

September 13, 2024

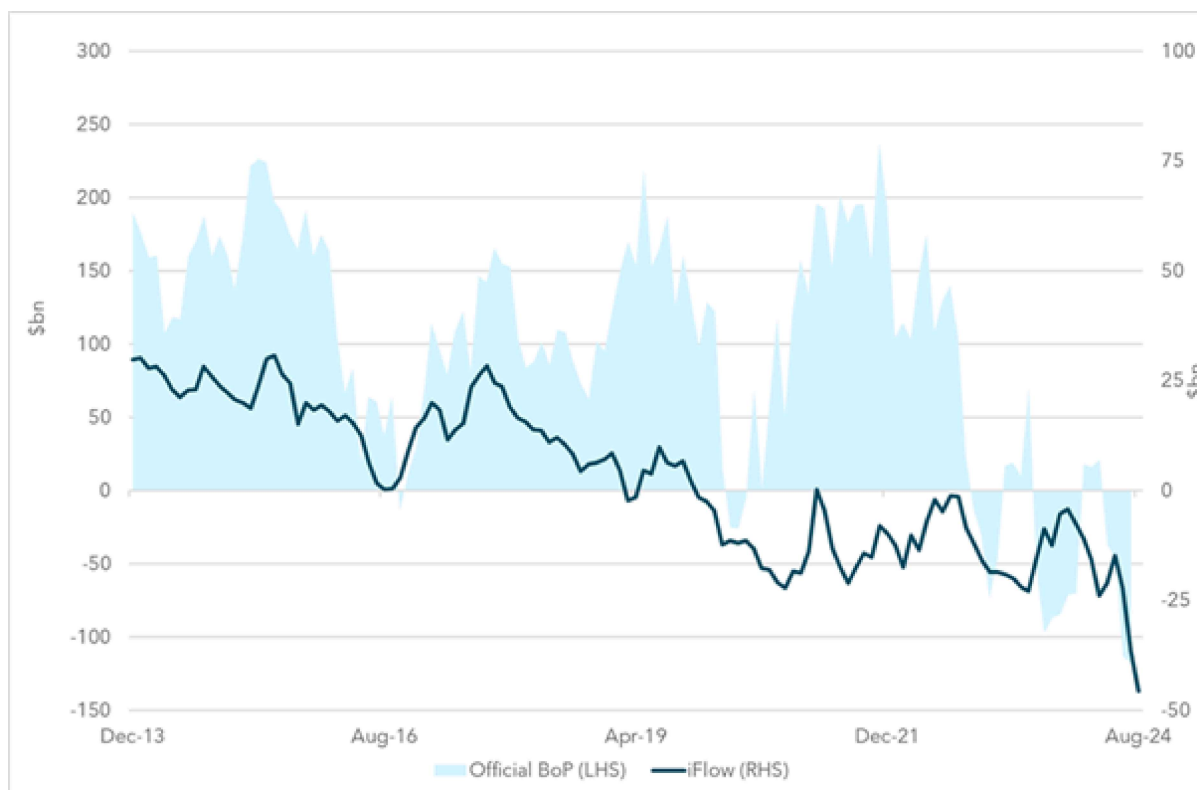
Neutral Rates and JPY

- **BOJ expected to confirm 15bp hike in October meeting** – if economy remains on track and after LDP leadership decision – still far from 1% neutral rate some BOJ members had floated as a target.
- **Fed expected to cut 25bp** and make clear further easing plans remain data-dependent – with the US election result not part of their consideration, but fiscal concerns rising.
- **The need for faster monetary policy actions in Japan and slower actions in the US** compared to market pricing drives a significant portion of the current volatility in FX markets. The uncertainty of growth and inflation looks set to remain essential to all market risks.

The debate for next week is about US and Japan neutral rate policy. We can contrast the process for finding the neutral rate in the US, where the Federal Reserve will employ more art to cut rates, while in Japan the BOJ, as it hikes rates, will take a more scientific approach to reach at least 1%. The factors behind these decisions start with real rates – the inflation expectations ahead, along with the balancing of economic growth and outside shocks. For Japan, the JPY matters significantly in the equation, while the US central bank has the dual mandate of price stability and full employment. The non-accelerating inflation rate of unemployment (NAIRU) used to be part of the US debate on rates, while the BOJ has since August added financial stability as measured by the volatility of the TOPIX stock index as a consideration. Both the Fed and BOJ have another special consideration this year with politics and fiscal issues as the LDP leadership choice and new plans for government spending matter significantly to the balance sheet of the central bank, while in the US the election and the makeup of Congress will determine the cost. All of these things matter to global markets with the keen focus on JPY and equities,

and the role of Japan savings in fixed income investments abroad. Our iFlow data highlights the limitations that both central banks must consider as they search for the neutral rate.

