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Time for the Bank of Japan to pivot

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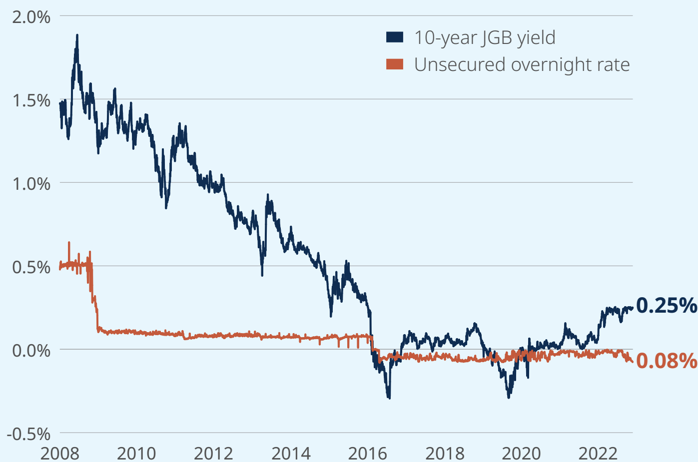
Highlights

- While the Federal Reserve and Bank of Canada have been raising rates quickly, the Bank of Japan (BoJ) has kept financial conditions loose. It could soon decide to tighten monetary policy by lifting its cap on government bond yields.
- Japanese inflation is solidly above target, inflation expectations for next year are approaching 2%, and official price statistics are hiding the extent of inflationary pressures.
- The Ministry of Finance has intervened twice this year to lean against yen depreciation. But the BoJ will need to lift the yield cap for the yen to strengthen sustainably in this macro environment.

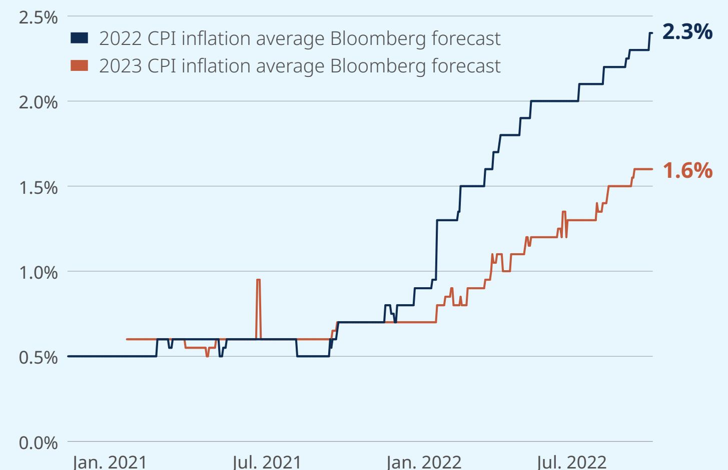
The Bank of Japan is zigging while other developed market central banks are zagging. By keeping its policy rate in negative territory and capping the yield on 10-year government bonds at 0.25%, the BoJ has opened a canyon between Japanese and US rates. The yen fell off the edge of that canyon this year, but the BoJ has stayed the course. However, the time for the BoJ to shift course could be approaching with inflation expectations approaching 2%, the yen (JPY) in the doldrums, and the Ministry of Finance (MoF) getting antsy.

Figure 1. The Bank of Japan could lift its yield cap sooner rather than later

The BoJ has maintained a cap on 10-year yields since 2016



The elusive 2% inflation is finally within reach



Notes: Via Bloomberg as of November 29, 2022.

