Global Macro Commentary

Japan: Back to "Normal"

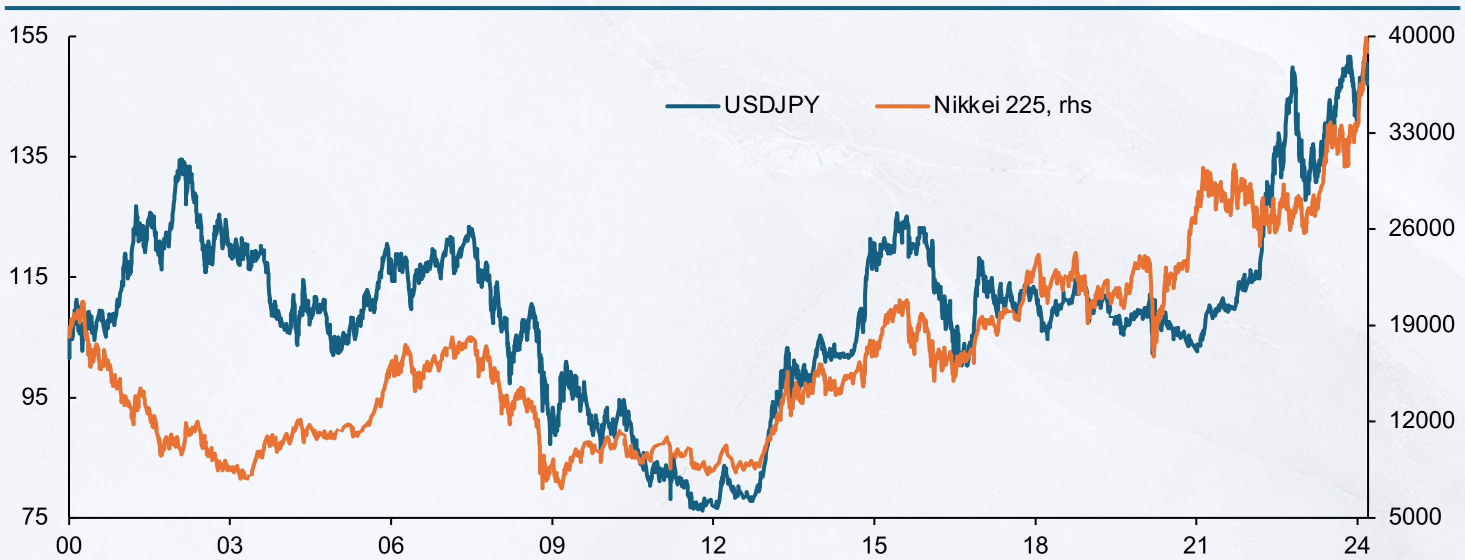
KEY MESSAGE

Strong Shunto result make NIRP exit more convinced. Wage hike pressures are driving up prices, with core inflation set to climb back to just below 3%, and it's supporting sustainability of 2% inflation. Anemic growth is attributed to supply constraints, but corporate earnings are strong, and firms show eagerness to invest despite labor shortages. **Meanwhile, BoJ is considering a new approach targeting the amount of JGBs purchased.** This change would remove guidelines on 10y yields and provide flexibility for the BoJ to normalize its balance sheet in the future through passive QT. The transition out of NIRP may involve raising RRR to incentivize interbank market functioning. However, future rate hikes may be limited due to tons of existing and unknown uncertainties.

Robust US economy could trigger duration sell-off, supporting USDJPY in the short term. Short JPY positions may unwind, but in the medium term, monetary policy divergence favors greenback. Retail investor outflows and portfolio flows add to the volatility. JPY may appreciate marginally but carry trade remains popular. **Market pricing of rate hikes by BoJ remains cautious, with 2y OIS trading at merely 0.22%**. Disappointment from BoJ's cautious stance in the past has made market reluctant to aggressively price in a hike. JGB yields are expected to rise slowly until the BoJ demonstrates a clear path towards monetary policy normalization.

We expect Japan's equity market momentum to persist, fueled by stable earnings, ongoing corporate governance reformation, and favorable macro factors. We overweighted on semiconductor, precision, machinery, and IT services sectors given solid profitability driven by the favorable exchange rate, industry recovery, and strengthening in core businesses.

Fig. 1: Positive correlation between Nikkei and USDJPY should reverse as Japan is rising again



Source: Bloomberg, CUIRS Investment Research

Global Equity Team (GET)
Reyna Kao
Co-President; Head of GET
reynakaocuhkirs2022@gmail.com

Global Markets Team (GMT)
Franco Hsu
Head of GMT
francohsucuhkirs@gmail.com

Gary Zhang
Head of GMT
garyzhangcuhkirs2022@gmail.com

Issuer of report:
CUIRS Investment Research

View CUIRS Research Report at:
https://www.cuhkirs2022.com/

Economics: 2% sustainable inflation in sight with 30y high Shunto result

Wage hike pressures driving up services prices. While nationwide core CPI inflation (all items less fresh food) did drop to 2.0% (y/y) in January, that was largely a reflection of continuing government subsidization of household energy bills, with new core inflation (all items less fresh food and energy) meanwhile running at 3.5%. Base-year effects associated with this subsidization are set to turn positive from February so that the core inflation rate is set to climb back to just below 3%. As the BoJ itself pointed out in a Bank of Japan Review paper published on 26 February, we are now starting to see growing evidence of wage hike pressures filtering through to prices in the services sector.