Exhibit #1: Japan Official Balance of Payments vs. iFlow

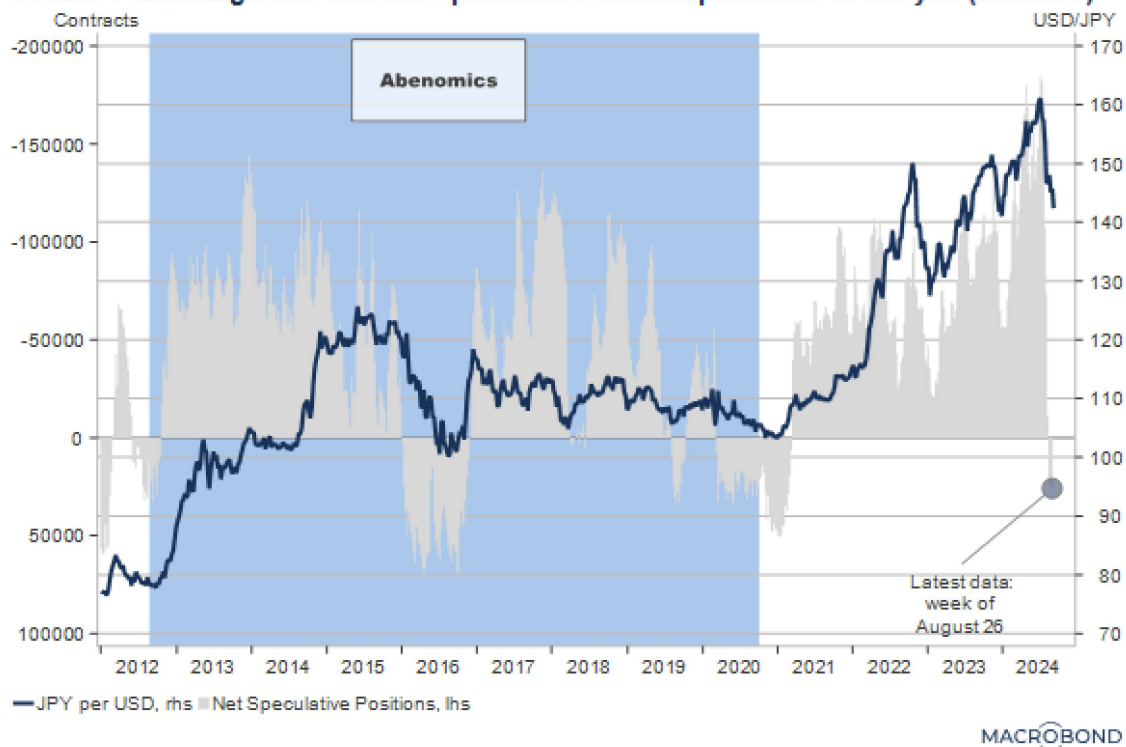


Source: iFlow, BNY

The surprise 15bp rate hike from the BOJ at the end of July, lifting the overnight target rate to 0.25%, led to a significant outflow by international investors from Japanese bonds and stocks. At the same time, the JPY strength that followed the “carry trade” hedge unwind supported Japanese purchases by domestic investors abroad. The official data from the Bank of Japan on Japanese buying of foreign bonds hit a record on the month of \$51.3bn – more than the July 2016 outflow – and added to concerns about the asset markets in Japan suffering a liquidity shock. Exhibit #1 highlights how the Japanese balance of payments problem shows up in 3Q current account and this will lead to political pressure to keep money at home. The new LDP leader will have this as a new issue to consider. The post-Prime Minister Kishida role for the government in JPY and growth will be something that the Bank of Japan must consider in its next set of meetings.

