Bridgewater®
Daily Observations
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Japan's Move Away from Negative Rates Now Looks Overdue

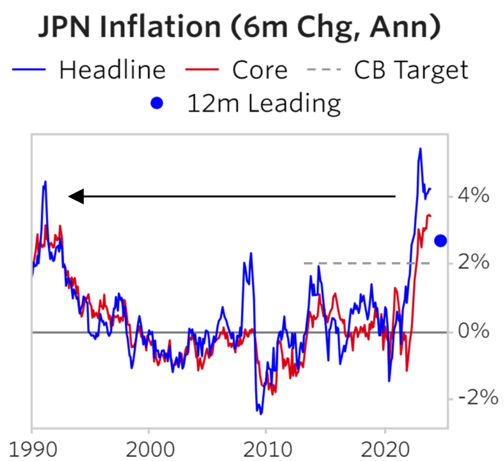
While inflation is less of a problem in Japan than other developed economies, it is now above target and the balance of risks now clearly points to the need for at least some policy normalization. However, Japanese short rates remain negative and very little tightening is discounted.

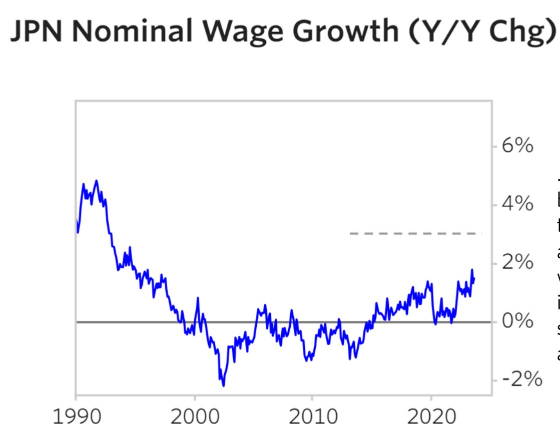
After decades of stagnant prices, ingrained deflation psychology, and weak asset prices, it is understandable that Japanese policy makers don't want to tighten prematurely. Japan also doesn't face the inflation problem that other developed economies do. Still, it is hard to look at how much conditions have changed in Japan, and not conclude that the extremity of the current policy mix no longer fits. Japan still has negative short rates, a bond yield pegged at 1%, and is continuing QE. The yen has been under pressure and hasn't been this cheap in decades, energy prices are creeping higher, and the global backdrop isn't as disinflationary as it has been.

There are risks of waiting too long. The BoJ has so far proceeded in a very gradual, cautious, and even dovish manner. And while they are likely to continue favoring such an approach, further currency weakness or energy price increases are undesirable, as they would reinforce inflationary pressures. Waiting too long to normalize policy risks having Japan fall behind the curve, which could require an abrupt and disruptive tightening. Some normalization is now priced in, but it is tiny, and we see the risks as asymmetrical (i.e., much more tightening is more likely than keeping short rates at zero and bond yields below 70bps).

The first set of six charts highlights what has changed relative to prior decades. Inflation, both headline and core, are now above target, with the moves in currency and commodity prices making it more likely to stick. Unemployment is near secular lows, the currency is depressed, equities are finally rallying, and home prices have been gradually rising for a decade. Wage growth has risen, but as the BoJ highlighted in its decision to stay on hold on Friday, it is still not the problem it is in other countries (that is the main argument for not yet doing much more than moving away from zero for now).

While inflation is tracking above the 2% target...