Fig. 2: Japan CPI

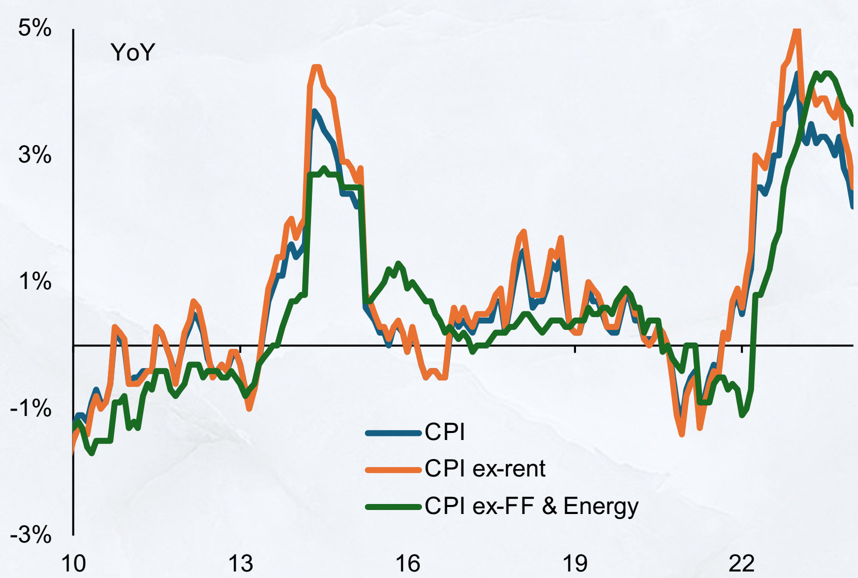
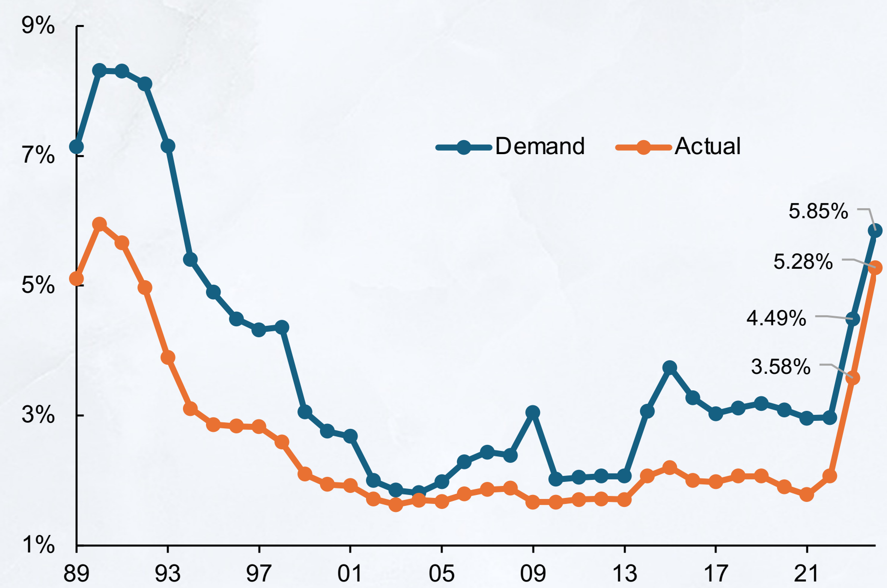


Fig. 3: Spring wage negotiation (Shunto) in focus



Rengo announcement point to strong wage growth. That said, the BoJ has already signaled that it will be making spring labor-management pay negotiations a major focus when arriving at its decision. Figures released by the Japanese Trade Union Confederation (”JTUC-Rengo") showed affiliated unions pushing for an average wage increase of 5.85%, with actual result of 5.28%. The first official tally of management responses provided a strong indication,with eventual outcome having historically only varied by around 0.1– 0.2pp from initial report. We thus see little point in the BoJ waiting until April to feel even more confident about spring wage hikes.

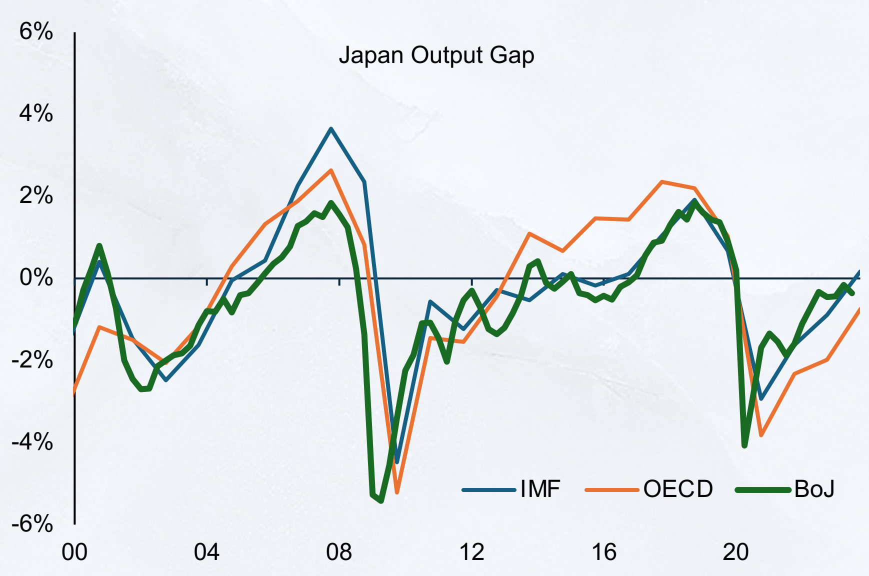
Anemic growth a reflection of supply constraints. As for the real economy, while preliminary GDP estimates for Q4 2023 show a second successive contraction, number corrected on March given subsequently released corporate capex data have come in strong. That should then make it easier to end NIRP without having to explain why such action is being taken with Japan in technical recession. Although production activity has been significantly depressed so far this year by the Noto Peninsula earthquake and Daihatsu safety testing scandal, we see little prospect of such factors having a sustained impact at the macroeconomic level.