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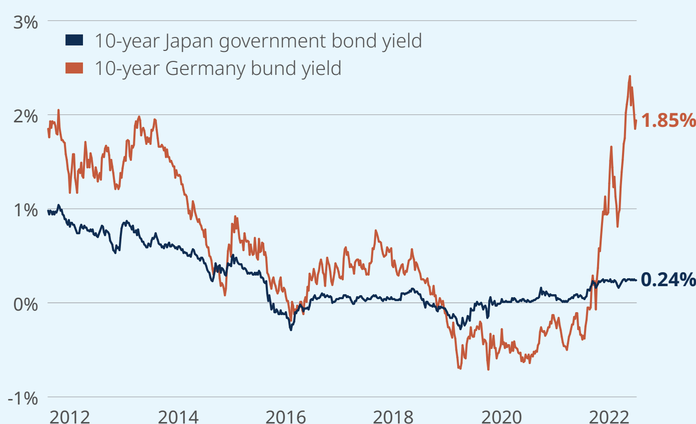
Annual price growth for 2022 is now on pace to exceed 2%, a welcome sight for the inflation-starved BoJ. Japan has only seen annual inflation above 2% once over the past 30 years, when consumer prices grew 2.7% in 2014. This was mostly due to a temporary effect from the introduction of a new sales tax, and inflation subsequently cratered below 1% in the following year. This time around, BoJ Governor Kuroda wants to see inflation stick, and he's probably liking what he's seeing this year. On October 28, the BoJ upgraded its forecasts for core inflation in the current fiscal year from 2.3% to 2.9%, with a forecast of 1.6% inflation in FY23 and FY24. Not quite 2%, but it's getting there. Consensus inflation expectations for 2023 have also been climbing quickly, something Kuroda said he would be looking for. As an additional sign of firming inflation expectations, Japan's trade union confederation, RENGO, will be requesting a 3% increase in wages in the coming round of negotiations.

Even with 3-month annualized inflation running at 4.0%, Japan's measured price growth is likely to be understating the current mismatch between aggregate supply and demand. The global energy shock, which has caused electricity prices to spiral out of control in most energy-importing European countries, is not reflected in Japan's statistics. Regulated utilities are eating the hit from surging energy import costs, insulating electricity consumers from price hikes. In the past year, import prices for coal have tripled and the price of natural gas has more than doubled. Yet electricity prices in Tokyo are only up 25%, compared to 200% in some German cities. Given tight global gas and oil markets, tenaciously high energy import costs will have ample time to slowly bleed into Japan's consumer price index.

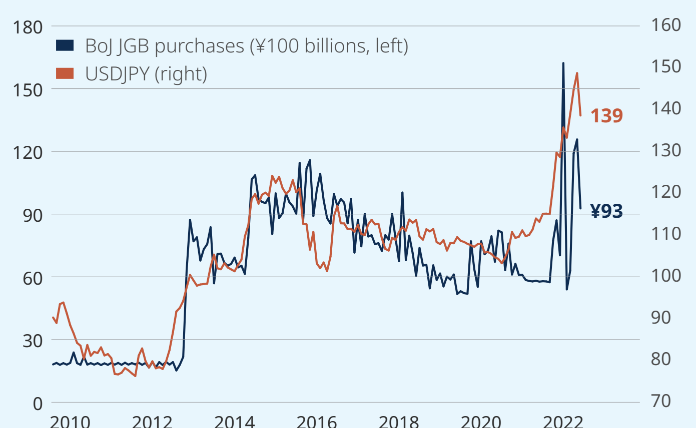
Even after rebounding against the US dollar (USD) following the downside surprise in US CPI for October, the yen remains by far the worst performing G10 currency in 2022. The MoF has intervened twice this year to lean against yen depreciation. But as long as the Bank of Japan commits to buying an unlimited number of bonds to protect the 0.25% yield cap, MoF interventions in the FX market are unlikely to have lasting effects on the yen's value. Suppose the MoF decides to buy yen and sell dollars from its reserves, with the goal of propping up the yen's value. Doing so would decrease yen liquidity in Japan's financial sector, putting upward pressure on interest rates. But any pressure on rates from the FX intervention would force the BoJ to buy more government bonds to protect its 0.25% cap. Monetary policy will not tighten, and the yen will remain depressed. If Japan wants a sustainably stronger currency, the yield cap must be lifted. Kuroda, the architect of the current yield curve control policy, will leave his seat at the helm of the BoJ next April. The next governor could opt to ease pressure on the yen, a weakness that has become a political headache for the government.

Figure 2. Upside for Japanese bond yields means upside for the yen's value

Similar macro situation, different yields



JPY had a respite, but remains historically weak



Via Bloomberg as of November 29, 2022.