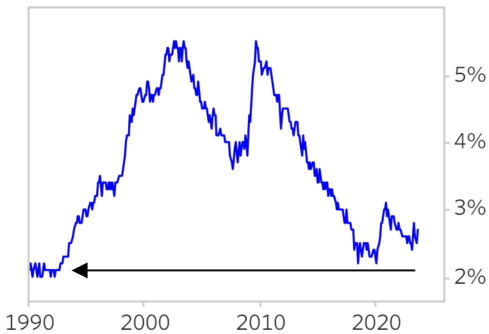




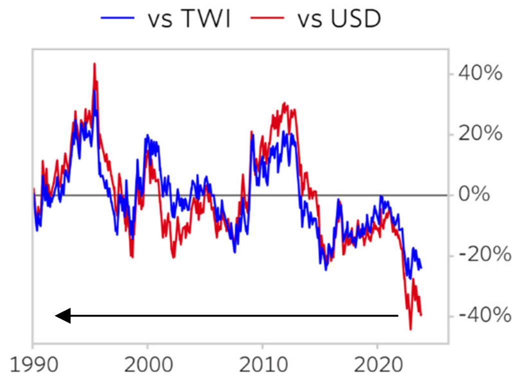
...wages are still below the level that the BoJ has flagged as being consistent with hitting its inflation target in a sustainable way, around 3%

JPN UE Rate

Cyclical conditions are about as good as they have been since 1990



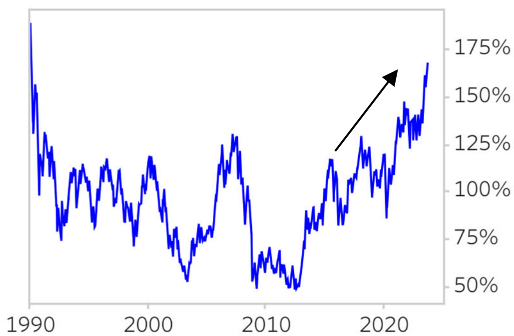
JPN Real FX



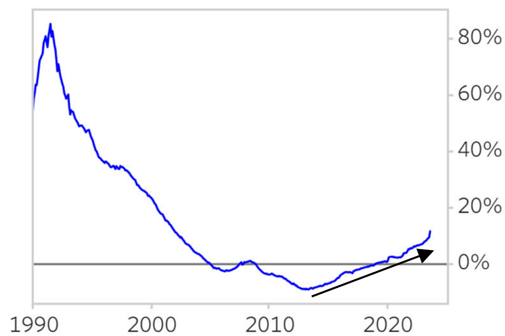
The yen has been falling rapidly and is currently at around its cheapest level in decades

JPN Equities in Local FX (Indexed to Jan 2019)

JPN equities have been rallying over the last few months on the back of easy monetary conditions and have now recovered most of the losses accumulated during the "disinflation decades"



JPN Home Prices (Indexed to Jan 2019)

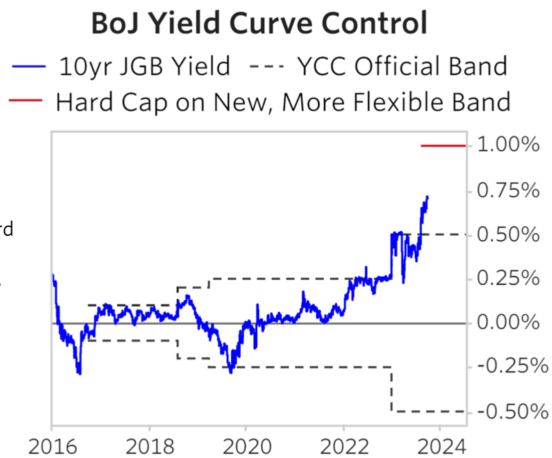


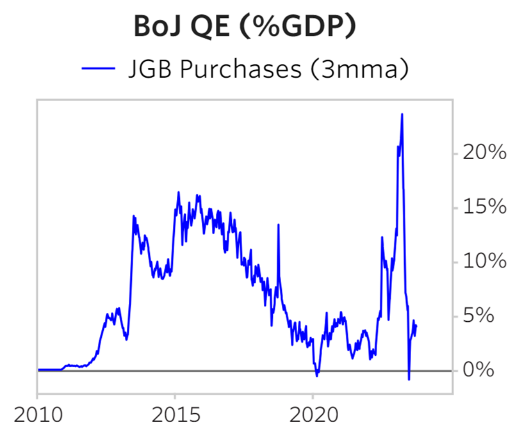
Home prices fell for 20 years and began recovering post-Abe. Recent prices have been strong.