Corporate earnings remain strong, and firms are seemingly eager to invest. The order backlog of capital goods continue to increase, while construction starts by manufacturers have recently been surging. It seems quite clear that the main issue for the Japanese economy has shifted from insufficient demand to supply-side constraints arising mainly from labor shortages.

Fig. 4: BoJ’s latest set of economy projection

		FY2023	FY2024	FY2025
Real GDP	Oct-23	1.8 to 2.0 [2.0]	0.9 to 1.4 [1.0]	0.8 to 1.2 [1.0]
	Now	1.6 to 1.9 [1.8]	1.0 to 1.2 [1.2]	1.0 to 1.2 [1.0]
CPI Ex-Fresh Food (FF)	Oct-23	2.7 to 3.0 [2.8]	2.7 to 3.1 [2.8]	1.6 to 2.0 [1.7]
	Now	2.8 to 2.9 [2.8]	2.2 to 2.5 [2.4]	1.6 to 1.9 [1.8]
CPI Ex-FF & Energy	Oct-23	3.5 to 3.9 [3.8]	1.6 to 2.1 [1.9]	1.8 to 2.2 [1.9]
	Now	3.7 to 3.9 [3.8]	1.6 to 2.1 [1.9]	1.8 to 2.0 [1.9]

Fig. 5: Output Gap should turn positive in 2024-25



Monetary: Passive QT will arrive amid at a very slower pace

On YCC, a recent article reported that the BoJ is considering moving to a framework targeting the amount of JGBs purchased after removing YCC, possibly at the current pace of JPY6trn/month. Given that BoJ already has a quarterly purchase schedule (link) indicating guidelines for the quantity and type of bonds purchased to a degree, the key change would be more so the removal of guidelines on 10-year yields at around 0.0% with the upper bound reference of 1.0%.

While keeping a lid on undue volatility after exiting YCC, this transition would also provide optionality for the BoJ down the road to begin normalising the balance sheet via passive QT, by managing the intended purchase amounts such that bond reinvestments are not conducted in full. In contrast, active QT or the outright selling of JGBs is extremely unlikely to be considered by BoJ for a couple of reasons, namely (1) the outsized influence the BoJ has in the JGB market, and (2) the strain on the BoJ's finances and thereby its credibility.

Fig. 6: BoJ B/S shall face very gradual contraction…

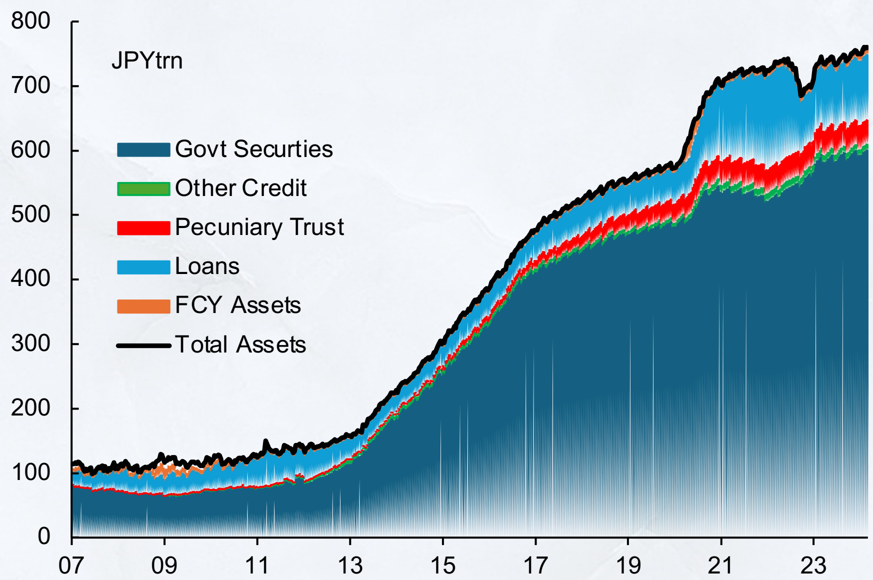
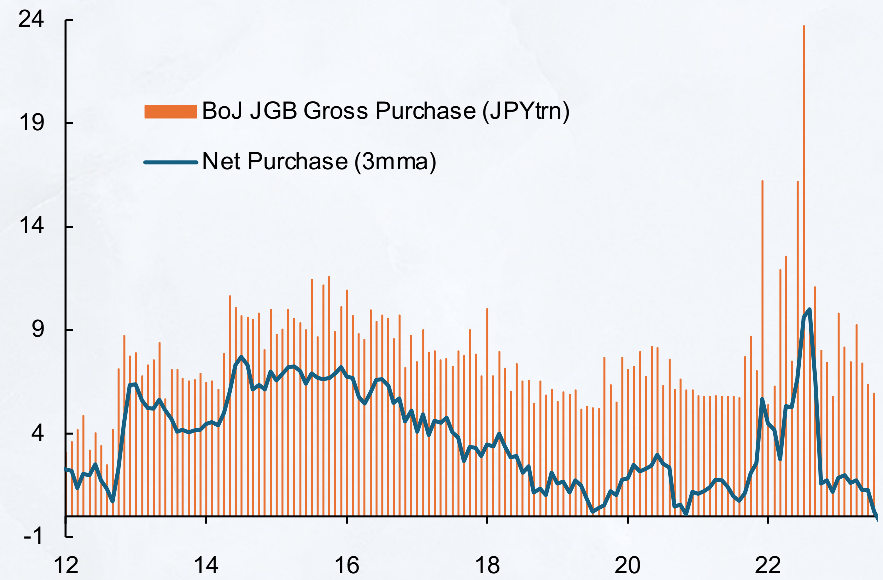


