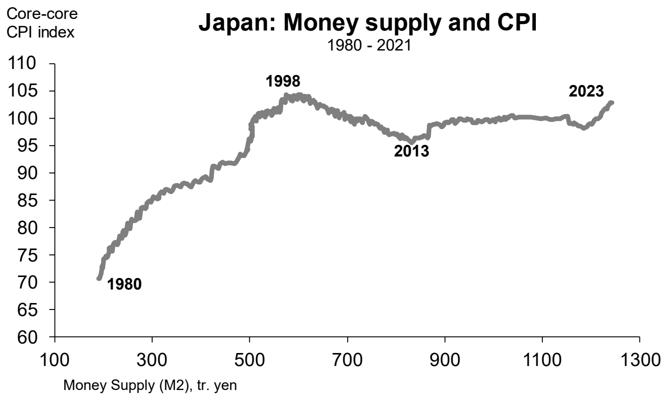
Source: Datastream, GenAM calculations

As regards the longer-term outlook, the question is whether higher inflation can be (at least in part) maintained. Ageing implies lower demand but also a tightening labour market and thus wage pressures. Nevertheless, the labour force started shrinking in 1997, and this has not prevented lacklustre wage growth. Moreover, two years with higher wages and inflation might not be enough to generate lastingly higher inflation expectations. Large firms' profits were able to benefit from temporary one-off effects (Covid), and inflation could be used to extend margins (margins have risen from 2020-2023 based on Topix), the basis for being generous with wages. However, economic theory suggests that a permanent wage-price cycle requires unionised labour markets and some monopoly power in the firm's goods markets. On top, demography issues[1] (decreasing domestic demand, overcapacity) will come to the fore. In sum, we tend to be sceptical that the wage-price cycle will bring inflation sustainably close to the 2% target and thus would allow to meaningfully reduce its degree of monetary expansion. This does not necessarily mean that the current level of policy support needs to be maintained "forever". In our macro models, nominal wage growth between 3-3.5% combined with a key rate of zero percent until the forecast horizon in 2033 does not produce inflation rates above 1.8%. Thus, it will be hard for the BoJ to argue that monetary tightening is warranted. Consistent with our view that QQE will be maintained, we see the BoJ not in the position to raise its key rate beyond scrapping the NIRP. Especially, we neither see a rate hike above 0% this year nor next.

3. Expectations regarding the broad review of monetary policy

Governor Ueda announced a broad review of monetary policy over 25 years within 1–1.5 years in April 2023, meaning the "Bank will assess the effects of various unconventional monetary policy measures […] (and) will analyse the impact of these measures on financial markets and the financial system, including their side effects […]." There were two workshops scheduled (Dec. 2023, and May 2024), with the timing of the second rendering it unlikely that a new monetary framework will be presented in April.

In an "ideal" world, the BoJ would share its diagnosis of why the Kuroda policy did not live up to expectations and outline the upcoming monetary policy framework for the next years including the BoJ's view on the effects of Japan's deteriorating demographics as well as its position on global warming. The chart below shows that the CPI index remained flat despite the massive monetary easing under the Kuroda policy since 2013. Only when the global energy price crisis reached Japan in early 2022, the CPI index started to rise. That poses the question of why the Ueda BoJ can assume this demand-pull inflation concept to now work and it also implies a critical stance regarding the unconventional monetary measures.



