BNY
iFlow
MACRO MORNING BRIEFING

July 26, 2024

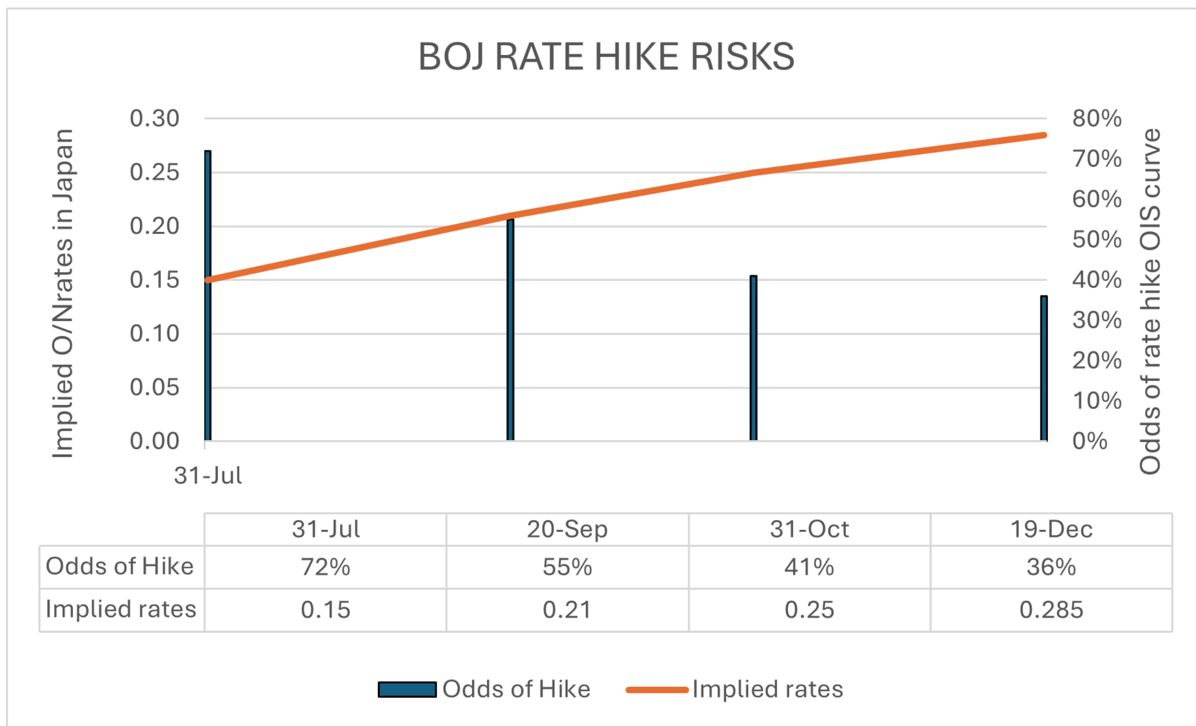
BOJ and the Real Rate Problem

The JPY is the biggest mover in FX markets in July. The Bank of Japan meeting on July 30 and 31 will set the tone for the rest of the summer. Markets were surprised by the new Japanese government intervention in the JPY after the lower-than-expected US CPI. The shift in FOMC rate cut odds helped the JPY gains, allowing the money spent by the MOF to have a greater effect. The JPY correlation to other markets as part of a carry trade is also significant, linking the JPY to equities and corrections in risk markets overall. Our iFlow data highlighted the risk of a reversal given that short holdings were over two standard deviations from normal and flows continued to be negative. The JPY moves in July have technical and fundamental significance, which matters to how APAC regional currency holdings play out.

- We see the BOJ raising rates in July and again in September and December, lifting rates to 35bps – some of this is linked to reversing JPY weakness, recognizing the link of JPY to inflation risks.
- We see the BOJ cutting its bond buying by ¥1trn to ¥5trn on the month and cutting at each meeting thereafter, to ¥3trn, or half of the current level, by fiscal year-end – this implies a 4-year path to return to pre-pandemic levels of bond holdings.
- We see the level of JGB yields rising to 1.25%-1.50% by September and expect further JPY gains to track real yields going forward.

