Fixed income in Japan: Lost in translation

Image source: iStock/agafapaperiapunta

Introduction

As financial markets brace for the release of Japan's April 2024 Core Consumer Price Index (CPI), expected to slow to 2.4% from March's 2.9%, the Bank of Japan (BoJ) stands at a pivotal junction. This forthcoming data, a stark contrast to the peak of 4.3% in July 2023, highlights the complexity of the BoJ's monetary policy landscape amid a significantly depreciated yen. The continued weakness of the yen, despite ending the world's only negative interest rate policy in March, underscores the profound challenges the BoJ faces. This focus explores the strategic manoeuvres within the larger context of global economic pressures, examining the implications of potential policy shifts not just for Japan, but for the broader global fixed income markets.

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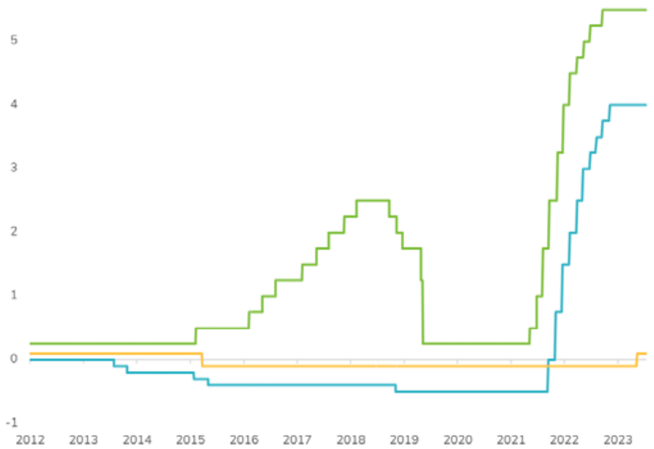
The Yen's Depreciation and BoJ's Policy Challenge

Since the start of 2021, the yen has lost about 35% of its value. This significant depreciation is fuelled by a combination of internal and external economic pressures. Domestically, Japan's prolonged battle with low inflation rates and modest economic growth has necessitated keeping interest rates at or near zero, making the yen less attractive to investors seeking yield. Externally, the stark divergence in monetary policies, particularly with the United States, has become more pronounced. The U.S. Federal Reserve's series of aggressive rate hikes starkly contrasts with Japan's ultra-low rates, prompting substantial capital outflows from Japan and exerting significant downward pressure on the yen.

Chart 1: Divergence in Monetary Policy Since 2021



Source: Bloomberg / A visual representation of the key rate evolutions across the BoJ, ECB, and Fed, highlighting the widening gap and its timeline.

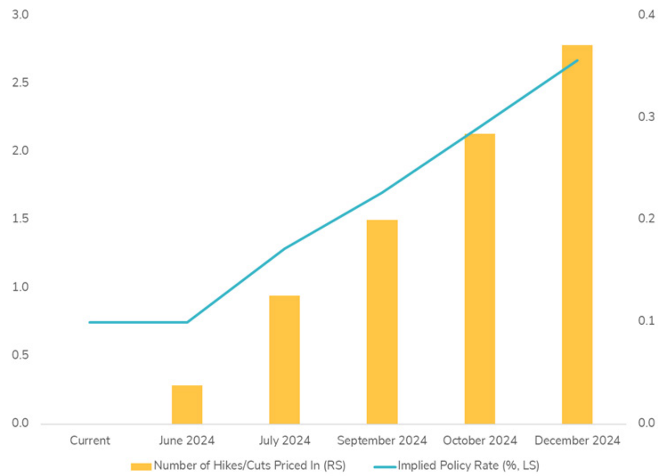
In response to these challenges, recent hawkish signals from BoJ officials suggest a shift towards more assertive policy measures may be necessary. Governor Kazuo Ueda's comments suggest that interest rates may need to be adjusted sooner than expected if inflation rises, due to the yen's depreciation.