However, de facto we expect the broad review to be limited in scope. In a recent speech, Ueda stressed very much the favourable effects the current inflation bout is having on

[1] Regarding the relationship of demographics and inflation it is often maintained that the dependent population (young and old) is associated with higher, and the working age population with lower inflation. So ageing would increase inflation. However, in Japan an IMF study finds that prefectures that aged at a faster pace experienced lower overall inflation. The relationship looks complex.

mitigating/resolving firms' price stickiness ("*the often quoted deflationary mindset*", the BoJ is surveying the firms' level on the topic) and a reduction of menu costs. Thus, the BoJ is likely to stress that the operating environment of monetary policy has improved (the willingness/ability of firms to adjust prices), rendering monetary policy more effective in the future compared to the Kuroda experience. We expect this line of reasoning the basic message for the upcoming policy review.[2] This then sets the stage for the QQE and the consequences of abolishing the NIRP and YCC in terms of a simplification of monetary policy tools. We expect:

- The competing monetary policy targets (see Box 1, quantity vs. interest rate) to be resolved for a quantity target (monetary base) with QQE maintained. We expect no explicit QQE target to be set to keep flexibility in case long-term yields should unexpectedly rise strongly. Consequently, we also see no attempt for QT at least over the next two years.
- The end of the NIRP renders the three-tier system (see Box 1) unnecessarily complex and the BoJ could opt for a single (unified) deposit rate.
- We expect the 2% inflation target to be kept, thus implicitly abolishing the "price level" target introduced under the Kuroda BoJ. However, it may be advisable to introduce some flexibility to the inflation target, but we do not expect that at this point.

4. Financial market impact

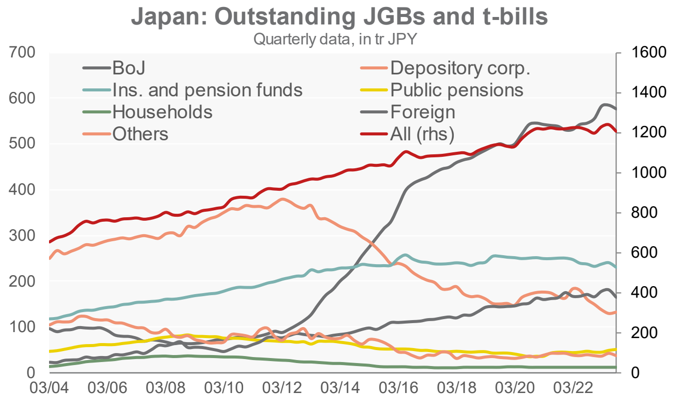
Japan's financial markets have been affected by deflation and YCC for many years, leading to exceptionally low Japanese bond yields. E.g., the yield on the 10-year JGB has only recently risen by 60 bps to around 0.7% (yield levels over 0.9% in Q4 2023 have proven unsustainable). The high international yield differential has caused the yen to depreciate, which along with corporate reforms, has helped Japanese equity markets to surpass a 30-year-old high.

> *Japanese financial markets dominated by the deflationary environment*

This chapter examines the impact of the modified BoJ's monetary policy on the changing macroeconomic environment. We will discuss the expected influence on the JGB curve and international bond markets. We will also explain why we forecast a moderate appreciation of the JPY in the medium term.

4.1. Recent JGB yield increase not sustainable

The JGB market has experienced moderate growth in recent years (see chart below). Notably, the BoJ's stake has rapidly increased since 2013, and it now holds nearly half of the outstanding debt on its balance sheet. While insurance and pension funds, along with foreign investors (until 2021), have also increased their holdings, all private investors have seen their share continuously decrease. In addition to the development of supply, it is essential to analyse how the BoJ's demand will develop going forward.