The BoJ could look to lift its yield cap once the inflation target is entrenched, which could happen in the next few months. The upside for Japanese government bond yields is significant, considering where German bunds are trading. Germany and Japan are in similar macro situations, with surging energy import prices turning hitherto perpetual current account surpluses into deficits. As a result, we are tactically underweight Japanese government bonds in the Global Macro fund.

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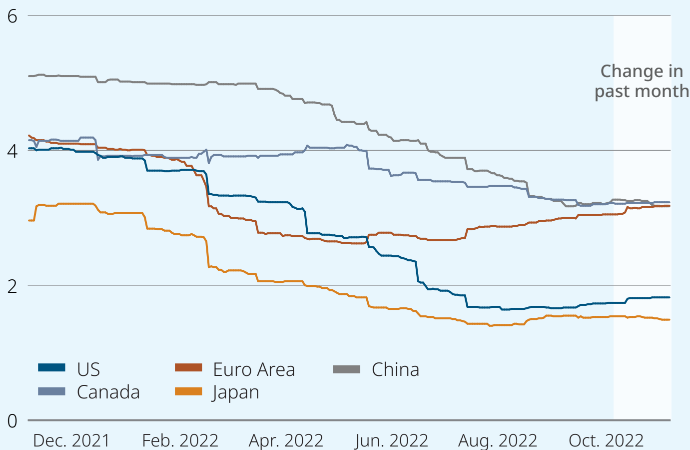
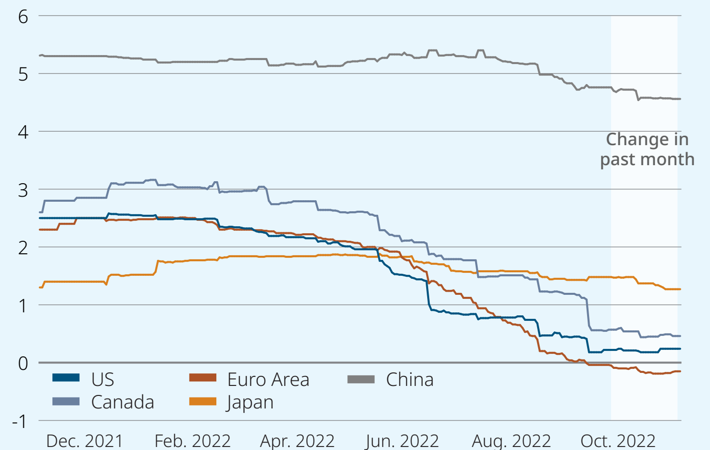
Global macro update

- Last month, **US inflation** for October came in below expectations. While the pullback in inflation is a welcome sign, we shouldn't overreact to a single data point. The Federal Reserve will want to see a string of downside surprises before it takes its foot off the brake. Plus, even with the deceleration in prices, month-on-month inflation still came in above 5.0% annualized, well in excess of the Fed's target. Furthermore, much of the downside surprise came from the health care component, which swung from 7% annualized inflation to -7% in the span of a month due to a methodological quirk.
- The 2023 consensus forecast for **Japan inflation** kept creeping higher in November, and now sits around 1.8%, just below the Bank of Japan's 2% target. A few weeks ago, both headline (+3.7%) and core (+2.5%) inflation numbers for October came in above expectations. We also saw Japan's trade balance for October come in well below expectations, with the second lowest reading of the series' history. The yen depreciation we've seen this year has contributed to both the climbing consumer inflation and the widening trade deficit.

