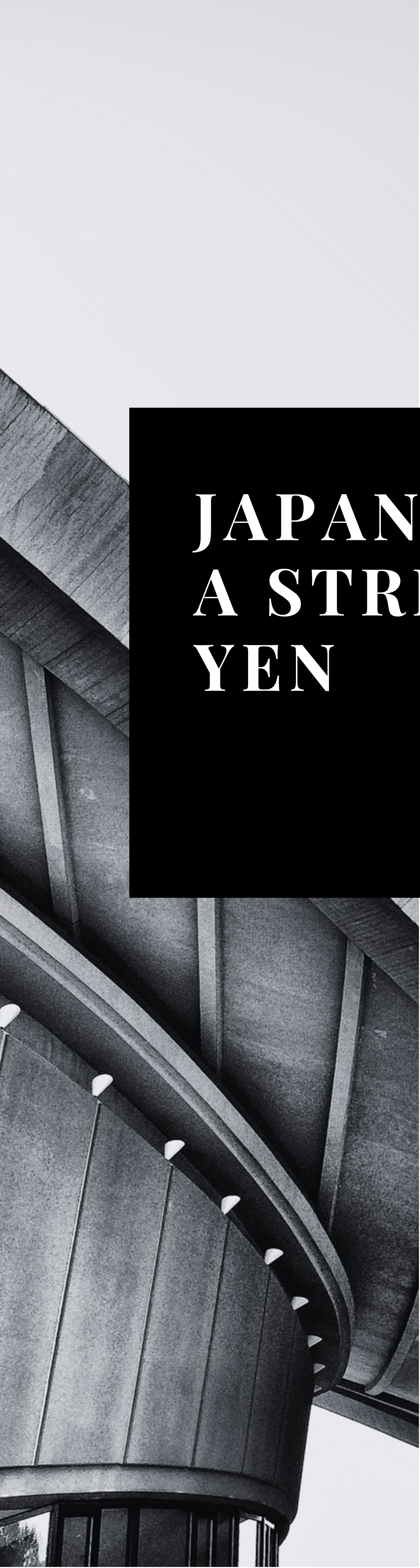

MAY 2023

JAPANESE BONDS AND A STRENGTHENING YEN

KNOCKOUT CAPITAL

PREPARED BY:

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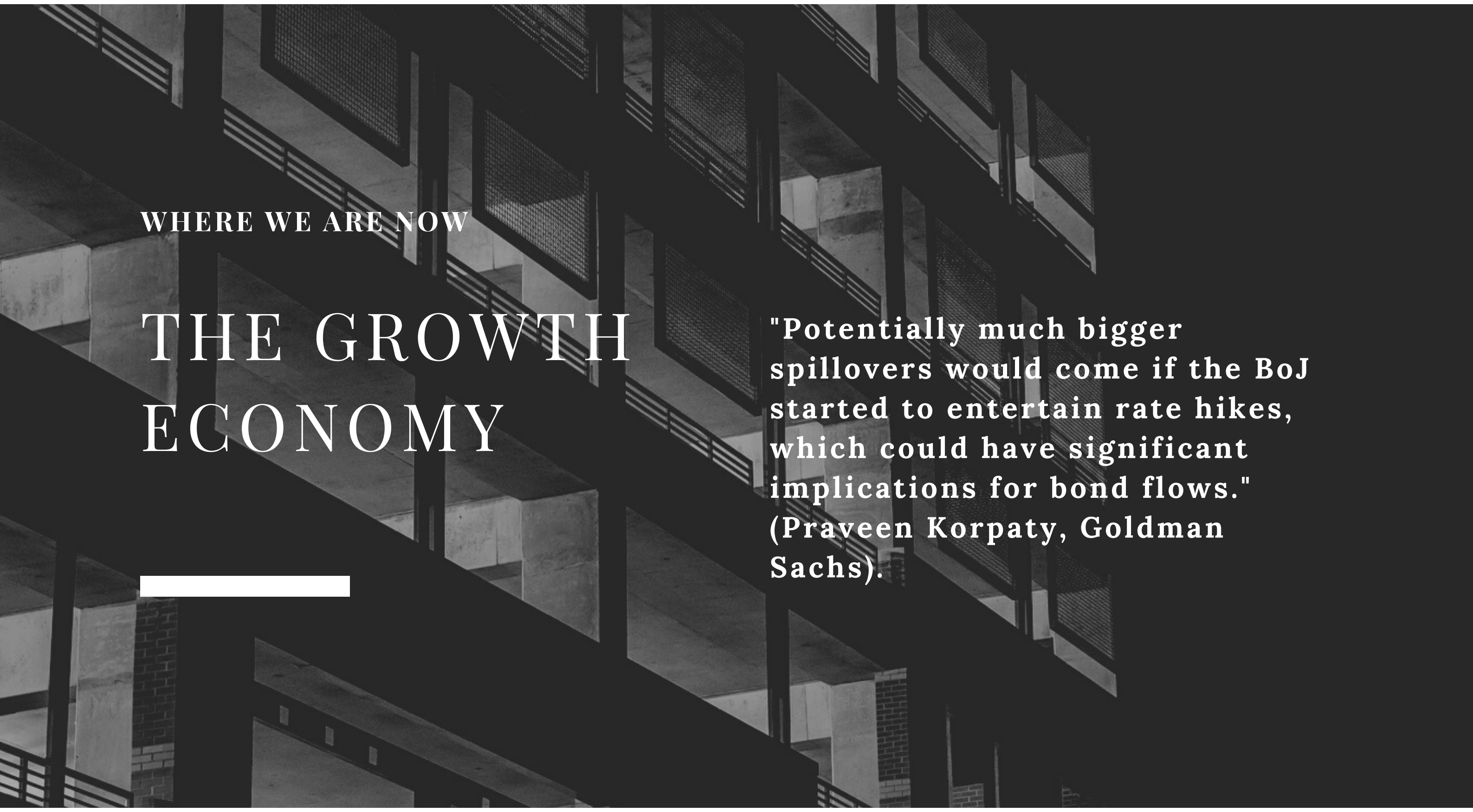