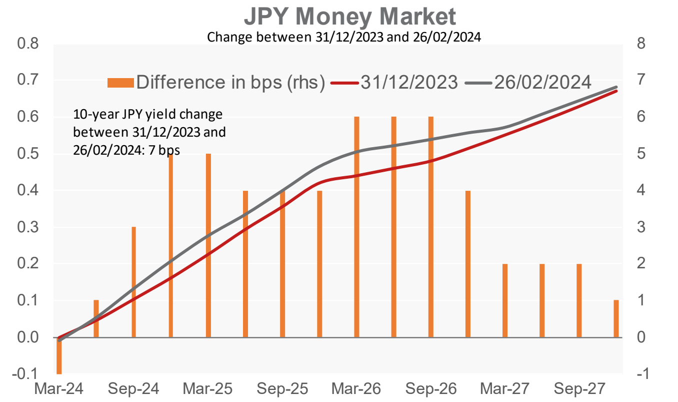
Source: Bloomberg, GenAM calculations

The outstanding volume of JGBs is expected to rise by JPY 75tr from 2023 to 2027, which is a decrease in growth compared to previous years amid decreasing fiscal deficits. This will alleviate some supply-side pressure. Given the dominance of JGBs in the BoJ balance sheet and the need to accommodate nominal growth, the BoJ will continue to intervene in the JGB market (see above). We expect the central bank to increase the volume of its JGB holdings by 90 tr by 2027, assuming it continues to expand its balance sheet annually in line with potential growth and the target inflation rate. Hence, it will continue to absorb almost JPY 2tr per month on average (in addition to reinvesting maturing bonds). Accordingly, we believe that the trend toward lower net purchases, which has emerged in recent months, will not continue.

Several market participants expect the BoJ to end QQE this year and stop net purchases of JGBs. Some market participants even forecast that the BoJ will scrap its inflation-overshooting commitment and reduce bond purchases further,

[2] The inability of monetary policy to „break the deflationary mindset", i.e., not to generate higher inflation expectations is only one way to explain the failure of the massive monetary impulse of the Kuroda BoJ. Other views apart from the special Japanese labour market are more e.g., the inherently deflationary tendencies of adverse demographics, or the balance sheet deflation, globalisation, menu costs explanations etc. We do not attempt to discuss these topics in this paper.

shortening its balance sheet (QT, similar to other central banks) in the medium term. However, as outlined above we disagree and see no potential for this due to the lack of a virtuous wage-price cycle. We expect the BoJ to maintain its QQE policy and it will even continue to buy JGBs from private investors. This will be all the easier as the JPY depreciation and the strength of equities caused pension funds and insurance to buy JGBs as part of rebalancing in 2023. However, it is unlikely to continue going forward. This will result in the BoJ's of the JGB market to approximately 52% by the end of 2027 (from 48% currently).



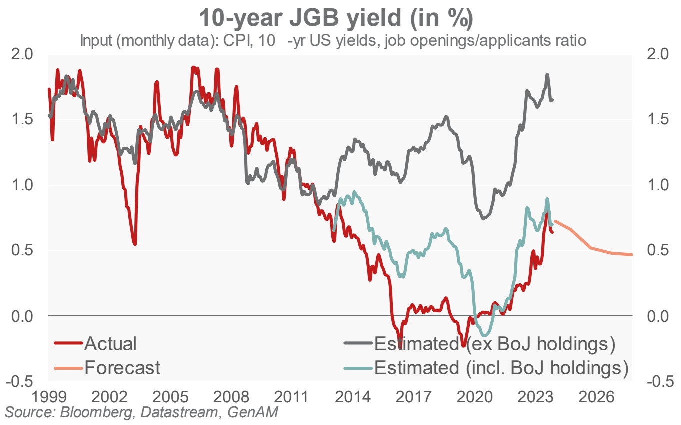
Source: Bloomberg, GenAM

The further increase in the BoJ share will leave its mark on 10-year JGB bonds in particular. In 2017/18, the central bank already purchased more than 100% of the newly issued bonds and currently holds more than 60% of all outstanding bonds with this maturity.

> *BoJ to remain a net buyer of JGBs for the time being, defying market expectations of QT*

Another crucial factor driving the yield on JGBs is the key rate level. The corresponding expectations have increased since the beginning of the year. Specifically, market participants are now pricing a rate of around 0.25% by the end of 2024, approximately 0.5% by the end of 2025, and almost 0.7% by the end of 2027. This means that they have moderately increased, not least due to the international environment (since the start of the year, the expected US key rate for the end of 2024 has increased by approximately 75 bps). As explained earlier, we believe that such significant key rate hikes are excessive given the inflation rate, which is expected to fall below the 2% target again. In this environment, a tightening of monetary conditions does not seem appropriate. Accordingly, our base scenario only anticipates an end to the NIRP policy short term but without any further key rate hikes until the end of 2027. Given the priced key rate hikes (which have already been reflected in JGB yield levels) the forecast adjustments will tend to dampen JGB yields across the curve.