Exhibit #2: JPY and CME Speculative Positioning

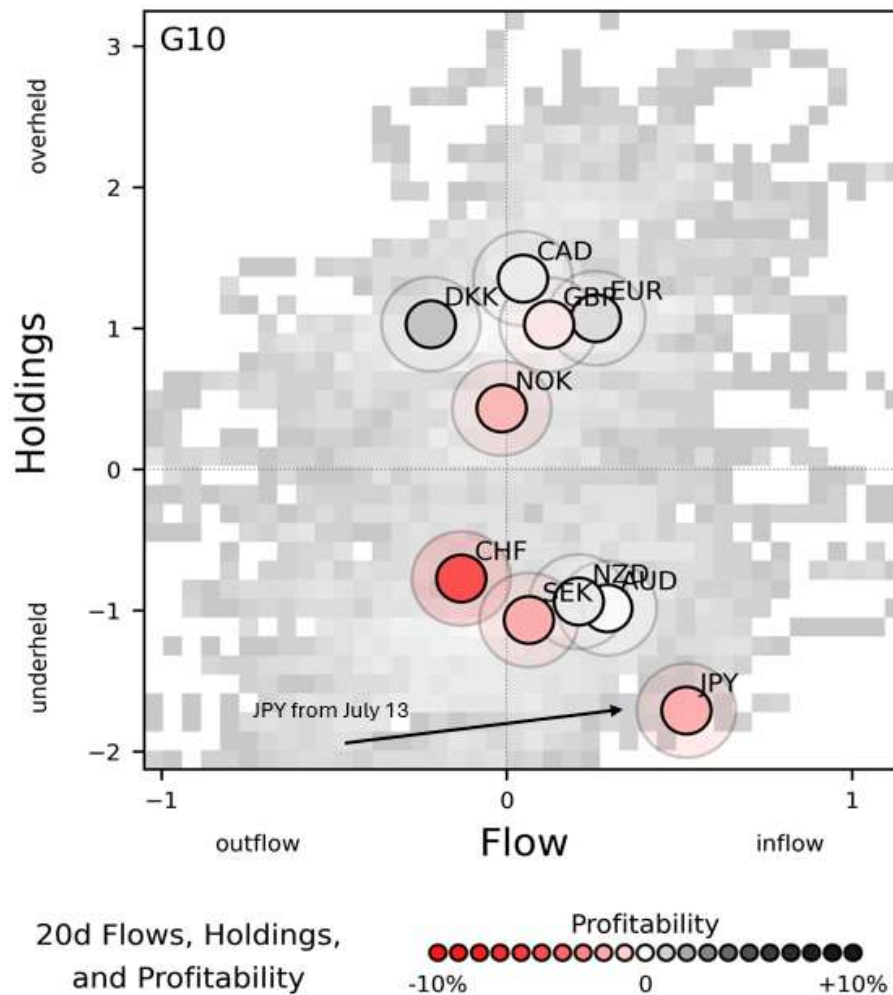
USD/JPY exchange rate and net speculative futures positions in the yen (inverted)



Source: Macrobond, BNY

The JPY short positioning unwind may have flipped for speculative accounts on the Chicago Mercantile Exchange (CME) – with faster moving money from hedge funds and CTA accounts and slower and more persistent flows in iFlow both suggesting continued JPY buying – although there were notable shifts in the last week ahead of the BOJ meeting next week. Exhibit #2 shows that JPY weakness has peaked, and the risk of further JPY gains is likely to continue for some weeks ahead. In fact, as we show in Exhibit #3 – real money flows have been playing the risk of JPY gains in every BOJ meeting since July 2023. Things are no different this time around. The bigger picture is that short JPY positions wrapped around asset positions remain critical to how USD/JPY trades in the months ahead. Behind those asset allocation decisions are how rate policies shift bond yields and equity markets.

Exhibit #3: iFlow G10 FX Positions and Holdings and Profitability



Source: iFlow, BNY

The Bank of Japan has three meetings left this year – September 19-20, October 30-31 and December 18-19. The expectations for a bigger shift in policy for the central bank are wrapped around their four meetings that deliver the Outlook report and this year that falls to October. There is nothing priced in the market for next week. Expectations are that the BOJ will hold rates steady and wait for more data. Just 10bp of hikes have been priced into futures for October 31. The volatility in 1-week options covers the FOMC the day before, making it noisy around the USD leg more than JPY. The current pricing implies 25% volatility or about a 1% premium – on the low side of recent BOJ meetings. The risk-reward for JPY continues to be biased toward the USD downside. Given the FOMC meeting and the risk of more easing after that meeting, it is more important to consider the neutral rate for both central banks in the months ahead.