BOJ could raise rates and cut bond buying on July 31 – all meetings are live for Governor Ueda throughout the rest of the year – there are four meetings left: July 31, September 20, October 31 and December 19, with the market pricing in two hikes of 10bps each, boosting the O/N rate to 30bps.

Exhibit #1: BOJ rate hike risk is modestly priced in market

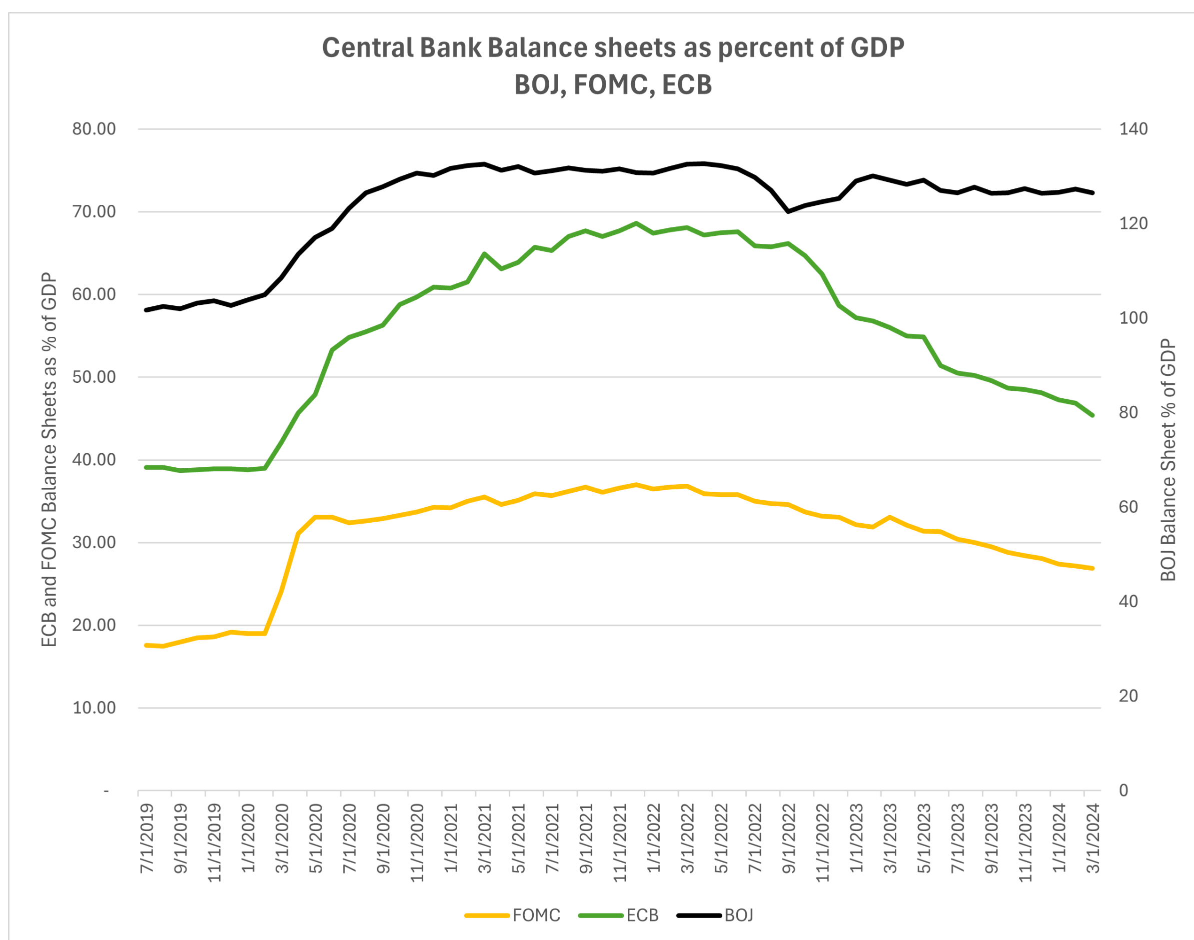


	31-Jul	20-Sep	31-Oct	19-Dec
Odds of Hike	72%	55%	41%	36%
Implied rates	0.15	0.21	0.25	0.285