The missing key rate hikes will be particularly noticeable at the short end of the curve. Currently, financial markets expect 2-year yields of 0.25% over the year and 0.6% over three years, but we see little upside from the current level of 0.15%.



Source: Bloomberg, Datastream, GenAM

Finally, the development of US yields is another important driver for JGB yields. It can be shown that the increase in yields since 2022 can also be attributed to higher US yields. While forwards expect US 10-year yields to move sideways over the next few years, we anticipate a decline to 3.2% by the end of 2027 due to lower US key rates and falling inflation. This factor is a major contributor to the decline in Japanese yields predicted by our regression models.

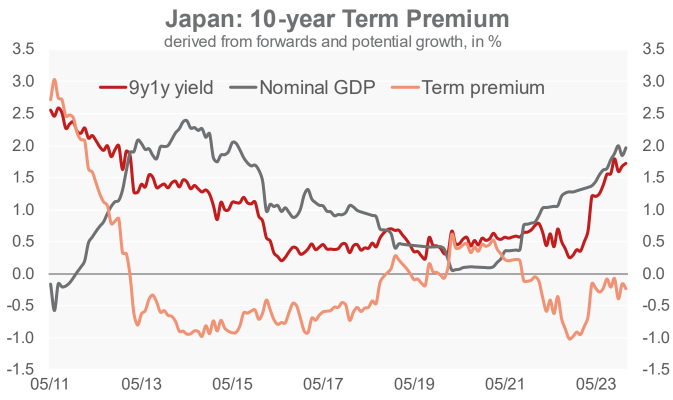
Based on BoJ's model for 10-year JGB yields (regression on core CPI, 10-year US yields, job openings/applicants ratio) the fair value is currently around 1.65%. Accounting for the stock effect of BoJ's JGB holdings of around 95 bps[3], the current fair value of 10-year JGBs decreases to around 0.70% - close to the actual level. Other models that explicitly consider the key rate yield comparable results.

> *Unlike forwards, our models suggest decreasing yields going forward*

It is crucial to note that, the future trend of the explanatory variables indicates a decline in the 10-year JGB yield. The fair value of 10-year JGBs is expected to decrease to around 0.5% due to declining inflation rates, an increase of the BoJ's share in the JGB market and falling US yields by 2027 (other models come to similar conclusions). This is contrary to the rise in yields expected by forwards (and some market

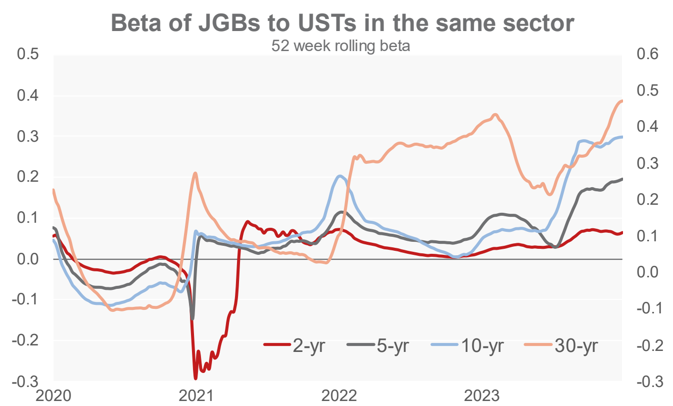
[3] Assessment for Further Effective and Sustainable Monetary Easing

participants). The forwards predict a 10-year yield level of 0.90% for the year and 1.30% by the end of 2027.