WHERE WE ARE NOW

THE GROWTH ECONOMY

"Potentially much bigger spillovers would come if the BoJ started to entertain rate hikes, which could have significant implications for bond flows." (Praveen Korpaty, Goldman Sachs).

The BoJ expects above-trend GDP growth for 2023. Thus, the pressure is on for bond yields to rise and for the policy to be more about capping yields rather than preventing negative ones. The BoJ's December announcement in effect replaces the 0.25 percent cap on yields by a higher, easier-to-defend 0.50 percent cap (Frédérique Carrier).

Th widening of its yield curve control (YCC) band in December suggests Japan is shifting from an aggressive to neutral monetary policy, there is a shift towards wage-led "demand-pull" inflation that sustainably achieves the BoJ's elusive 2% inflation target. Shunto wages are bound to increase an average of 2.8%. Workers in the world's third-largest economy have been emboldened by policymakers' calls for wage hikes to sustain a frail post-pandemic economic recovery threatened by a four-decade high inflation (Takaya Yamaguchi, Reuters).

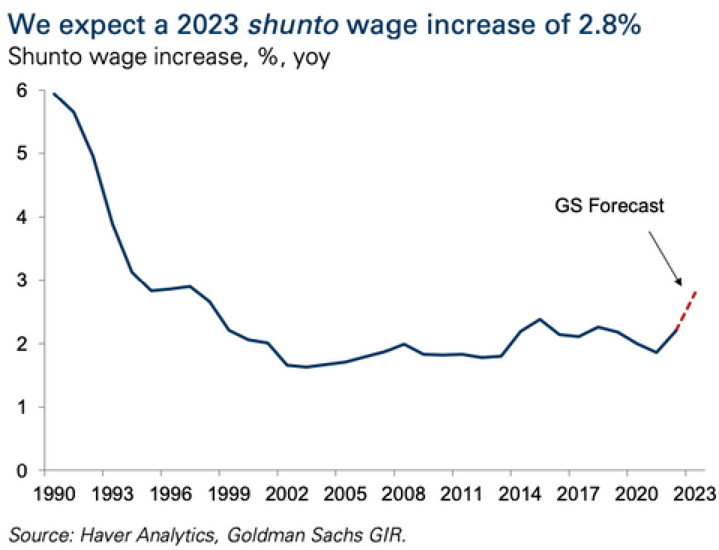


Figure (1)
Shunto Wage Negotations

RAMIFICATIONS

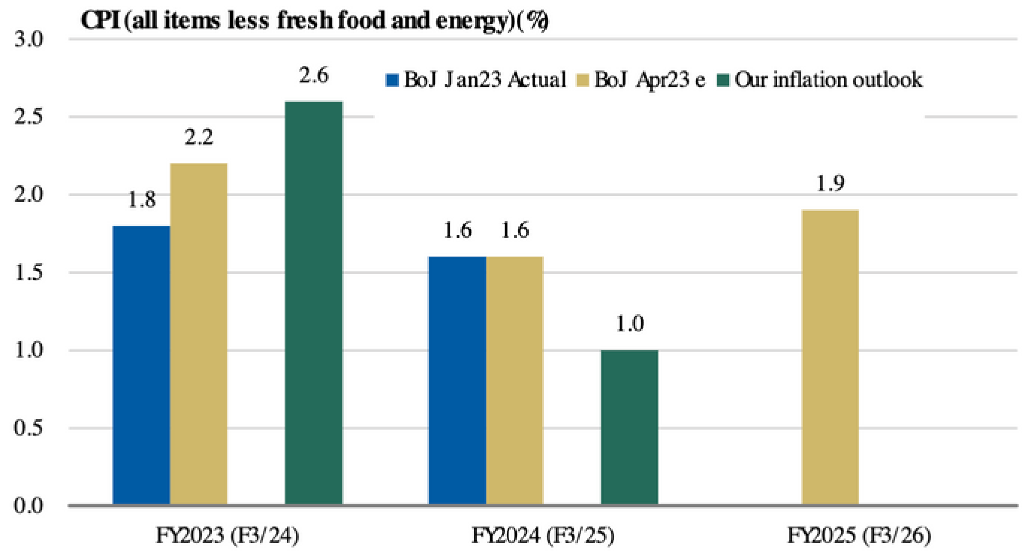
YIELD CURVE CONTROL

The BoJ widened the band in response to a request from the Kishida Administration to operate YCC in a more flexible manner, as the government seems to have thought that a lack of flexibility in managing YCC amplified the impact of yield differentials on the exchange rate, exacerbating the significant weakening of the Yen.