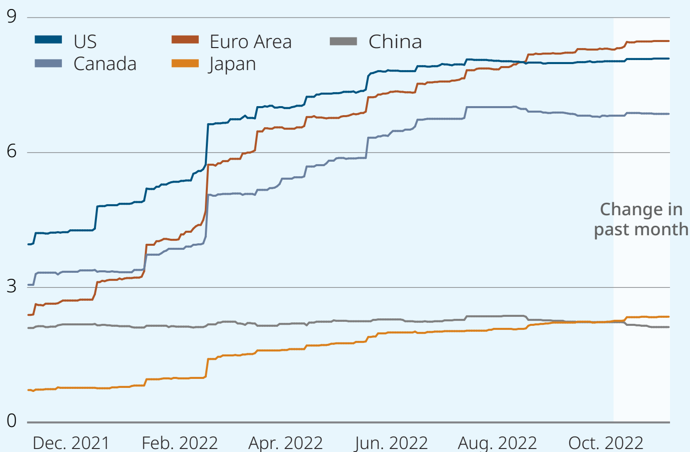
2022 real GDP growth forecast (%, consensus)



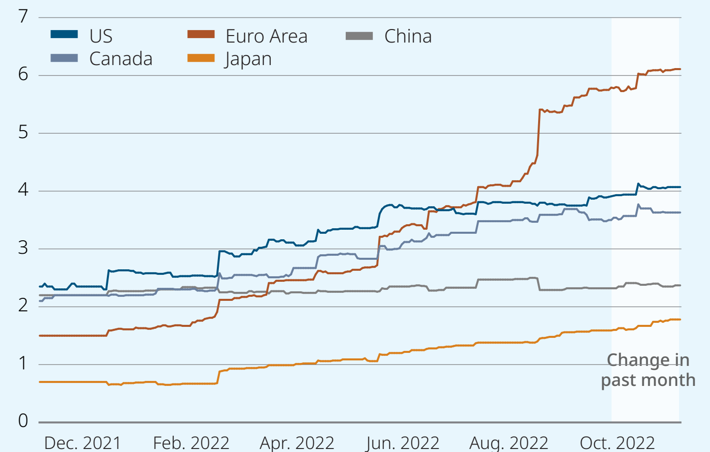
2023 real GDP growth forecast (%, consensus)



2022 inflation forecast (%, consensus)



2023 inflation forecast (%, consensus)



Notes: Average growth and inflation forecasts from Consensus Economics as of November 30, 2022.

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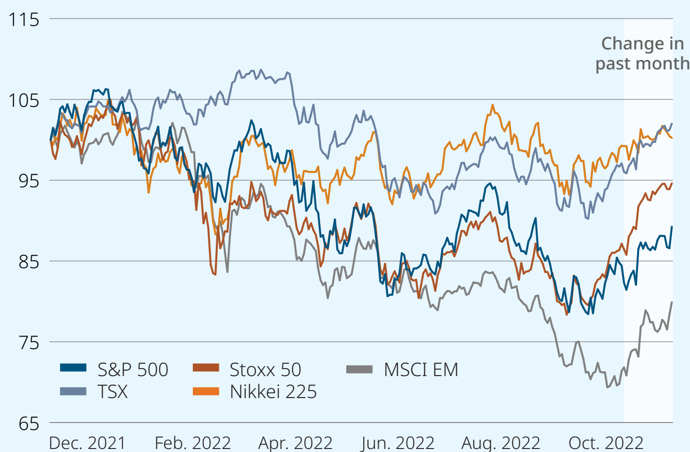
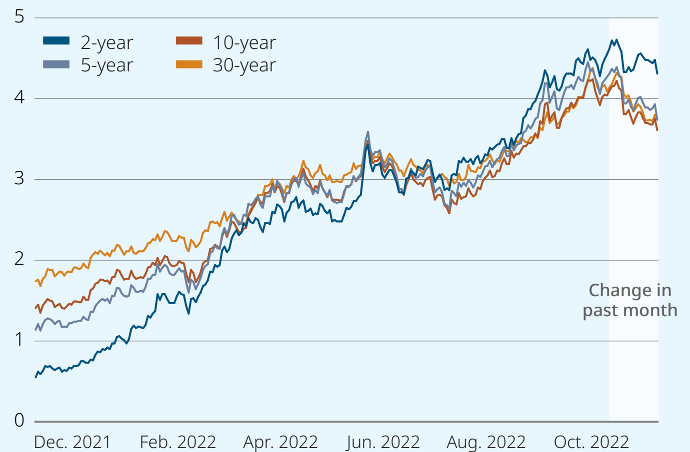
Capital markets update