Fig. 7: …as net JGB purchases continue to decline



Widening the YCC band last year effectively announced the BoJ's intention to taper JGB purchases. In the next phase, returning to target the amount of bond buying would provide a potential glide path to passive QT further down the road (though not anytime soon), in line with Governor Ueda's modus operandi of being gradual.

We expect the transition out of negative rates to come in the form of raising the rates applied on the Macro Add-on Balance and the Policy-Rate Balance to 0.1% and 0.0%, respectively, to incentivise smooth functioning of the interbank market. The two-tier reserve remuneration structure would imply the Tokyo Overnight Average Rate (TONA) to fluctuate between 0.1% and 0.0%.

Looking ahead, expectations need to be tempered with regard to further subsequent rate hikes. Domestically, households have been on a considerably weaker footing due to negative real wage growth. While structural factors will help sustain upward pressure on nominal wage growth, labour productivity growth on the other hand, a factor in real wage growth, has remained lacking. The BoJ will also need some time to monitor the economy's adjustment to non-negative rates, with the comprehensive monetary policy review also still underway. Government subsidies on energy too, remain in flux as to whether it expires during 2Q24 or is extended, which will have implications on the outlook for households and inflation. With so many unknowns, the BoJ will rightfully proceed with caution.

Fig. 8: TONA should shift back to post-NIRP level

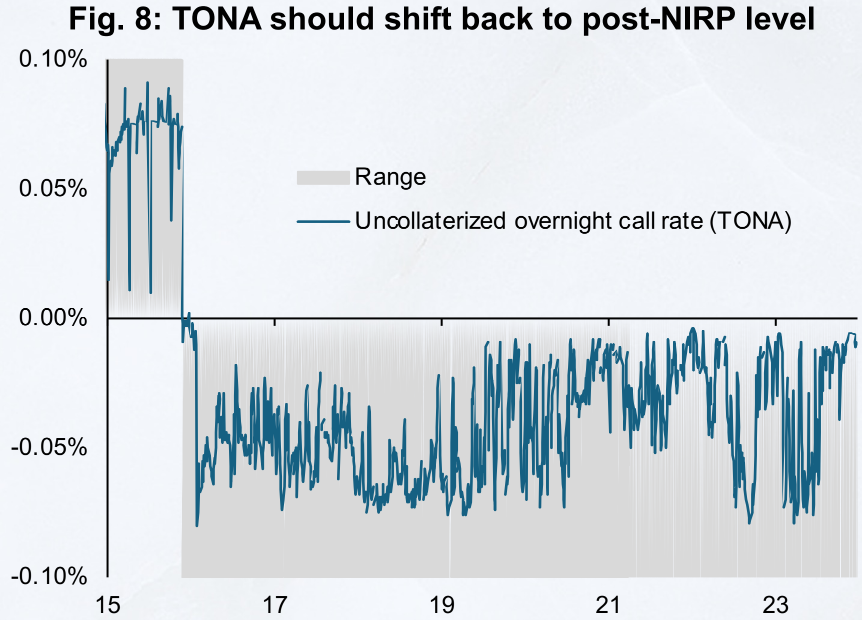
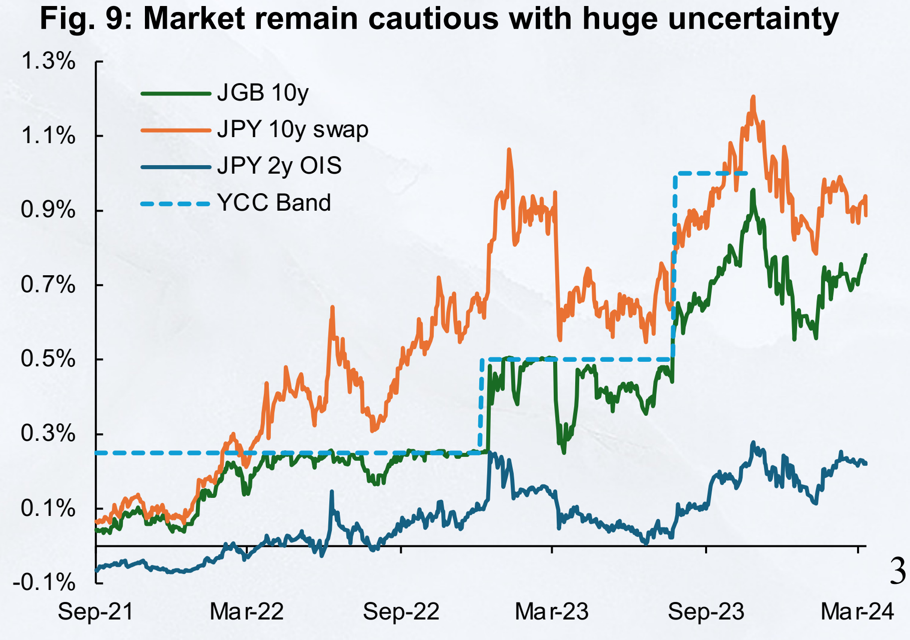