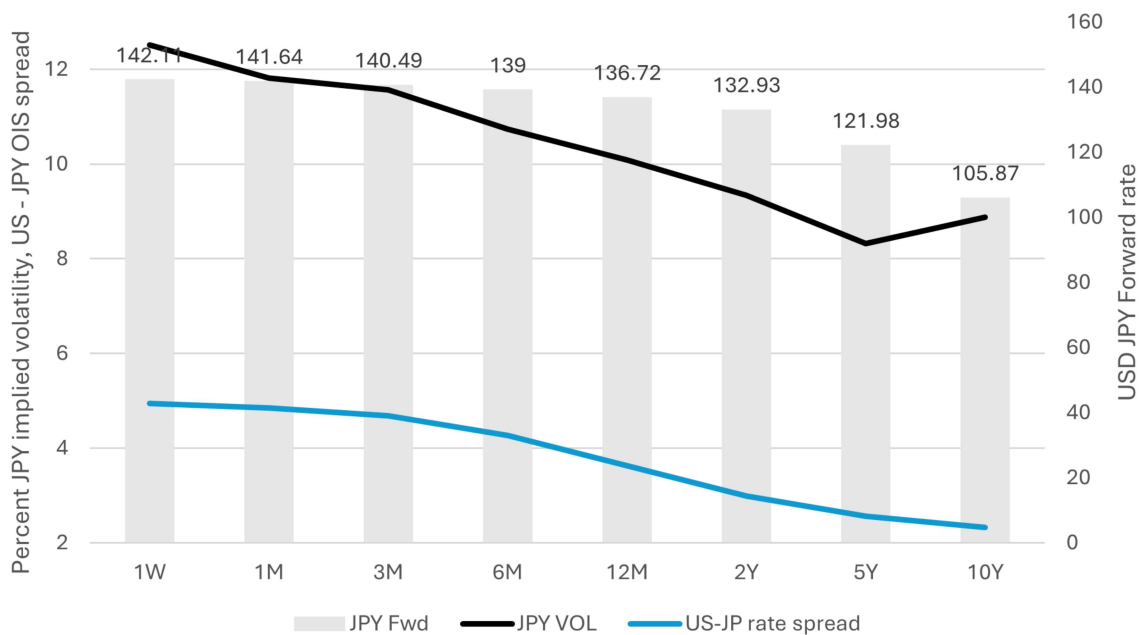
If the only consideration for the Bank of Japan was getting JPY to fair value – which we suggested in other pieces was 120 – then in five years the market sees the USD/JPY forward getting you there and perhaps most importantly, the US-Japan real rate spread using inflation-indexed yields gets you there as well. If the terminal rate in Japan gets to 1% by January 2027, the implication is that we will see CPI below 2% in five years. Conversely, the US side of the equation also matters as the

market prices the terminal rate near 3%, which implies US inflation is 2.1%. Obviously, the balancing act for the Bank of Japan is in the inflation target and the logic of actions to get rates to anchor around manageable growth against their CPI. The role of JPY in this equation is complicated. Exhibit #4 shows this risk, as the current volatility in FX markets drops notably after one year, but the spike back in ten years highlights the longer-term uncertainty of both fiscal and monetary policy in the US and Japan. The risk of JPY returning to the levels of the 2016-2020 Abenomics period requires clarity about the new LDP leadership and their fiscal policies.

Bottom Line: Looking ahead to next week, JPY and the BOJ seem less important to the market in the short term than the FOMC and the debate about a cut of either 25bp or 50bp, but this could be a mistake as the JPY, which has moved from 162 to 142, has already shifted global allocation mixes in stocks and bonds. The lesson of volatility learned from July 31 and the implications for October 31 are important for how markets see the risk going forward. Our data show continued reluctance on the part of global investors to return to Japanese equities and bonds. Similarly, the US has seen little international buying of its shares since August and only shorter duration buying in bonds. Both Japan and the US have fiscal policy risks for new governments and those are likely to be the bigger risks to both the BOJ and the Fed in the months ahead.

Exhibit #4: Japan Curves and Volatility

JPY Forwards vs. JPY Vol and US-JP rate spread



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Please direct questions or comments to: iFlow@BNY.com



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