- The **S&P 500** bounced sharply following the downside US inflation surprise on November 10, before chopping around 4,000 for the rest of the month. Emerging market equities outperformed other major indices as the Chinese government unveiled measures aimed at stabilizing real estate markets and opened the door to looser Covid rules.
- **Long US Treasury yields** eased back below 4% in November as the relatively soft inflation print for October lowered the odds of a long-term inflation spiral. The yield curve inversion deepened, with the 10-2 Treasury spread reaching -0.75% for the first time since 1981.
- **The US dollar** lost ground against most major currencies in the second half of November. The Japanese yen, the most undervalued G5 currency relative economic fundamentals, benefitted the most. The yen gained 3.9% against the USD on November 10, the day US inflation came in below forecasts.

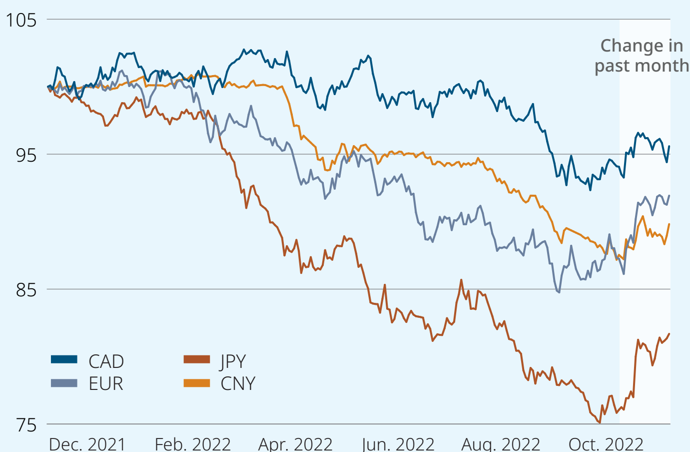
Equity indices (one year ago=100)



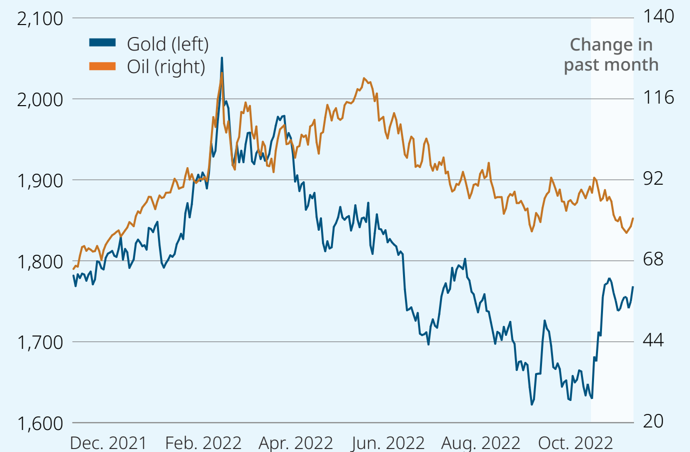
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD)



Notes: Financial data from Bloomberg as of November 30, 2022. Total return equity indices are in local currencies, except MSCI EM, which is denominated in USD.

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What we'll be watching in December

December 14: Federal Reserve rate decision

- On November 2, the Fed's Open Market Committee decided to hike the Fed's policy rate by 0.75% for the fourth consecutive meeting. Markets now expect the Fed to slow down the pace of hiking, with traders betting on a 0.50% hike on December 14.

December 15: European Central Bank (ECB) rate decision

- The ECB is a tough spot with inflation above 10% and the Eurozone likely entering a recession this winter.
- After the invasion of Ukraine in February, eurozone inflation forecasts for 2022 rose much faster than forecasts for 2023, as the disruption to energy markets was expected to cause a one-off increase in prices rather than persistent inflation. With governments reacting to the energy shortages with deficit-financed support programs for households, the temporary price shock could turn into sticky inflation.