If the financial system volatility settles down and inflation remains higher than the BOJ's assumptions, the BOJ may move to reassess the tolerance band or remove it entirely during the first half of fiscal 2023 (Hiroyuki Seki, Mitsubishi UFG Financial Group).

Abandoning the YCC early will cause large market economic disruptions. Only when market speculation subsides the BoJ will consider retreating from YCC. Housing, construction, and real estate tend to suffer when interest rates rise, while higher rates are beneficial for the financial industry. A stronger currency hurts exporters (but is a tailwind for households) as it contains cost-push inflation. Equity corrections affect corporate sentiment, which weights on capex and reduces consumer spending, although the impact of this channel is small in Japan relative to other countries (Naohiko Baba, Goldman Sachs).

Figure (2)
Upward revision to FY2023 (F3/24)



e= Morgan Stanley Research forecast
Source: Bank of Japan, Morgan Stanley Research

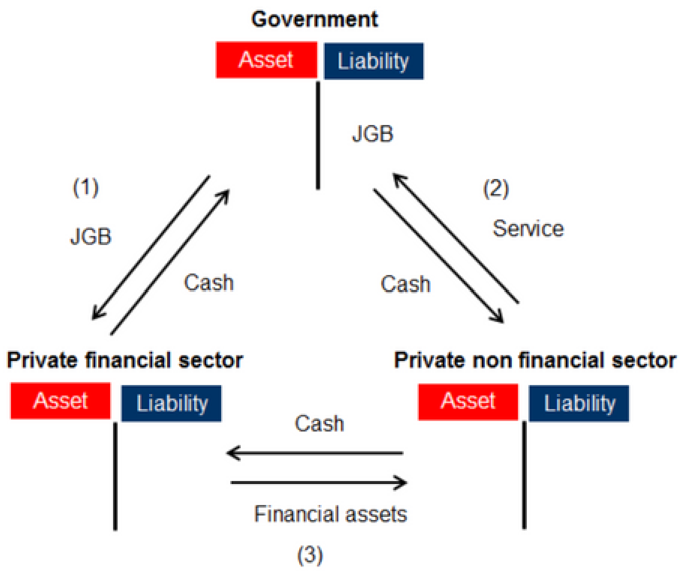


Figure (3)
Flow of funds related to JGB issuance

Figure (4)
TONA: the belly is becoming cheap

ANAEMIC 10Y YIELDS

The GoJ itself effectively ends up contributing the funds used to purchase the bonds it issues (Figure 3). 10y yields are currently anemic (Figure 4). If the BoJ were to completely abandon YCC, JGB yields would likely rise due to the removal of the BoJ demand for JGB.