Source: Bloomberg, BNY

BOJ balance sheet constraint has been in market pricing for years. The ability of the Bank of Japan to roll off bonds in 2H 2024 is underpriced, as many see the constraint of their holdings and rates forcing them to go slowly. The largest worry for investors is the role of government debt and what a rate hike means for the cost of debt servicing. The FY 2024 estimate for debt service is ¥27trn – almost 25% of the overall budget. The BOJ reverse spread risk is on its holdings leading to paper losses. The risk of the BOJ surprising with a faster roll-off of its holdings remains high even as the balance sheet as a percentage of GDP has been holding above 120% since the pandemic. Japanese bond market players surveyed by Reuters earlier this month said they expect the BOJ to slow monthly bond buying to around ¥4.65 trillion on average in the initial year, and to ¥3.55 trillion in the second year. The path of other central banks normalizing their holding post-pandemic – from the FOMC to the ECB – show that different paces have various effects on the economy. The BOJ has yet to respond to the pandemic stimulus that other G10 banks have started to unwind. Clearly the tool of quantitative easing (QE) was more important to Japan, with zero rates, than to the ECB or the Fed, as they carried out 35% of their balance sheet expansion during the pandemic. The FOMC did the least of the big five central banks, but their quantitative tightening took longer.

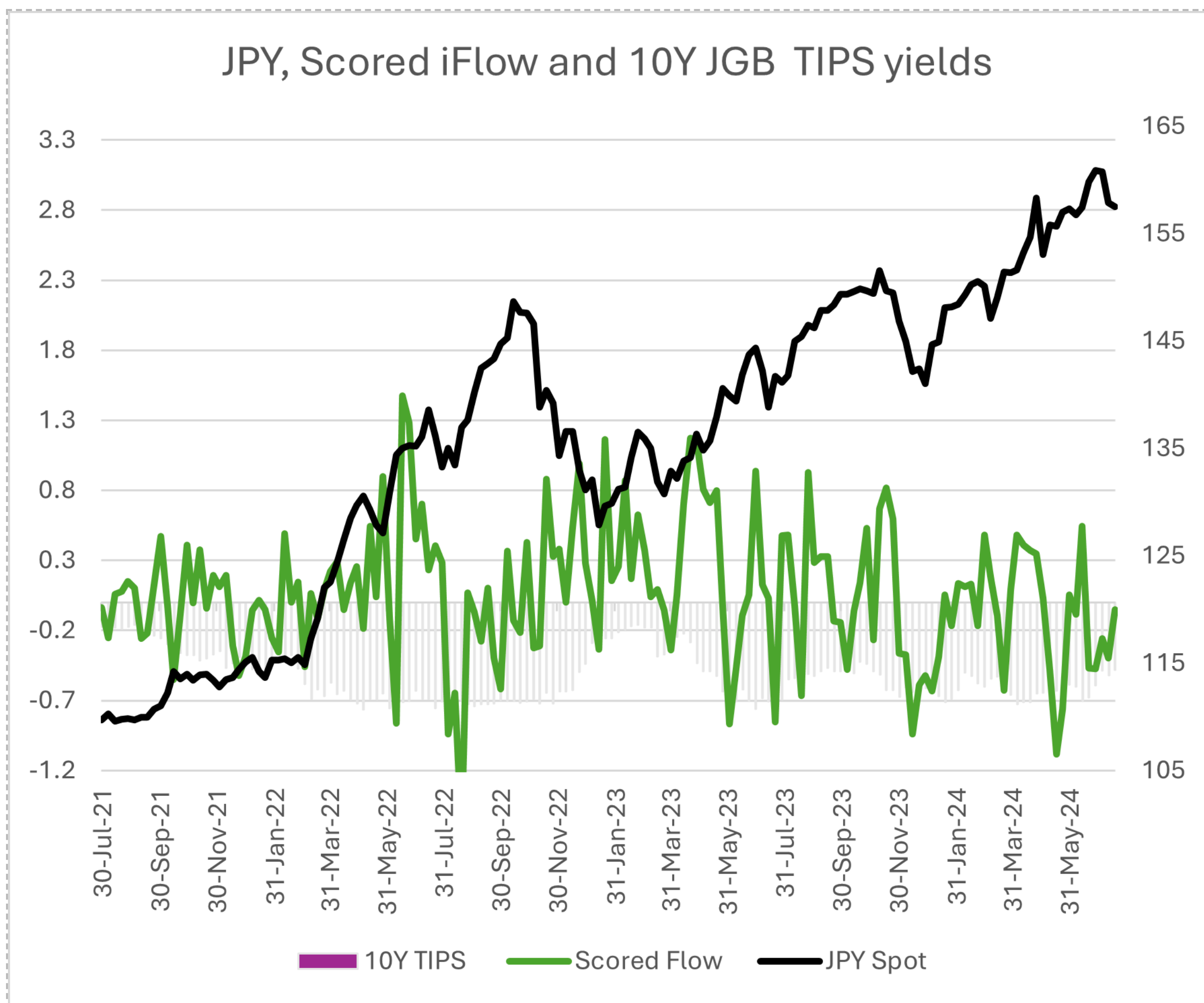
Exhibit #2: BOJ has a long way to go for its balance sheet