Policy Normalization Has Barely Started. Pressures on the YCC Have Abated. Little Is Priced In.

Japan has, so far, made some very slight adjustments to its easy policies. The yield curve control (effectively a bond yield peg) has been gradually widened. Bond yields have risen from 0% to 0.7%. Yields are currently well off the 1% upper end of the band, and since the interventions in the days after the latest widening, the BoJ hasn't needed to buy bonds to support its policy. The significant pressures on the band and money printing have abated. Meanwhile short rates remain slightly negative. As a result, even as policy has slightly tightened, Japan remains the easiest developed world economy. As the rest of the world tightened, Japanese yields became lower on a relative basis, supporting Japanese assets while putting downward pressures on the yen. This mix looks increasingly undesirable given the progress made on inflation.

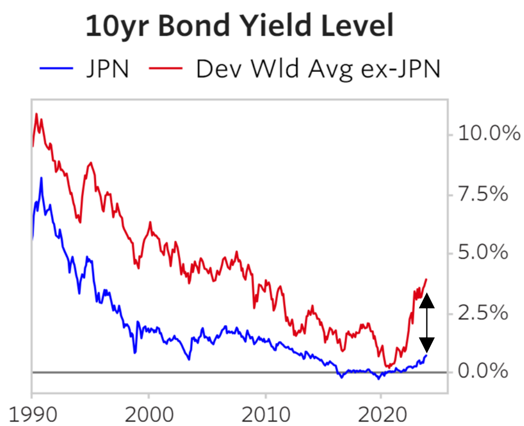
The BoJ is now treating 1% as a hard cap and buying flexibly when yields rise above 0.5%

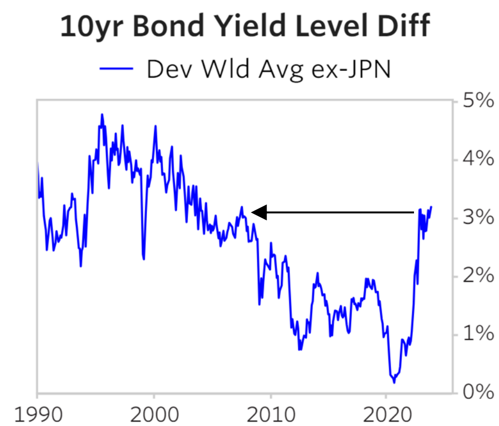




The BoJ has continued printing yens to maintain the yield cap. However, as pressures to defend the cap have recently reduced, so too has the level of BoJ purchases.

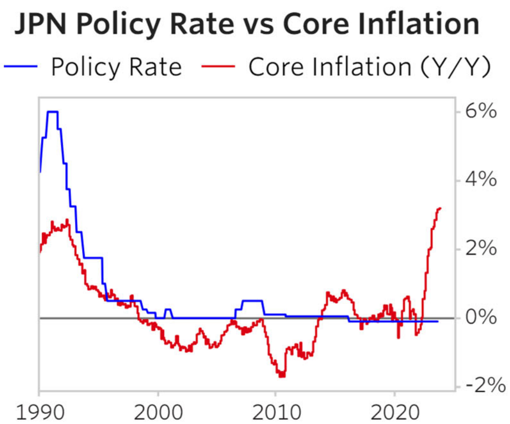
Despite the slight tightening of conditions in Japan, the spread with other developed markets has continued widening...