Source: Bloomberg, BoJ, GenAM

The models do not consider all factors relevant to future yield development. The term premium has increased since the end of 2022 (but it is still in negative territory, see chart above), and monetary policy uncertainty may raise it further as investors seek higher compensation. Even speculation about the end of QQE may increase the term premium. Although we expect the continuation of QQE to slow down the increase, even speculation about an imminent end to accommodative monetary policy may lead to a rise in the term premium. Finally, the positive correlation with the US term premium also has the potential to increase the Japanese term premium.



Source:Bloomberg, GenAM

However, the sensitivity of long-term sectors to US yields has recently increased significantly (less so for short-dated sectors, see chart below), which is only partially reflected in the applied models (coefficient of 10-year US yields between 0.20 and 0.25). Hence, assuming that the BoJ will officially end the YCC in the short term, the expected decline in US yields should have an even stronger effect on Japanese yields than our models suggest.

Overall, we do not expect higher 10-year JGB yields but rather to fall slightly – although not to the levels indicated by our models. This is also because the risks to our base scenario are asymmetrical. While a stronger decline in inflation and/or a global economic downturn can trigger lower long-term yields, there is also a substantial upside risk. If, unexpectedly, a sustained period of higher inflation occurs, the BoJ will hike key rates, causing a more significant upward shift of the entire yield curve.

Hence, we do not anticipate any unexpected adjustments that could catch financial markets off guard and endanger Japan's debt sustainability going forward. Sustained low yields (below nominal growth) mean low funding costs for the government. The future bond market movements are likely to occur within an orderly framework. This applies even more as the BoJ is well aware of the threads of mishandling the normalisation process leading to a destabilizing of the financial system and has prepared the process well.

4.2. Limited impact on global bond markets

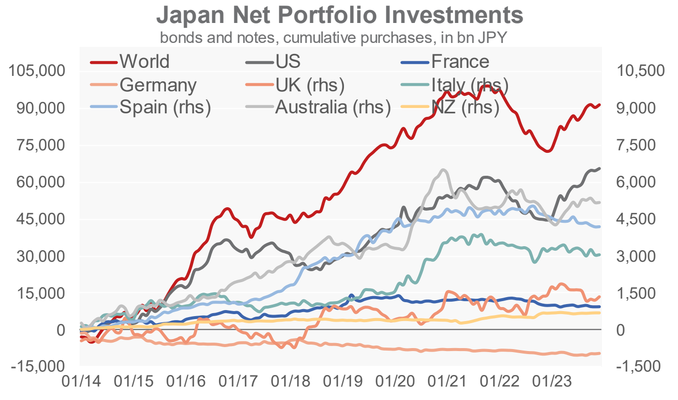
In recent years, overseas investors have made few purchases in JGBs, resulting in a manageable net position held by foreigners. The non-domestic share has decreased due to the BoJ's purchases, and it is unlikely that much will change in the future given the still unattractive yield level.

On the contrary, Japanese investors have been heavy buyers of non-domestic bonds over the years. Accordingly, there are now concerns that a shrinking international yield spread could lead to the repatriation of Japanese funds and disrupt global bond markets. And more so as on a currency-hedged basis non-domestic bonds are already yielding significantly less than JGBs.

> *Japanese investors have resumed building positions abroad since late 2022*

According to the Ministry of Finance, actual positions were reduced from Q1 2021 to Q1 2023, affecting all foreign markets. However, while the reduction in EA government bonds continued until December 2023 (latest available figures), the trend has reversed for US Treasuries since the end of 2022. Currently, the stock of US Treasuries is at a new historical high (see chart below). Hence, despite the yield disadvantage, there is no clear trend toward repatriation.

According to our forecast, the yield gap is expected to shrink in the coming years, making it more attractive to keep funds within Japan. However, history has shown that there is no automatism. Moreover, opening FX-unhedged positions remains a possibility (implying a higher yield before considering FX developments). E.g., Japanese life insurers' plans indicate a preference for FX-unhedged foreign sovereign bonds (regardless of possible FX losses).