Source: Bloomberg, BOJ ECB, Fed, BNY

The role of real rates and JPY is clearly correlated. Financial repression from the central bank will, over time, work to fix the Japan debt problem, but economic growth will suffer. Currency devaluation and the inflation that follows it is another route. The spike in USD/JPY in September 2022 followed the dip in real 10-year yields to -0.70%. While the focus of traders has been on the US/Japan bond yield spread, the role of real rates is more important. The iFlow data also tracks real yields, albeit with notable volatility and seasonality. The next big seasonal risk for JPY will be September, when the FOMC easing expectations may lead to a significant shift in spreads to Japan rates. The link of JPY weakness to BOJ decisions ahead seems to point to both JGB and rate hikes to fight the FX undervaluation.

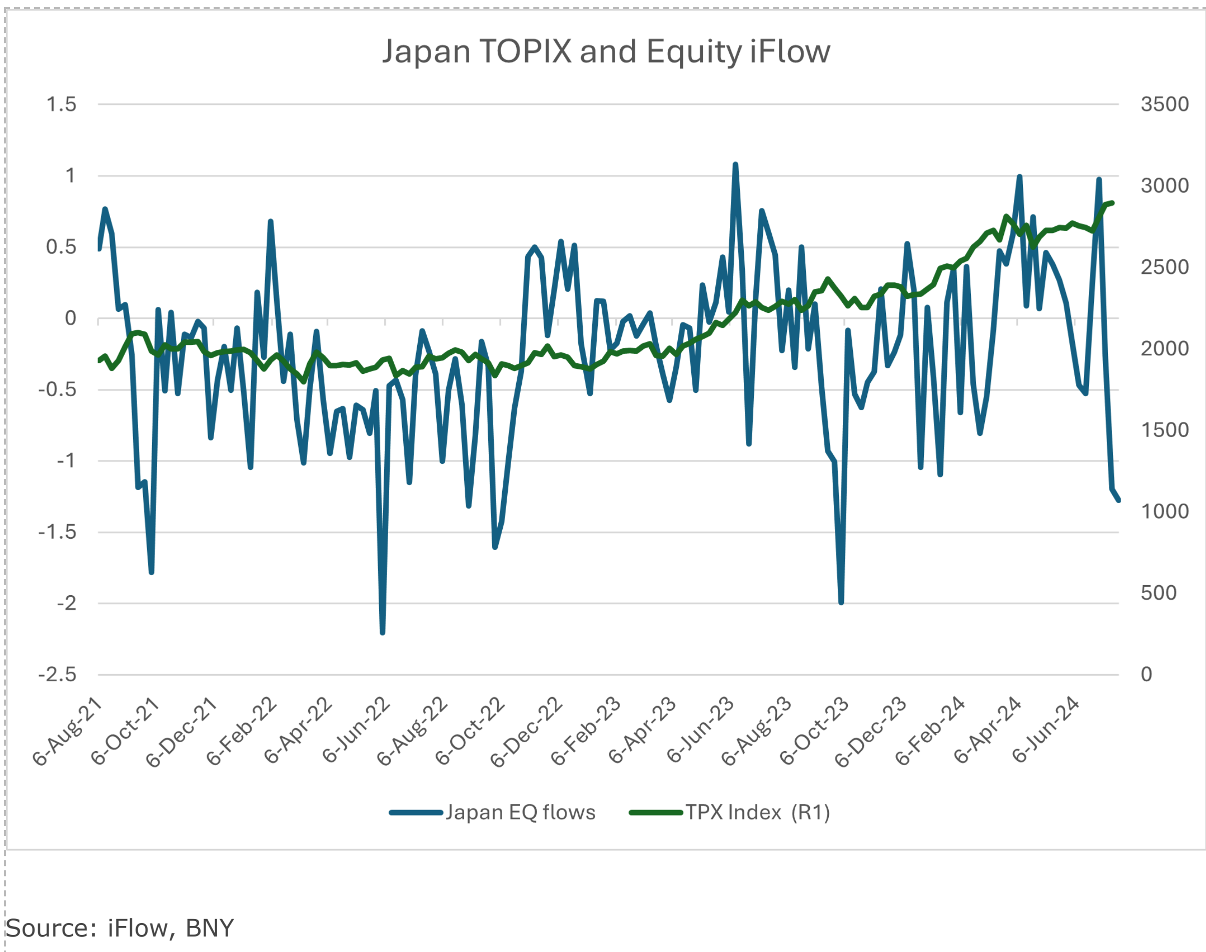
Exhibit #3: JPY and real rates are significantly correlated