BoJ's Monetary Policy Tools and Adjustments

The BoJ is considering a range of strategies to counteract the yen's decline without solely relying on foreign exchange interventions. These include raising interest rates, scaling back its bond-buying program, selling off holdings in foreign bonds, or waiting for monetary easing from other major central banks like the Federal Reserve and the ECB. Each strategy carries significant implications for Japan's economic stability and the global fixed income landscape.

Historically, Japan's ultra-low interest rates have underpinned its monetary policy aimed at stimulating economic growth and curbing deflation. However, the recent yen depreciation and corresponding rise in import prices are fostering arguments for the BoJ to consider raising interest rates. While higher rates could attract yield-seeking capital flows and thereby strengthen the yen, they could also suppress domestic economic growth by increasing borrowing costs.

Chart 2: Market Forecasts of Interest Rate Changes by the Bank of Japan



Source: Bloomberg. This chart predicts the likelihood and timing of rate changes, reflecting the market's expectations and the central bank's potential responses

The BoJ recently implemented a tactical reduction in its purchases of Japanese government bonds (JGBs), specifically targeting the mid-term range of five to ten years. This move, the first of its kind in 2024, occurred last week and was designed as a one-day adjustment. However, it was short-lived, as it precipitated a significant sell-off in Japanese rates. This episode underscores the sensitivity of the market to changes in the BoJ's bond buying strategy and highlights the challenges the BoJ faces in attempting to fine-tune its approach. The intent behind this reduction was to initiate a gradual increase in long-term yields, thereby boosting the attractiveness of JGBs and helping to stabilise the yen. The strategy aims to enhance JGB appeal without triggering excessive market volatility. Nevertheless, the immediate market reaction indicates a swift and unpredictable response to changes in BoJ purchasing behaviours, signalling that the market remains on high alert to the central bank's monetary policy cues.

Chart 3: The evolution of the 10-year Japan yield

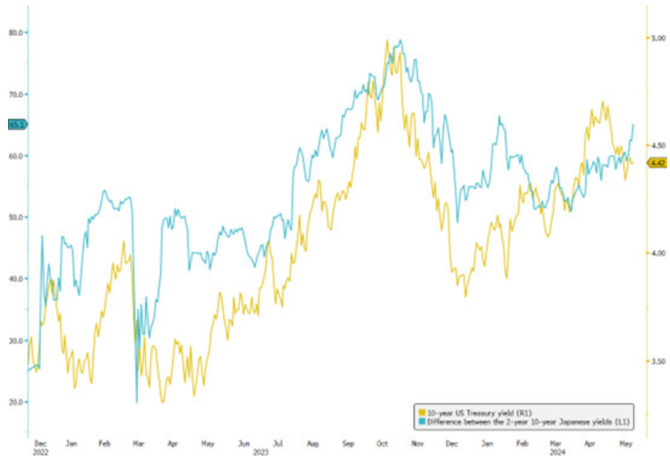
Source: Bloomberg. This graph tracks the shifts in the 10-year JGB yield over recent years, highlighting the effects of policy changes and external economic pressures.

Finally, the BoJ could also decide to reduce its US Treasury holdings, like the actions currently being taken by the Bank of China to protect its currency. The management of Japan's extensive holdings of U.S. Treasuries is another crucial aspect of its monetary policy. Changes in these holdings can significantly impact U.S. interest rates and, by extension, global bond market dynamics. Furthermore, a shift in investor sentiment and capital flows could result. The BoJ holds substantial US Treasury securities as part of its foreign exchange reserves. Selling these assets could serve as a tool to protect the yen's value by decreasing its foreign reserve holdings, thus buying yen in the process.

Global implications of BoJ's strategic shifts

Japan's monetary policy adjustments carry significant ramifications for global fixed income markets. As the Bank of Japan contemplates increasing Japanese bond yields, this strategy may attract global capital, influencing yields across other major markets, including U.S. Treasuries. The potential rise in yields could make Japanese bonds more attractive relative to their international counterparts, redirecting investment flows and impacting global financial stability.

