Mizuho Market Comment

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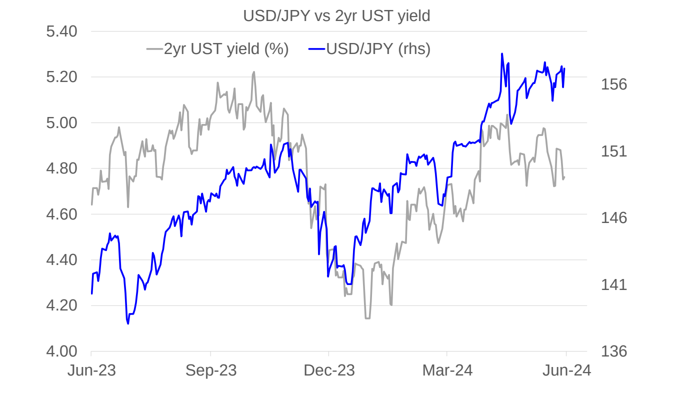
BoJ preview – Boarding the QT train

- **BoJ set to reduce bond buying at the upcoming meeting, signalling tighter policy ahead**
- **Statement and Ueda's press conference watched for signs of next rate hike**
- **Relative policy rate spreads to remain wide but slowly move in favour of a firmer JPY…**
- **…which we expect to bolster JPY into year end**

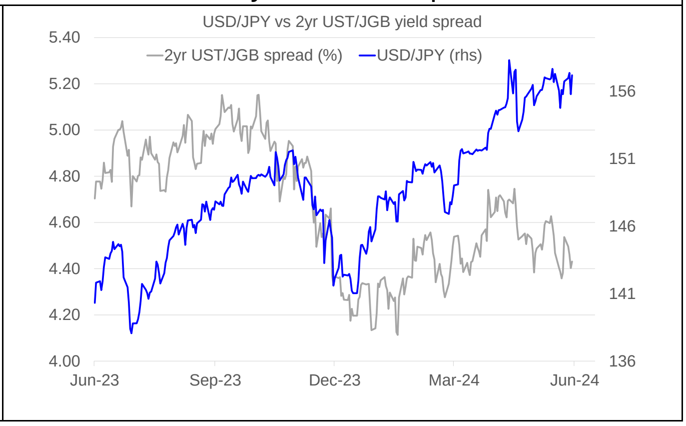
Cautious rhetoric leaves BoJ progress underappreciated
One might argue that for all his cautious rhetoric, BoJ Governor Ueda is actually tightening policy quite quickly. NIRP and YCC are already in the rear-view mirror and a reduction in bond purchases is already seen as a done deal at the upcoming meeting. The only question mark about the bond purchases is how explicit the BoJ will be when it reduces the amounts. The current Rinban framework is highly flexible and we expect that the BoJ will retain that flexibility. The reduction is likely to be vaguely expressed but it widely seen as bringing monthly purchases down from ~¥6trn much closer to ¥5trn. This is close to a figure that would see the BoJ balance sheet shrink going forward, albeit at a modest pace. The BoJ is boarding the QT train.

The cautious rhetoric seems designed to prevent the bond market getting ahead of itself. Given Japan's difficult fiscal position this is perhaps understandable. However, the bond market is not the only asset market in Japan. The fx market is also an important from a number of perspectives. The weakness or strength of the currency will impact import prices and thus inflation. It can also influence decisions on where to produce and also where to invest. The yen has been very weak, potentially in part because Governor Ueda's dovish rhetoric is obscuring how fast the BoJ is moving. Looking at the usual corelation between USD/JPY and the 2yr UST/JGB yield spread, it is fair to say markets seem to be under-appreciating the rise in JGB yields. The 30-day correlation between USD/JPY and UST yields is higher than the correlation with the 2yr UST/JGB yield spread. This seems somewhat counterintuitive given that currencies are relative prices.

USD/JPY tracking UST yields…



…more than the 2yr UST/JGB spread



Source: Bloomberg

We do not see JGB yields being especially sensitive to a formal reduction in Rinban ranges at the upcoming meeting, as the move is widely anticipated. A large move at the start of the process would be odd, hence our expectation of a ~¥5trn amount, which may be further pared back later in the year. We see the BoJ as using the Rinban as a signal that tighter policy is on the way, as its not yet ready to hike rates. The BoJ is under pressure from the government to take action to stem yen weakness and the Rinban reduction signals that it is preparing to hike. The BoJ has appeared much keener to acknowledge the impact of the weak yen in the wake of a meeting between PM Kishida and BoJ Governor Ueda in early May. Government popularity remains in the basement and the weak yen is a factor.