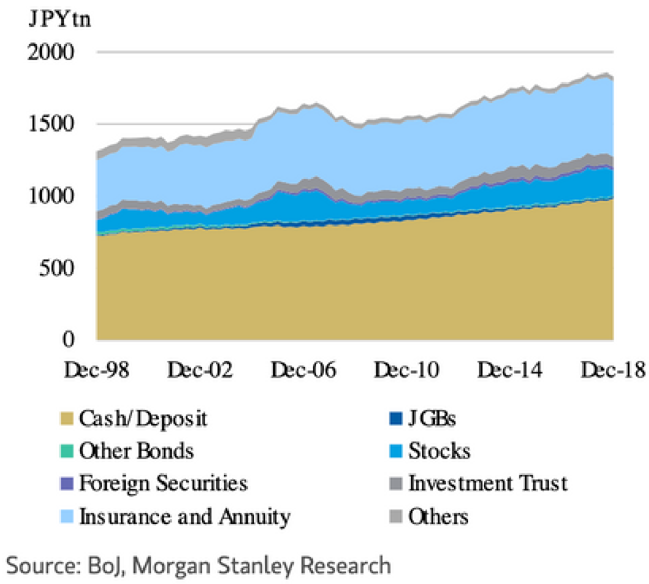


Figure (5)
Asset breakdown of Japanese households

UNDERSTANDING INVESTORS IN JAPAN

Institutional investors in Japan typically invest through FX exchanges and foreign bonds, and moreso due to the drop in 10y yields. Low yields domestically have sent Japanese investors abroad in search of yield and carry, and this has contributed to consistent capital account deficits (and current account surpluses) for the country (Koichi Sugisaki, Morgan Stanley). Foreign bonds became unattractive on an FX-hedged basis due to other central banks' aggressive hiking campaigns.

Households tend to invest in safer assets deposits, principal guaranteed insurance products, and annuities. When investing in risky assets, households tend to favor products offering higher yields and/or the prospect of capital gains.

THE YEN

Greater BoJ flexibility will continue to support the Yen, fueled by a dovish Fed. Higher U.S. interest rates are the main driver of USD/JPY. Furthermore the Yen may appreciate due to the assess on equity markets.

The balance of risks still favors the Yen

Expected JPY performance in scenarios of US economic cycle and BoJ policy

	Dovish BoJ	Hawkish BoJ
US Soft-Landing	**Weaker JPY** (GS baseline*)	**Stronger JPY** (more likely combination)
US Recession	**Stronger JPY** (safe-haven inflows dominate)	**Stronger JPY** (less likely combination)

**Tactical Yen depreciation can extend as US yields rise before seeing more sustained appreciation later on once peak rates are in sight and the market likely continues to test a BoJ exit.*

Source: Goldman Sachs GIR.

Figure (6)

Situations for strengthened Yen

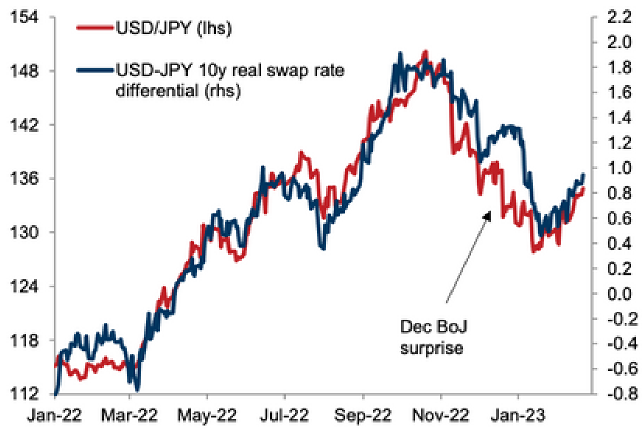
Deutsche Bank judges that right now the Japanese currency is around 30% cheaper than its "equilibrium fair value," a level that the analysts peg around ¥100 per dollar. While noting that there are other factors at play in the valuation of the yen, the analysts reckon it could hit that level if there were to be a total normalization of policy by the BoJ (Anya Andrianova).

For the yen to appreciate, the BoJ must lay the groundwork for monetary tightening.

Banks including UBS Securities and Credit Agricole CIB expect the Japanese currency to jump about 10% versus the dollar by the end of the year, driven by a narrowing interest-rate differential as well as concerns over the US banking sector (Matthew Burgess, Bloomberg).

Rate differentials have been the main driver of USD/JPY

USD/JPY (lhs), pp (rhs)



Source: Bloomberg, Goldman Sachs GIR.

Figure (7)

Higher U.S. interest rates are a key driver of movements in USD/JPY

The increased likelihood of greater flexibility in BoJ policy skews the balance of risks towards further Yen appreciation.

US real rates and the odds of a US recession, will ultimately be the biggest driver of Yen performance. If the US enters a recession, the Yen should strengthen regardless of BoJ policy owing to safe-haven inflows and a narrower yield differential should the Fed respond with rate cuts. (Karen Fisherman, Goldman Sachs).