Fig. 9: Market remain cautious with huge uncertainty



FX: External factors matter more for USDJPY

USD-JPY has risen more than other Asian peers year to date. This is partly a reflection of its sensitivity to UST 10-year yields. As the US economy continues to perform robustly and beat the market expectation in March, the dot plot may change in March FOMC - likely to see more members expecting only 50bps cut in 2024 and higher terminal rates. This could trigger duration sell-off and the correction in over-optimism of "no-landing", which better supports the USDJPY in the short term. On the other hand, the market is not expecting the BoJ to be more hawkish over the medium term. In our view, this means that there is room for the market to price in more rate hikes, depending on the BoJ's comments post-normalization. And the narrowing spread between the demand wage hike and the result on shunto suggests there's more room for BoJ being hawkish.

Moreover, Considering that short JPY speculative positions are now at extreme levels (**Fig. 11**), then the JPY can probably avoid a 'buy the rumor, sell the fact' situation when the BoJ does hike, and USD-JPY can still fall further. But the short JPY position unwind can only buffer the currency in the short term. From a medium-term perspective, Yen can benefit from the monetary policy divergence between the Fed and BoJ. Despite this, we don't see a huge drop in USDJPY in 2024, as huge carry advantages still skew to the strong greenback. Our 2024YE USDJPY forecast is 135.

Fig. 10: Policy divergence buffer JPY in 2024 marginally

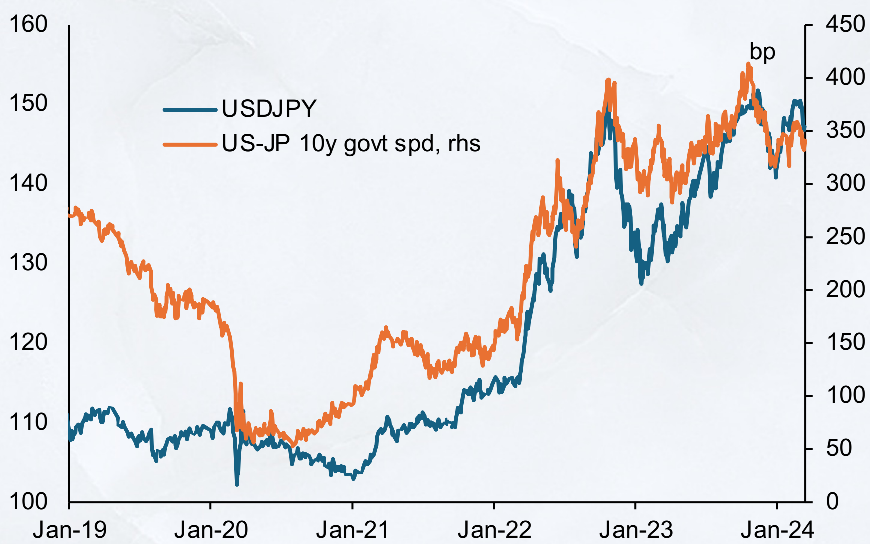
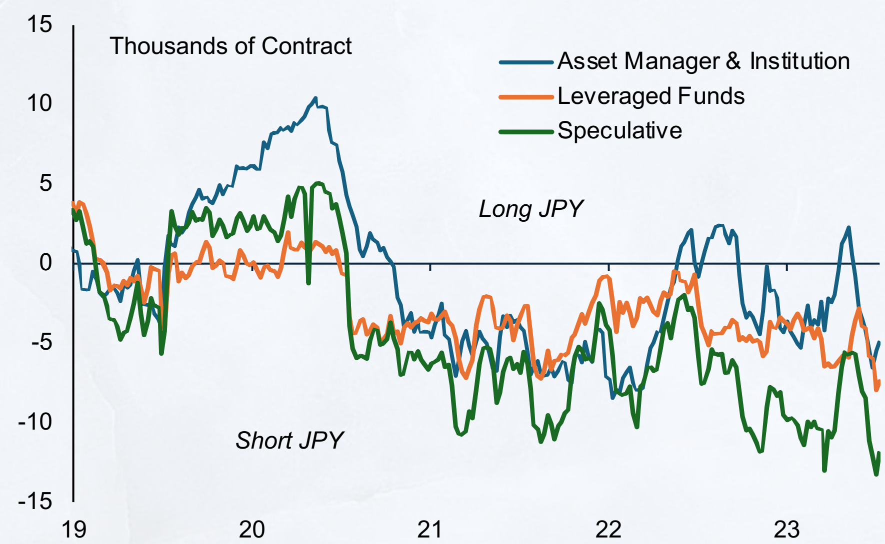