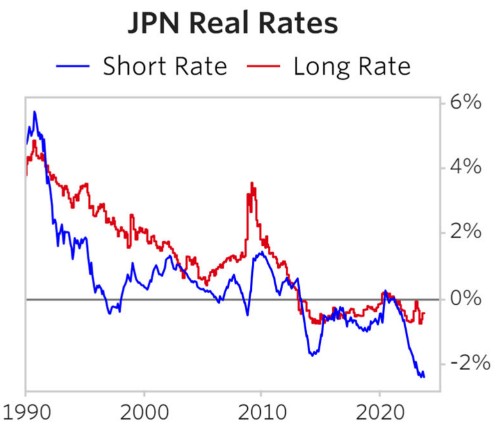


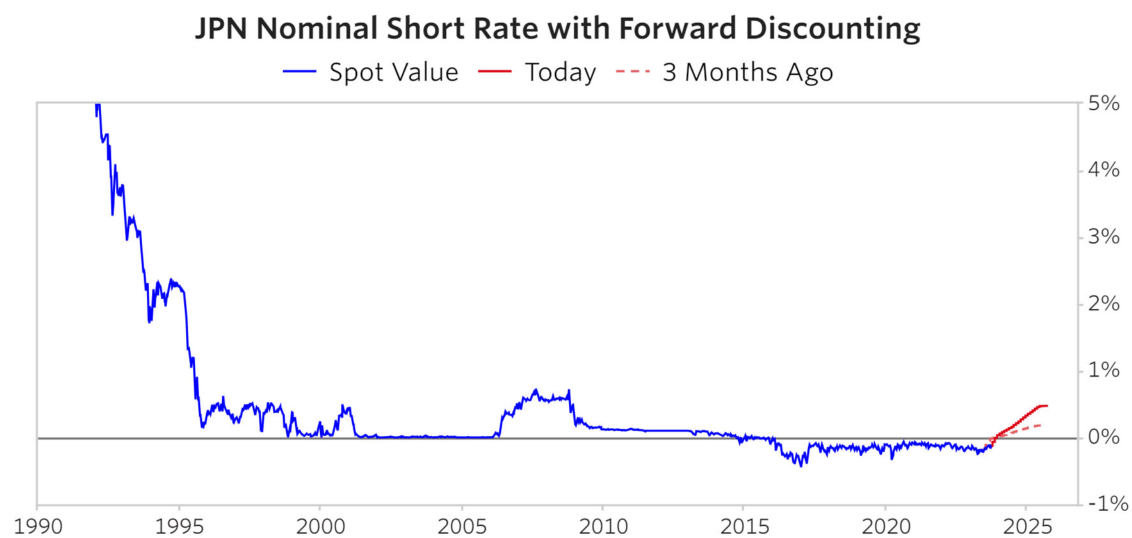


...to levels not seen since the 2000s, when Japan was fighting deflation and weak growth

At this point, the case for negative policy rates is inconsistent with conditions. The real short rate is as negative as it has ever been and does not seem warranted amid acceptable growth levels, inflation above target, a tight labor market, and a weakening currency. And, while further tightening and normalization is now priced in, we think the pace is likely to be faster than what is priced in. Delaying normalization for the next couple of meetings won't create material problems, as political considerations appear to be pushing the BoJ to stay on hold until early 2024. But ultimately, more tightening than priced in looks likely to us, and it is possible that the BoJ may be pushed to act sooner rather than later if something new happens (e.g., more downward pressure on the yen, further increases in energy prices, etc.).







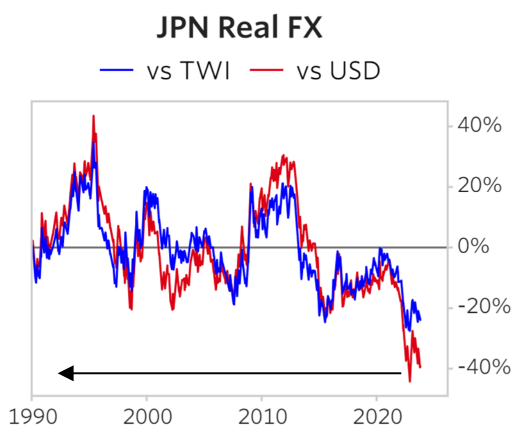
Pressures Are Mounting Around the Currency and Could Further Intensify in the Absence of Policy Normalization

