CIO Memo

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Japan: end of negative interest rate regime in sight

Key takeaways

- BoJ Governor Ueda said that Japan could soon end its decades-long negative interest rate regime with higher inflationary pressures.
- Japanese banking stocks reacted positively to Ueda's statements. The JPY strengthened and JGB yields rose.
- The monetary policy shift may create short-term headwinds for Japanese equities, but our overall long-term view is constructive.

1. What happened?

Over the weekend, the Bank of Japan (BoJ) Governor Kazuo Ueda announced that Japan could soon end its decades-long negative interest rate regime. The decision could be taken as soon as the beginning of the next year when the BoJ would have sufficient data to determine the sustainability of wage hike and inflation above its 2% target.

The JPY has been under significant pressure due to contrasting monetary policy and rising interest rate differentials with the U.S. JPY/USD weakened past the key 145-mark last month, a level at which BoJ started buying the JPY last year for the first time since 1988. Ueda's weekend comments seem to be aimed at halting the JPY's decline against the USD. The JPY has been the weakest G10 currency since the beginning of the year, down almost 12% against the USD.

The announcement comes hot on the heels of the yield curve control (YCC) relaxation step taken at the end of July 2023. The BoJ raised the target band at which it would buy 10-year Japanese government bonds (JGBs) to 1% from 0.5% earlier. The BoJ introduced YCC in September 2016 to maintain 10-year JGB yields at 0% and stimulate the economy that had been plagued by years of low growth and low inflation. The BoJ's July move was a big surprise for the markets.

Price pressures in Japan remained high in July. As expected, headline overall inflation remained at 3.3%, while the "new" core rate, which excludes fresh food and energy, rose from 4.2% to 4.3%. Within headline inflation, declining energy and goods prices had offset an acceleration in food inflation. Meanwhile, robust demand for services provided a boost to the core rate. Taking into account tax changes, services had increased in price by an average of 2.0% in July – the highest rate in 25 years. This was mainly due to hotel and mobile phone prices. Some local governments had reduced or ended discounts under the nationwide travel subsidy programme, while several telecommunications providers revised their rates.

2. How did markets react?

Broad Japanese equities were largely flat today in response to Governor Ueda's comments on ending negative interest rates. Benchmark Topix was up slightly by 0.06% today. However, the Topix Banks Index was up a significant 4.7% to its highest level since 2008. The JPY appreciated 0.9% against USD to 146.6, as of 7pm Tokyo Time today, compared to the high of close to 148 last week. The 10-year JGB yield rose to 0.706% today compared to 0.647% at last week's close.

3. What does it mean for investors?

BoJ Governor Ueda's comments suggest that policymakers are discussing a pivot away from the monetary stimulus of the past decade, even as global concerns heighten about a slow economic recovery. The Japanese economy appears to be finally seeing Abenomics come to fruition some years after previous prime minister Shinzo Abe rolled out the policies in 2012.

While the BoJ is still largely data driven, we think ending negative interest rates could be under serious consideration given Ueda's weekend comments. In the next few months we think the BoJ is likely to take a first step of shifting from negative to zero interest rate policy and then another step of lifting the policy rate to a slightly positive rate towards the middle of 2024.

The Japanese banking sector is likely to benefit the most from the rising rate environment. The sector has been suffering for years from near-zero interest rates. A gradual normalisation of monetary policy would boost the net interest margin of Japanese banks which has lagged that of global peers for years.

Meanwhile, the key risks to the rate hike forecasts could be the fact that inflation may not overshoot the 2% inflation target permanently combined with a slowing global economy.

The end of super easy policy could cause ripples in the financial market, leading to the JPY strengthening and JGB yields rising. In our view, if the BoJ chooses to pivot away from easy monetary policy, there may be short-term headwinds for the equities market as there has been an inverse relationship between the JPY and the Nikkei stock index. However, we have overall relatively constructive views on Japanese equities for the long run as the fundamentals of Japanese corporates remain strong while valuations are attractive.

Glossary

The Bank of Japan (BoJ) is the central bank of Japan.

Core inflation refers to a measure of inflation which excludes some volatile components (e.g. energy). These excluded components can vary country by country.

The G10 comprises Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

JGB stands for Japanese Government Bonds.

The Nikkei 225 Index is comprised of 225 stocks of the Tokyo Stock Exchange.

TOPIX refers to the Tokyo Stock Price Index.

USD is the currency code for the U.S. dollar.

Yield Curve Control (YCC) is a monetary policy action whereby a central bank purchases variable amounts of government bonds or other financial assets in order to target interest rates at a certain level.

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