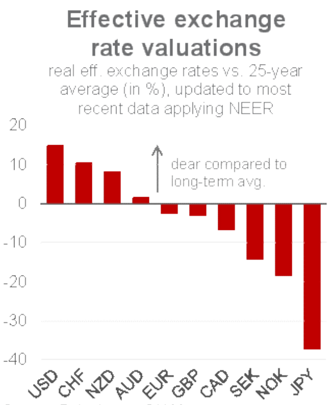


Source:Bloomberg, GenAM

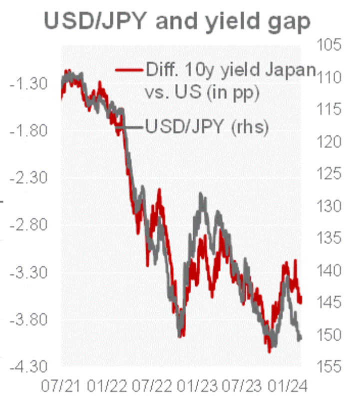
Overall, there is a possibility of increased repatriation to negatively impact global bond markets. However, based on our cautious JGB yield forecast and the experience of the last few years (despite the lower yield on a currency-hedged basis, Japanese investors have continued to build up positions abroad), we believe the risk is low.

4.3. Moderate appreciation of JPY ahead

The prospective monetary policy divergence between the Fed and the BoJ is set to translate into a recovery of the Japanese yen, even though a muted one. On various metrics, the JPY is deeply undervalued (37% vs. long-term mean in the real eff. exchange rate, 32% in PPP terms vs. the USD), albeit a part of the latter can be ascribed to differences in per-capita income.



Source: Datastream, GIAM



Source: Datastream, GIAM calculations

The USD/JPY remains heavily tied to the yield gaps, even though also on this ground, the JPY has recently lagged the narrowing yield trend (see chart). This is partially due to the terms-of-trade shock from high energy prices (Japan imports most of its primary energy needs), but the JPY has also lagged last year's oil price moderation and the improved trade balance.

Looking ahead, the expected narrowing of yield differentials by about 90bp in the 10y segment alone may account for just 5% of a lower USD/JPY over the next three years. But we assume that the combined end of NIRP and YCC, which defy the global easing trend of major central banks, will also be a trigger helping to unwind some of the yen's strong fundamental undervaluation. The persistent inflation gap vs. the US (which requires a rising JPY nominal exchange rate to avoid an even deeper undervaluation) also points to some JPY upside.

Overall, we expect the USD/JPY to retrace into the lower 140s over the next 12 months and into 130-135 by year-end 2027.

5. Conclusions

In this Core Matter, we explained why we do not expect the wage-price cycle in Japan, which many market participants had hoped would lead to stable, higher inflation rates, to fully materialise. This has direct implications for monetary policy: The BoJ is likely to end the YCC and NIRP in the short term but will refrain from further rate hikes and tapering of JGB purchases. As a result, yields on short-dated JGBs are unlikely to rise in the medium term and those on longer-dated JGBs may even fall slightly. The appreciation of the yen is also likely to be less than currently priced in forwards.

Nevertheless, the yield differential with global bond markets will narrow in the coming years as global yields are expected to decline. Fund outflows caused by the shrinking yield gap are more likely to affect the EA markets than the significantly higher-yielding US government bond market – which has already become apparent recently.

JGBs appear less attractive for US investors due to the yield advantage that will continue to exist and the expected price gains on US Treasuries. However, on a total return basis (hedged) JGB investments remain attractive for EA market participants. The yield disadvantage is much smaller, and the only slightly converging yield gap prevents a significant outperformance of EA government bonds versus JGBs. Particularly very long-dated JGBs look promising and appear suitable to reap the hedging benefit.

Imprint

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