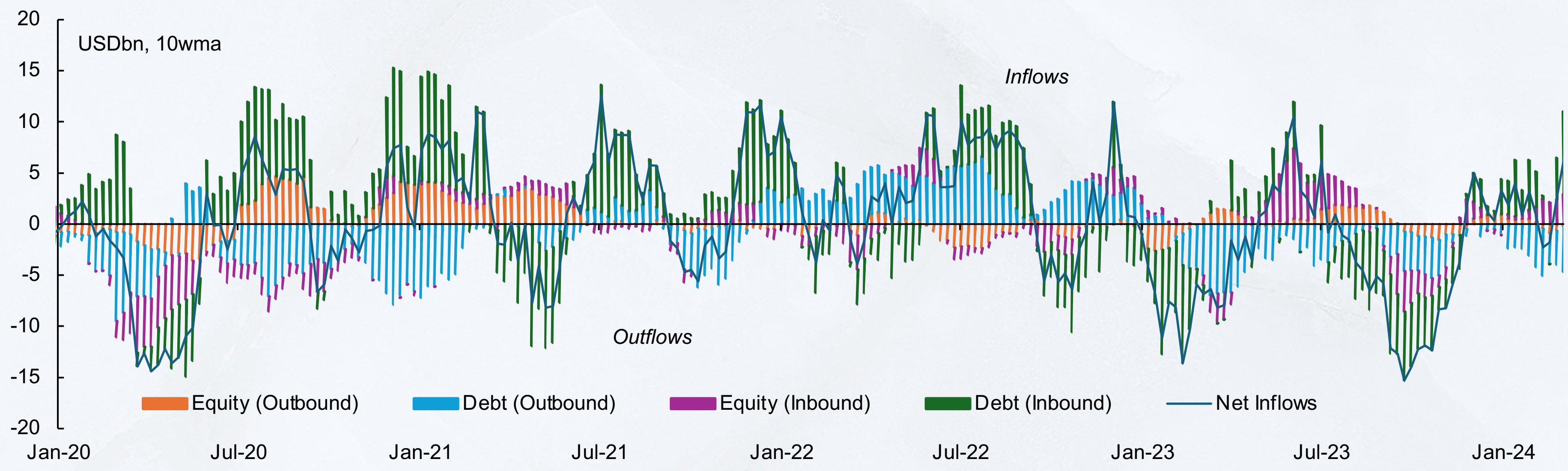
Fig. 11: Short positions unwind could better floor JPY



Apart from the external factors, Retail investors divest into foreign equities following changes to the NISA program (which provides capital gains tax exemptions). With effect from 2024, investment limits for NISA were raised. In Jan-Feb, investment trusts bought USD15bn of foreign equities, three times what they normally buy on average (USD2.5bn per month). Notwithstanding the significant retail outflows, the weekly portfolio flows remain supportive for local currency as the optimism around the Nikkei has been sustainable with the AI frenzy and corporate governance reform.

If we extrapolate and annualize these recent equity outflows, USD90bn outflows should be reached. That amount of associated FX purchases could negate the potential FX hedging flows from lifers (lifers own USD700bn foreign assets and 10% increase in FX hedging ratios could mean USD70bn of sell USD-JPY flows), although we don't expect a huge move on Japanese lifers' FX hedging behaviors as the change of accounting rule requires to include FX-hedging cost into PnL (Reuters, 9 Aug 2023). **To conclude, we believe the portfolio flows could be volatile as both global and domestic equity markets remain attractive with different themes.**

Fig. 12: Japanese weekly portfolio flows keep being supportive for Yen



For the downside, We believe it's hard for USDJPY to break 152 along with higher US rates. JPY NEER has already traded at 30y historical low, while the REER already broke the historical low after the Plaza Accord. And the undervaluation already leads to a 'J-curve' effect in balance of payment – imports contraction and boosting service exports. The tourism trade surplus is now actually at an all-time high (annualized USD30bn). Furthermore, the MoF seems to keen on intervening the market to defend JPY from depreciating further beyond its multi-decade low of 152. Therefore, we are of the view that JPY could marginally appreciate for both NEER or REER perspective from here but underperform HY FX as carry trade is getting more popular with tons of external uncertainties.

Fig. 13: USDJPY break 152 is unlikely...