Could a rate hike boost activity?

Generally, I am happy to line up with economic orthodoxy that suggests rate hikes make borrowing more expensive and thus retard economic activity. However, there are some circumstances where a hike will may have a smaller impact than usual and Japan may be in such a situation. The weak yen is clearly a factor in pushing up prices, especially food and energy, which are two of the things that consumers notice most. In turn, higher prices are weighing on consumer confidence as is clearly evidenced by looking at the recent economy watchers surveys. If a rate hike was to lift the yen, then the benefits for consumption might outweigh the traditional impact of higher borrowing costs. Higher rates also benefit savers and both the households and the corporate sector have large savings that would see a mild increase in renumeration in the event of a rate hike. It may be that Ueda doesn't even need to hike, rather just talk about hikes in a less oblique manner, stressing that policy is tightening. If he can convince investors that the yen has finally bottomed, that would likely have a positive impact on consumer sentiment. It may not be the case that a hike can boost activity but I believe that in the current circumstances it may be less detrimental to activity than in more normal circumstances.

BoJ policy more uncertain than other major central banks

We can see a number of reasons why the outlook for BoJ policy is more uncertain than it is for other major central banks. Firstly and most importantly, it has been a very long time since Japan has endured a hiking cycle. How the economy responds to higher rates is less certain than in other major economies. Note the head of the Japan Banking Association said this week that the BoJ will raise rates "extremely gradually", while assessing the impact of higher rates. Secondly, the BoJ has a currency problem. Most other major central banks don't need to take the currency into account beyond the usual impact on import prices and inflation. As noted above, in Japan the impact of a weak currency runs deeper. Thirdly (and partially related to 2), the BoJ is subject to more political interference than other G10 central banks. The weak yen is a problem for the government and thus it's also a problem for the BoJ. That said, if Trump were to become US president again, the BoJ would slide down the list of developed world central banks subject to political interference as Trump is likely to try to force the Fed to lower interest rates. Fourthly, Japan's GDP data are more volatile when compared to the potential growth rate. Q1 GDP dropped 0.6%QoQ. Given that Japan's potential growth rate is likely ~0.6%, this makes judging the current situation difficult.

Soft data of late – further softness may restrain BoJ's ability to hike

Recent activity data have been on the soft side. Indeed, we have revised down our 2024 GDP forecast to 0.0% This seems an inauspicious backdrop for a tightening cycle. However, the weak 2024 forecast is driven by the drop in Q1 GDP. Going forward there should be a rebound. Q2 GDP is seen as more than fully reversing the Q1 drop. Forecasts for activity in 2025, when inflation drops and real incomes rise, remain upbeat for now, allowing the BoJ to keep the hiking cycle on track. Further BoJ tightening to some extent depends on the impact of the wage round, which should be more visible in the wage data over the next few months. Last year, the larger-than-expected spring wage agreements never showed up in the national wage data. Should this year's spring wage agreements suffer a similar fate, then we would need to re-consider our outlook for a modest tightening cycle in coming quarters.

We expect the BoJ to hike 25bp in October but the risks here seem to be earlier rather than later, especially if the wage data look better at next iteration (print for May, due in early July), which should be the first print to capture the spring wage agreements. There are also some question marks over the scale of the initial hike. The BoJ may decide to start with a smaller hike. Given the concerns about the currency we expect a larger hike. We expect that the BoJ will hike again early next year and again next spring taking the policy rate to 0.75%. Beyond that we believe the scope for further hikes is limited and see rates peaking out close to 1.0%. By this time next year it should be apparent that 2% inflation looks unlikely and overtightening risks pushing the CPI down below the 1.0% level.

Tighter BoJ policy to support JPY

Against the backdrop of this modest tightening cycle in Japan and modest easing cycles overseas, we see scope for the yen to firm modestly, once the BoJ starts to tighten and central banks overseas, most notably the Fed, start to ease. It is also the case that QT overseas may slow just as Japan starts to step up on this front. We maintain our forecast for USD/JPY to hit 145 by year end. We see front-end UST yields as drifting modestly lower from current levels into year end. USD/JPY may be topping out and with JPY positioning deeply negative, USD/JPY may be subject to sharp dips in the wake of soft USD data releases, as was the case in the wake of this week's US CPI data.