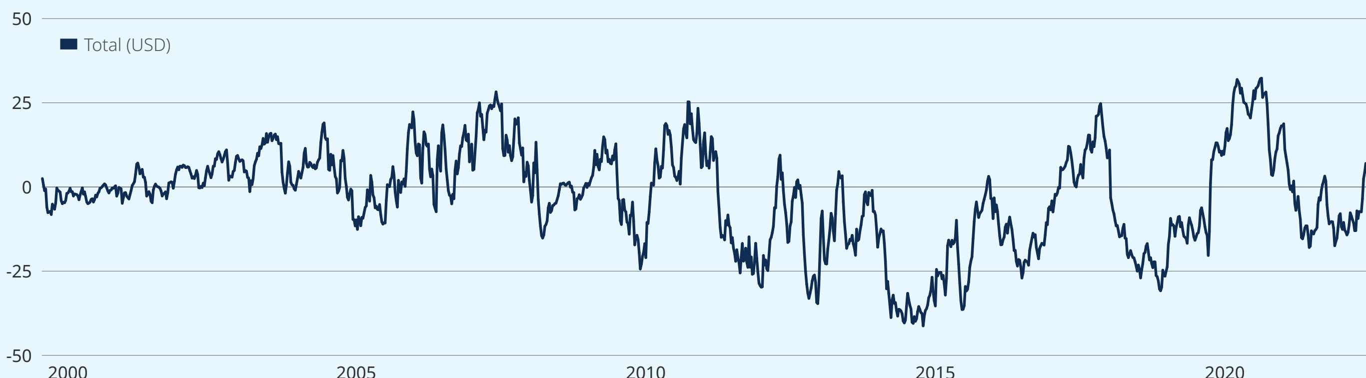
December 15: US retail sales

- Over the past few months, the US economy has held up much better than some recession-callers had predicted. Resilient consumer spending partly explains the positive growth of the last few months. In the US national accounts for Q3, strong services consumption (+2.8%) compensated for fledgling goods consumption (-1.2%).
- Data from payments providers suggests that US consumer spending on Black Friday weekend hit an all-time high, even after adjusting for inflation, which could bode well for November's retail sales number.

Emerging theme

- Speculators' US dollar positioning turned from long to short in November. Fund managers, on average, are now betting on the USD to depreciate.
- The USD surged in 2022 due to geopolitical uncertainty and aggressive rate hiking by the Federal Reserve. With inflation on a downward trajectory in the US, the forces that held up the USD are waning, leaving it extremely overvalued relative to other G5 currencies. Over the next few years, this overvaluation should act like gravity on the USD, pulling it down towards fair value.
- According to the Commodity Futures Trading Commission's data, which covers only a small portion of FX trades, fund managers are betting on the euro to gain value on the USD. We prefer the Japanese yen, which is the most undervalued G5 currency and could benefit from an eventual scrapping of the Bank of Japan's yield control policy.

US dollar futures positioning



Notes: Bloomberg as of November 28, 2022.

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Capital market returns in November

Category	Index	Return
Major Asset Classes	Global Equity	5.65%
	Global Bonds	4.72%
Regional Equity (local)	S&P 500	5.59%
	TSX	5.60%
	Nikkei	1.41%
	FTSE 100	7.12%
	EuroStoxx 50	9.70%
	MSCI EM	14.83%
Styles	US Small Cap - Large Cap	-2.87%
	US Value - Growth	1.56%
Sovereigns	USA 10-year Treasury Future	2.38%
	CAN 10-year Gov't Bond Future	2.36%
	GBR 10-year Gilt Future	4.46%
	DEU 10-year Bund Future	1.76%
	JPN 10-year JGB Future	-0.03%
Fixed Income	US High Yield Bonds	1.87%
	US Investment Grade Bonds	6.11%
	US Leveraged Loans	1.59%
	CA Provincial Bonds	3.55%
	CA Corporate Bonds	2.95%
	CA Inflation-Linked Bonds	2.23%
Alt	Gold	8.26%
	Oil	-6.26%
	Global REIT	6.46%
	Global Infrastructure	4.75%
FX Spot	CAD/USD	1.57%
	GBP/USD	5.14%
	EUR/USD	5.30%
	JPY/USD	7.75%

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Notes: Market data from Bloomberg as of November 30, 2022. Index returns are for the period: 2022-11-01 to 2022-11-30. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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