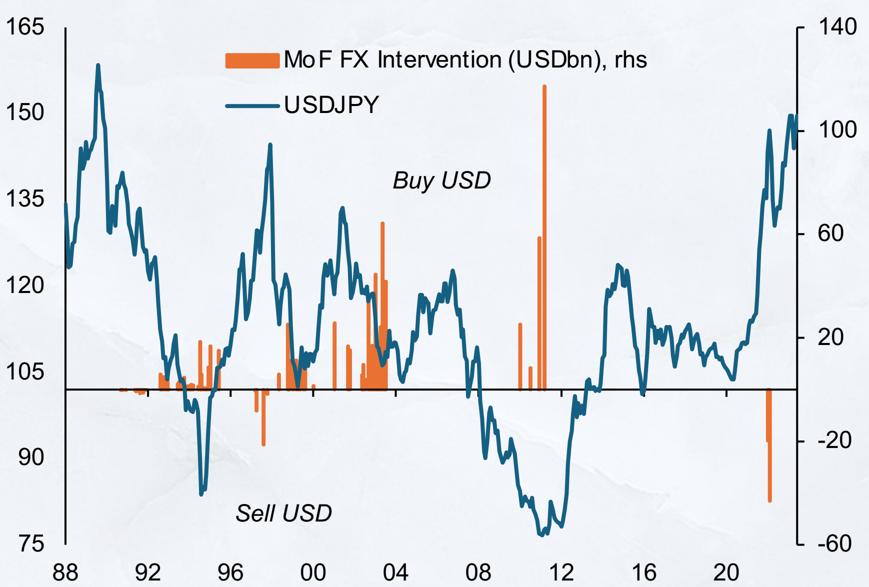
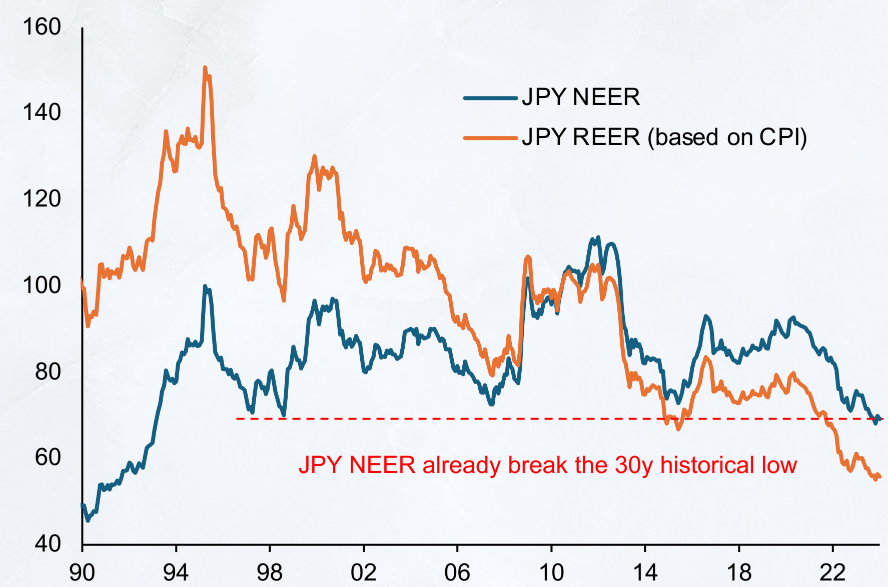


Fig. 14: ...as MoF keen on protecting JPY



Rates: Yield rise shy until the BoJ delivers

Market pricing of rate hikes more cautious: Although the market appears to have become more confident about March action, the OIS market does not price in the BoJ's first rate hike in full until April. Moreover, the OIS market is only pricing in 100% of the rate hikes priced at the peak of 2023 (with 2y OIS trade at 0.22%, **Fig. 9**).

We think that the reason that the market has recently become more cautious about pricing in policy change is because it has repeatedly been disappointed by the BoJ's cautious stance. Talk of policy normalization in Japan started almost two years ago. However, since then the BoJ has only tweaked its yield curve control policy with no action on the policy rate to date. Hence, the market has become reluctant to aggressively price in the BoJ hike, and JGBs tend to trade at rich levels relative to the policy outlook, with the 10y yield at low 0.7% levels and the 5y around 0.3%. **As a result, We expect JGB yields to rise slowly until the Bank of Japan proves it is set to normalize monetary policy beyond simply ending its negative rate policy.** We also provide two trade idea below:

1) **JGB 20s30s flattener**. We view the current 20s30s as steep, likely due to JGB supply reduction from Q1 this year, instead of Q2. However, it should flatten as market becomes accustomed to the reduction, to 15bp by YE, around the mid level in 18-22. The 20s30s steepening in 2022 was due to the 10y YCC cap and is unlikely to be repeated.

2) We like to **Pay JPY IRS 1y1y @0.44%** to avoid tail risk in case the BoJ does not exit from the NIRP at March. And it has more potential room to rise from here as market has priced in limited hike after 1y, in our view.

Fig. 15: JGB 20s30s may turn flatten

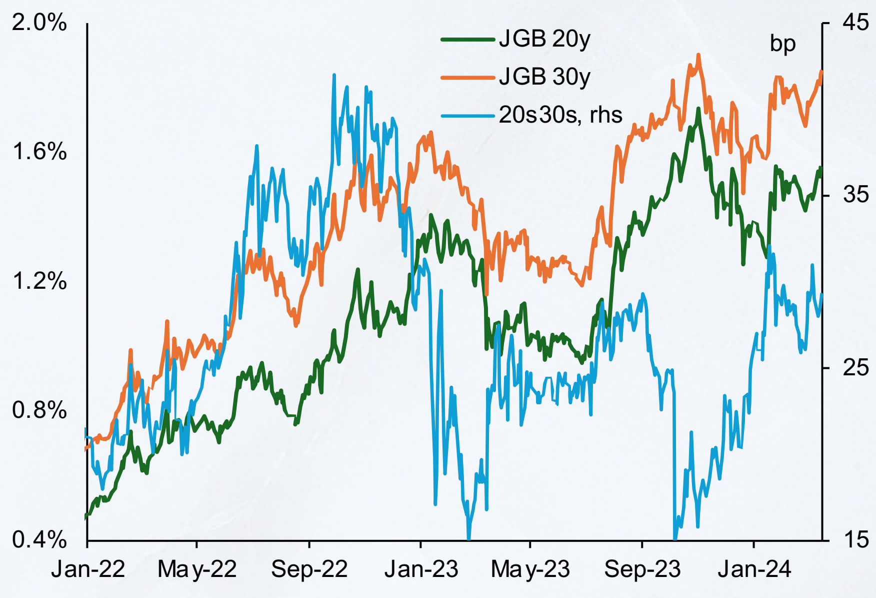


Fig. 16: Paid 1y1y to hedge the dovish BoJ

Equity: Upward trend continues

In March 2024, the Nikkei 225 index passed its record intraday high of 40,000 for the first time in history on 4 March, then pulled back by approximately 3.4% in the following weeks. The strong gain in Japan's equity market is due to the weakness of the yen against the dollar, the shift of investor appetite from the Chinese market to Japanese equities, and the rise in chip-related stocks. Despite the most recent retreat, we remain positive on the Japanese stock market. Looking forward, we expect an upward trend in the Japanese equity market to persist, supported by the following factors:

1) **Corporate governance reform to attain investors' interest:** The Tokyo Stock Exchange (TSE) corporate governance reform represented a key investment theme in 2023, which drove investors' attention in the Japanese market. Corporate governance is expected to continually be on a strengthening path as more policies are executed in 2024. For instance, Japan’s reconditioned tax-free investment system, NISA, starting in 2024, will aim to ignite stock market interest from retail investors. Moreover, TSE published a list of companies that have disclosed information concerning “action to implement management that is conscious of the cost of capital and stock price”. These measurements would contribute to an improvement in corporate governance, which ultimately drives valuation re-rating.

2) **Growth momentum backed by earnings:** We overweighted on semiconductor, precision, machinery, and IT services sectors as they recovered from industry cycle downturns and could deliver more promising earnings driven by favorable foreign exchange rates, solid underlying fundamentals, and business transformation under digitalization trends. In particular, we viewed Japan's semiconductor sector as a key beneficiary under the global semiconductor supply chain. As for IT service sector, we see it facilitates innovation to resolve aging and labor shortage issues in Japan, helping companies to achieve digital transformation. Adding on the geographical and macro factors, as more foreign investors come into the market, the liquidity and efficiency improve, enabling Japanese equities' positive fundamental stories to play out.

The headwinds of the Japanese market are the relatively low liquidity compared to Asia DM equity markets, and demographic issues - an aging and declining population that may threaten sustainable growth in the long run. To alleviate the potential risks, one should consider a combination of macro and micro factors - global economy, inflation, monetary policy, domestic demand, and companies fundamental, to assess Japan's equity market potential.

Disclaimer

This report is generated by the analyst at CUIRS Investment Research (hereby “CUIRS” including any of its member). CUIRS is a non-profit student organizations aims to enhance the student’s investment research ability in Hong Kong. This report is not an investment recommendations and CUIRS is not responsible for any clients, the information and investment insights is published only for students’ self-practices.

All information provided herein is for informational purposes only. CUIRS do not invest money or act as a financial adviser to clients or accept investment commissions or fees. Financial investing is a speculative, high-risk activity. No offers to buy or sell any security are being made on this student research report.

THERE CAN BE NO ASSURANCE THAT ANY PRIOR SUCCESSES, OR PAST RESULTS, AS TO INVESTMENT EARNINGS, OR OTHER INFORMATION, CAN BE USED AS AN INDICATION OF YOUR FUTURE SUCCESS OR RESULTS.

READERS OF THIS REPORT ARE ADVISED TO DO THEIR OWN DUE DILIGENCE WHEN IT COMES TO MAKING BUSINESS AND FINANCIAL DECISIONS AND ALL INFORMATION

YOU AGREE THAT THE CHINESE UNIVERSITY OF HONG KONG INVESTMENT RESEARCH SOCEITY (“CUIRS”) OR ANY OF ITS MEMBER.ARE NOT RESPONSIBLE FOR THE SUCCESS OR FAILURE OF YOUR BUSINESS DECISIONS RELATING TO ANY INFORMATION PRESENTED BY THIS REPORT OR ANY CONTENT GENERATED BY THE CHINESE UNIVERSITY OF HONG KONG INVESTMENT RESEARCH SOCEITY (“CUIRS”) OR ANY OF ITS MEMBER.

No Investment Advice
The information in this report has been complied from sources we believe to be reliable, but we do not hold ourselves responsible for its completeness or accuracy. It is not an offer to sell or solicitation of an offer to buy any securities. All opinion and estimates include in this report constitute our judgement as of this date and are subject to change without notice. The report is for academic purpose only, you should not regard this report as an investment/legal/tax/financial/any recommendation or offer to buy any securities.

Any use, disclosure, distribution, dissemination, copying, printing or reliance on this publication for any other purpose without our prior consent or approval is strictly prohibited. All rights reserved to CUIRS and any of its members, including the direct composers of this report.

CUIRS will not accept any responsibility or liability whatsoever for any use of or reliance upon this publication or any of the contents hereof. Neither this publication, nor any content hereof, constitute, or are to be construed as, an offer or solicitation of an offer to buy or sell any of the securities or investments mentioned herein in any country or jurisdiction nor, unless expressly provided, any recommendation or investment opinion or advice. This research report is not to be relied upon by any person in making any investment decision or otherwise advising with respect to, or dealing in, the securities mentioned, as it does not take into account the specific investment objectives, financial situation and particular needs of any person.

CUIRS Analyst Certification
The CUIRS analysts hereby certify that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

About The Chinese University of Hong Kong Investment Research Society (CUIRS)
Established in 2022, CUIRS was founded by 7 undergraduates at The Chinese University of Hong Kong, to enhance students‘ investment research ability across various asset classes in global markets, to further achieve future career success. Our goal is to establish strong in-house research abilities by delivering high-quality monthly research.