Chart 4: Japan Yield Curve vs 10-year USTs

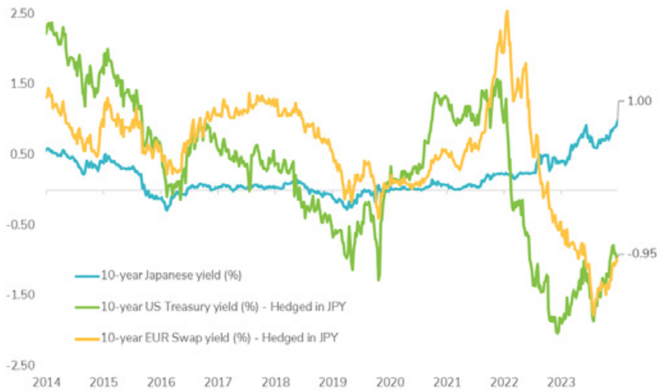


Source: Bloomberg. Comparative analysis of the yield curves of Japanese government bonds and 10-year U.S. Treasuries, providing insights into the relative attractiveness and resultant investment flows.

An uptick in Japanese interest rates could also have a profound impact on currency markets. A stronger yen reduces the value of overseas income for Japanese investors when converted back to yen, potentially making investments in foreign assets, such as US Treasuries and European bonds, less attractive. This dynamic could diminish demand for these assets, potentially leading to a shift in global capital flows.

10-year Japanese yields vs US treasury and EUR swap hedged in JPY

Chart 5: Japan Yield Curve vs 10-year USTs



Source: Bloomberg. This chart shows how the 10-year Japanese yield is becoming much more attractive other rate market once swapped into JPY.

Should Japanese yields become more appealing, domestic investors might opt to allocate more funds to local bonds instead of foreign markets, precipitating a potential outflow from US and European bond markets. This reallocation would likely elevate yields in these markets as bond prices decline due to reduced demand. Despite the increased attractiveness of domestic yields, Japanese investors have shown a pronounced preference for US Treasury holdings. In Q1 2024, despite the improved yield prospects in Japan after hedging, Japanese investment in US Treasuries surged, now accounting for 15% of total foreign holdings. This suggests a cautious approach from Japanese investors, possibly due to concerns over potential selloffs should the BoJ tighten monetary policy more aggressively.

Chart 6: US Treasuries Holdings by China and Japan

Source: Bloomberg. This chart displays the holdings of US Treasuries by China and Japan, highlighting trends and shifts in investment strategies by these major players.

The secondary effects on Europe could be significant, especially if rising US rates lead to a global shift in bond market dynamics. Higher US rates might pull investment flows out of European markets, pushing up yields there. Conversely, if investors perceive European markets as more stable, funds might migrate from the US to Europe, potentially lowering yields in Europe in the short term.

Conclusion

The imminent release of Japan's April 2024 CPI and the ensuing policy decisions by the Bank of Japan will play a pivotal role in determining the country's economic trajectory and broader global financial stability. As captured in this analysis, the adjustments made by the BoJ carry far-reaching implications that resonate through global markets, influencing currency dynamics and shaping investment strategies across the globe. As the BoJ leans towards potentially more assertive monetary adjustments, the ripple effects on global markets are expected to be non-negligible. These policy shifts, from interest rate adjustments to strategic interventions in bond markets, underscore a critical juncture not only for Japan but for international finance. They highlight the delicate balance between domestic economic needs and the interconnected nature of global financial systems. Investors and policymakers around the world must remain vigilant, prepared to adapt to an evolving economic landscape that is increasingly influenced by Japan's strategic decisions. The agility with which these stakeholders respond to Japan's monetary policies could dictate the stability and attractiveness of global fixed income markets. As we navigate these turbulent economic waters, Japan's policy moves remind us of the profound interconnectedness of our global financial ecosystem, where the interpretation of one nation's policies can have far-reaching impacts worldwide.

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