Source: Bloomberg, BNY

For the Bank of Japan, the bigger issue for the normalization of policy is how to keep the economic recovery intact, with consumption being the key factor. The role of balancing the pain of higher rates on consumers against the pain of a weaker JPY has been linked by the central bank to wages. The key factor in BOJ thinking in the past has been the level of equities, so the stall of the Nikkei in the last two months is a cautionary factor for too fast a normalization. Further to this logic is that the JPY short position by foreigners as a "carry paying" hedge against long Japanese equities no longer has the same power. When you look at the BNY iFlow data into Japanese equities and the TOPIX, you can see that investors sell rallies because they are long. The long positioning in the Nikkei and the current doubt about global risk makes the role of JPY as a safe haven more likely a factor than any rate differential pressures. The ability of the MOF intervention to wash out the short JPY positioning of foreigners will not be about equity corrections, but something else.

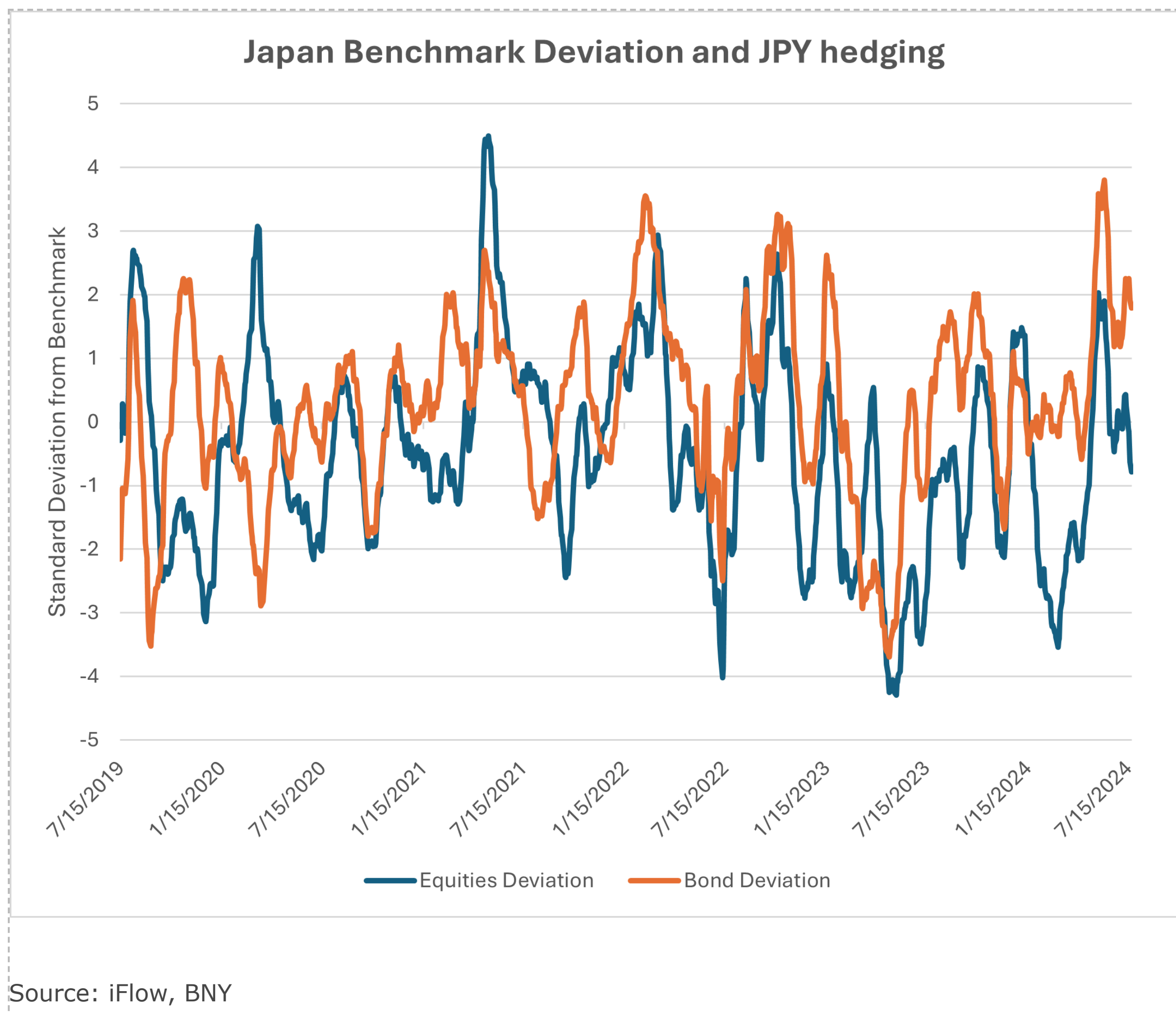
Exhibit #4: JPY not set by equity hedging



Source: iFlow, BNY

The monthly benchmark of JPY hedging to equities is episodic and has been less of a factor than bonds since the start of 2024. For month-end, the JPY buying required to catch up to benchmark Japanese exposures is led by the JGB markets and only this week did the equity market balance out against this move. The weaker bond performance requires an unwinding of some of the JPY hedging. The two standard deviations move of Japan bonds in July stands out as the biggest factor for JPY moves into August. This adds to the volatility of the BOJ meeting and makes the risk for 150 tests in JPY even more significant.