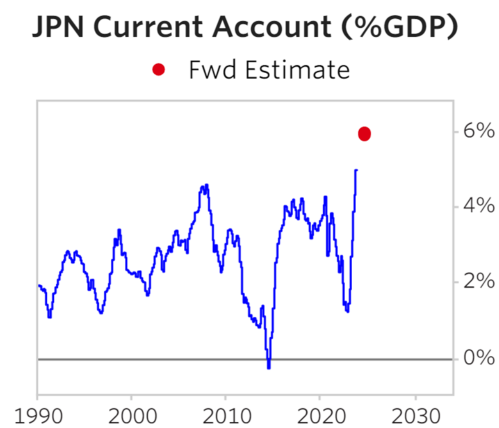
The fact that policy makers (and markets) are again talking about a possible FX intervention to defend the currency is another sign of how late in the normalization process they are and of how pressures are mounting.

Negative real rates and a very large (and widening) interest rate differential with the rest of the developed world remain downward pressures on the currency. The yen is now back to historical lows in real terms, following a very rapid depreciation path over the last few months, even after the BoJ expanded its YCC cap to 1% in July.

Last year, the MoF intervened in the FX market at similar levels of USD/JPY, and in recent weeks, policy makers have been again signaling discomfort with the depreciation in the currency. Should they wish to intervene, policy makers have a decent amount of capacity to do so. However, **FX intervention is unlikely to be a sustainable way to support the yen as long as the BoJ keeps its current monetary stance**, since the yen's weakness is not related to currency stability, but rather to the extremely easy and unwarranted monetary policy. As such, **FX intervention may be seen as a way to keep "buying time" before the BoJ embarks on a normalization of policy**, but is unlikely to reduce existing structural pressure on the yen on its own.

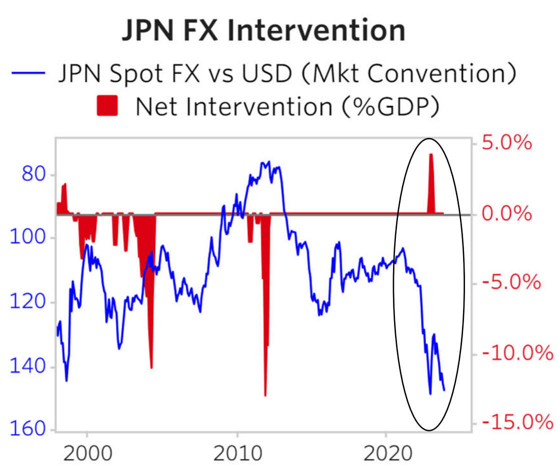
Japan real FX is at historical lows...

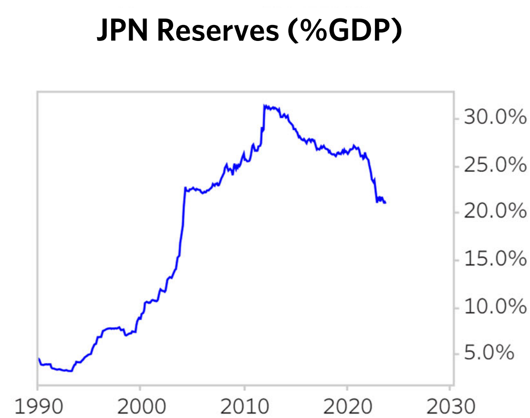




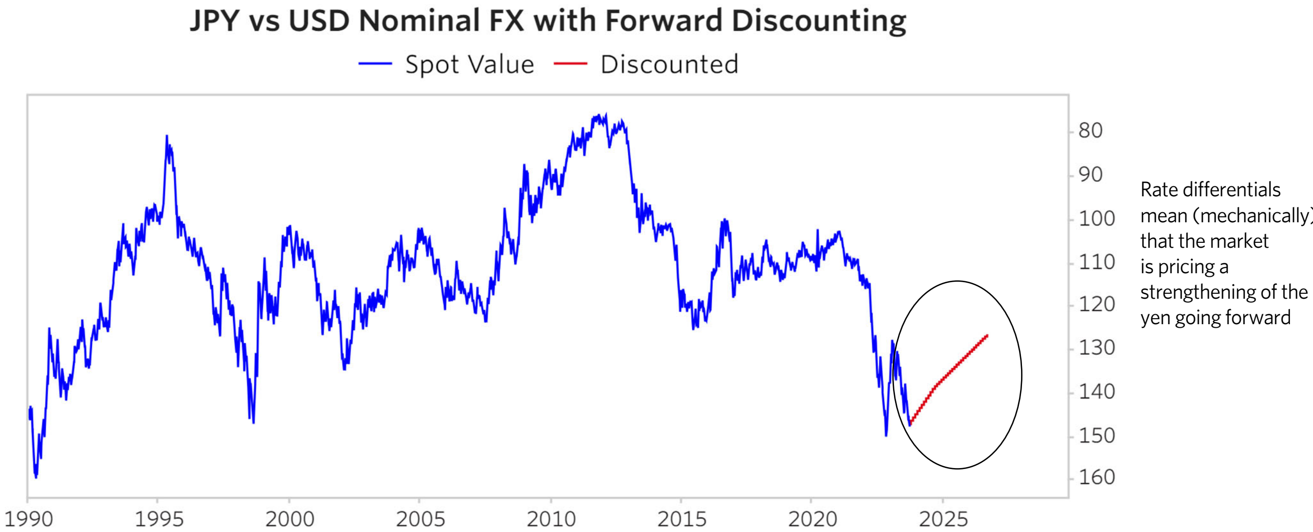
...despite record high current account surplus

Last year, the MoF's FX intervention took place at similar levels of JPY/USD. While it was successful in supporting the yen for a short period of time, the yen is now back to the same level since monetary conditions have not evolved.





Should the MoF wish to intervene, they have significant firepower at their disposal



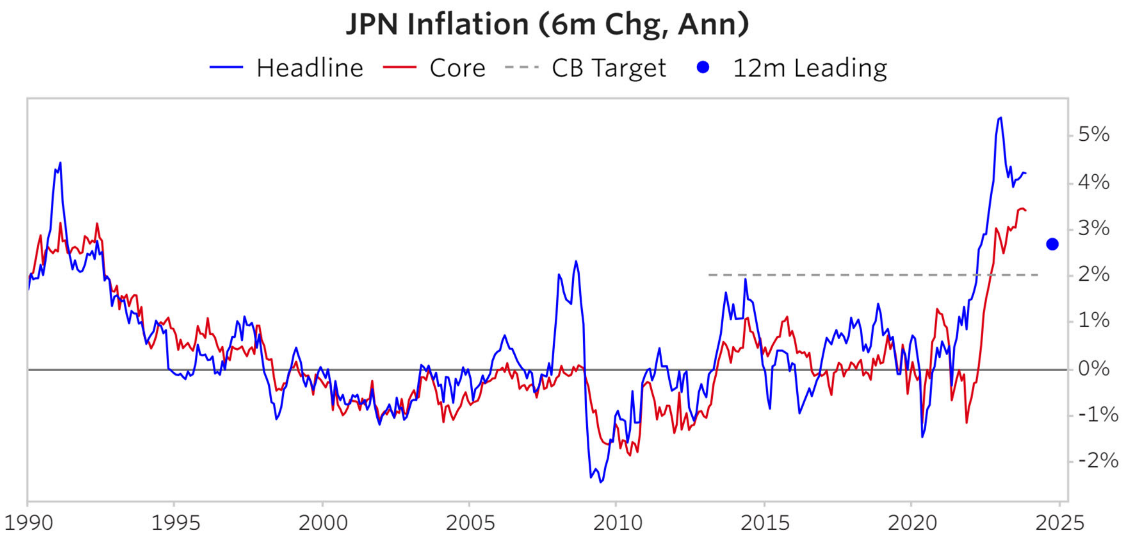
Appendix: A Deeper Dive into Japanese Inflation and Whether Higher Inflation Rates Are Sustainable