Exhibit #5: JGB performance dominates JPY hedging in 2024

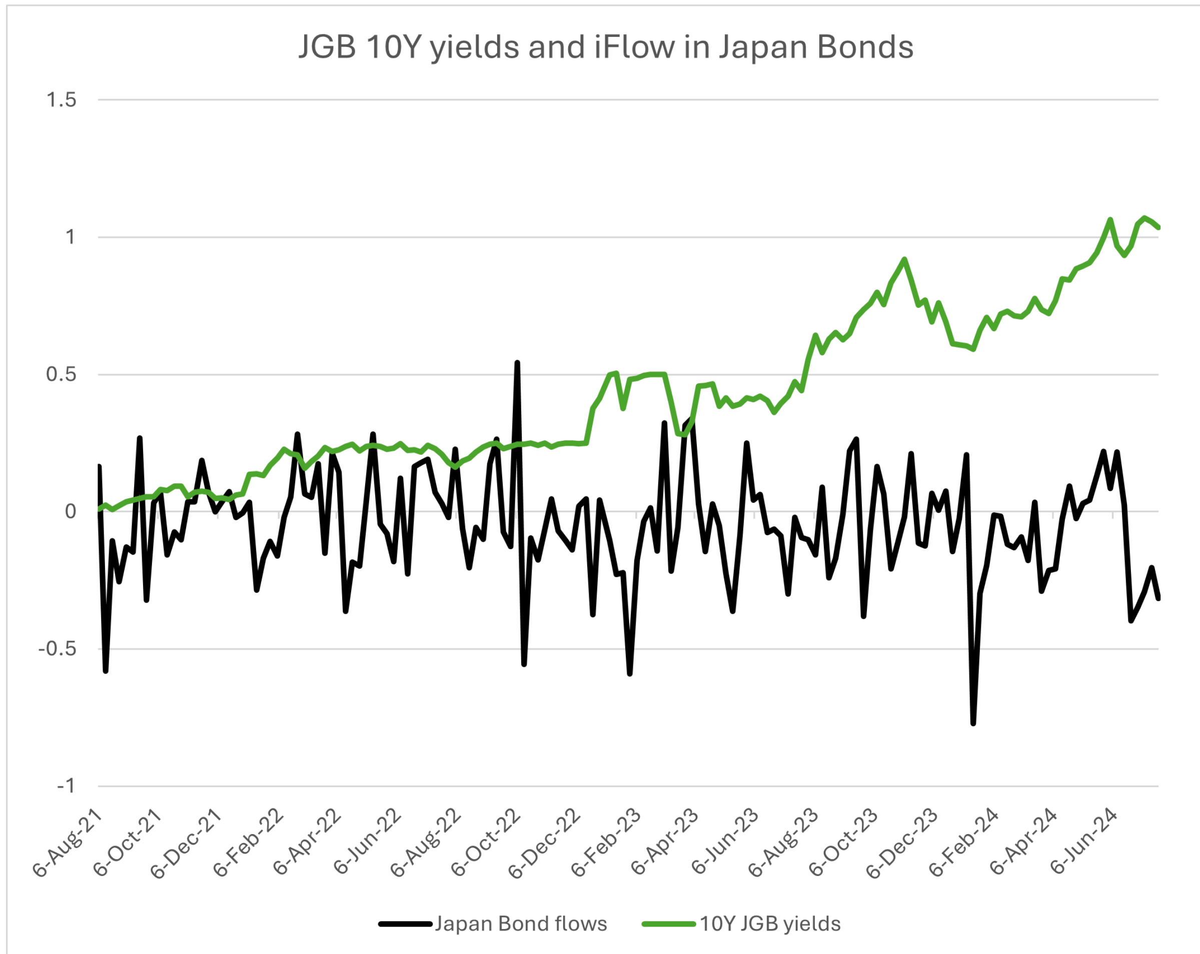


Source: iFlow, BNY

Bottom line: The Bank of Japan has a myriad of factors to consider at its next meeting, including the cost of rate hikes and bond roll-offs on the real economy. The effect of both on the USD/JPY rate matters significantly to global markets as well. The unwinding of JPY carry trades and JPY short hedging in equities will help JPY regain some of the 10% losses it saw in the 1H 2024. For JPY to get back to 130-140, where most analysts would see as near fair value, the real rate in Japan needs to rise and economic growth must continue. The BOJ balancing act rests on how higher rates hit homeowners as they roll over their floating rate debts, as exporters deal with JPY gains hitting profits and as service businesses deal with foreign demand. Keeping the economy going rests on exports, tourism and consumer demand holding regardless of rate levels. The foreign demand for JGBs should help the BOJ in this process and the government in funding the debt. However, we can clearly see that in 2024, the BOJ has not done enough to bring on JGB demand, all of which revolves around real rates, with inflation over the 2% headline being the key drag. For the rest of the world, the rise of JGB yields matters given the $4trn in holdings for US bonds along with 10% of the Australian and Dutch debt markets.

Expect JPY to reflect this balancing act first, while AUD, EUR and US bonds digest BOJ decisions over the next few weeks.

Exhibit #6: How JGBs trade will set the course for JPY



Source: iFlow, BNY

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