Core inflation has been running around 3.4%, with high inflation in both goods (reflecting FX weakness and high CMD prices) and services (though here, we're mostly seeing a recovery in prices back to pre-COVID levels driven by a delayed reopening, and we're not yet seeing sustained high inflation beyond these base effects).

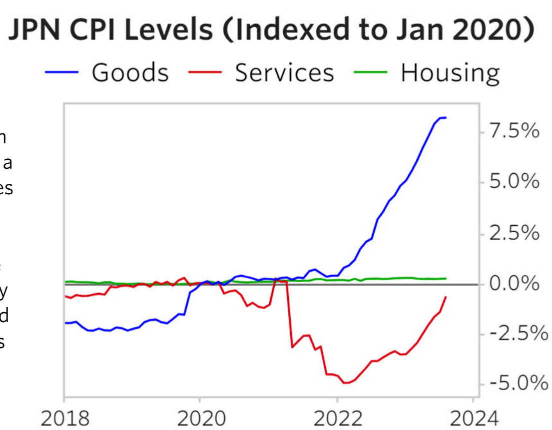
Looking at timely prints of the subcomponents of inflation, we can see that there is a slowdown in prices for food and energy, which, in turn, is passing through to goods prices, which are also slowing. However, services prices are still increasing, and are currently trending above core inflation (likely on the back of resilient growth and increasing wages).

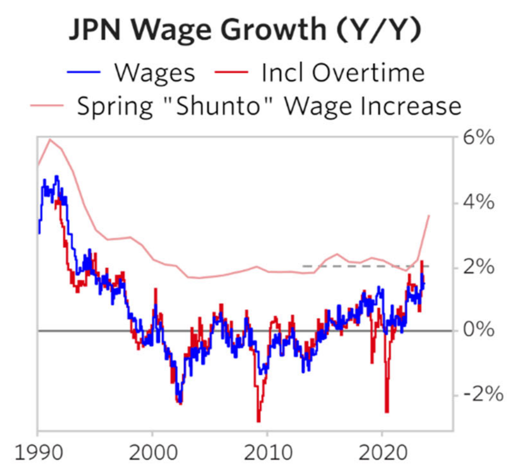
Going forward, an ongoing slowdown of food, energy, and goods prices, combined with stabilizing wage pressures, are unlikely to sustain inflation at its current level. As such, inflation dynamics seem tilted toward stabilization and compression over the next few months. Inflation is currently projected to come down to 2.5-3%, which, while somewhat above target, is more desirable than problematic for policy makers who have struggled with deflation for decades.

Risks to this view seem tilted to the upside, given the impact of potential external shocks, such as high commodity prices and a widening of interest rate differentials should other developed markets embark on a second wave of tightening that could lead to a further weakening of the yen. Inflation dynamics may also depend on the size of the fiscal support to be designated in next year's budget (currently being discussed by the government). As such, risks of inflation stabilizing at a higher level than indicated above are significant.



Services inflation seems to reflect a recovery of prices to pre-COVID levels, while goods prices are being affected by FX weakness and high CMD prices





Wages stabilizing below the 2% inflation target

Inflation rates outside of housing and energy are now quite high. In addition, the current negative pressure on energy prices is mostly behind us and may reverse going forward.

Inflation Subcomponents (1x6, Ann)