BOJ OFFICIALLY COMMITS TO DECOUPLING FROM THE FED

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The Bank of Japan (BOJ) de-facto eased policy at this week's board meeting. They introduced "forward guidance" on top of their long-standing policy of QQE—quantitative and qualitative easing. In short: the board now spelled out its commitment to allowing a desynchronization between rising U.S. rates and Japanese rates staying anchored around zero. They even committed to a timeline: rates will stay anchored around zero at the very least until the effects of the consumption tax hike in October next year have fully played out. This suggests early 2020 as the earliest target date for any actual rate hikes in Japan.

The official text of the board meeting says it all. It is entitled "Strengthening the Framework for Continuous Powerful Monetary Easing," and it reads, "The bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including effects of the consumption tax hike scheduled to take place in October 2019."

Operationally, the BOJ committed to maintaining its short-term policy rate target at minus 10 basis points (bps) and for the 10-year JGB yield confirmed the same target rate as before at "around zero." In fact, a footnote in the board text spells out that "in case of rapid increases in the yield, the Bank will purchase JGBs rapidly and appropriately." They also reconfirmed that added JGB purchases will come to around ¥80 trillion per year.

Meanwhile, the BOJ's equity ETF-buying program was also reconfirmed at an annual pace of ¥6 trillion, although the composition was changed away from the price-weighted Nikkei 225 Index toward the market cap-weighted TOPIX (the former was cut from ¥3 trillion to ¥1.5 trillion p.a., the latter raised from ¥2.7 trillion to ¥4 trillion, with the remaining ¥0.3 trillion going to the physical and human capital ETFs as before). The change in portfolio composition is a modest positive for Japanese financials due to their relatively higher weighting in the market cap-weighted TOPIX.

Interestingly, the policy board has revised down its central tendency forecasts for both GDP growth and CPI inflation: board members now expect GDP growth to basically halve from 1.5% in FY2018 to 0.8% in FY2019 and FY2020, while CPI inflation is forecast to stay below 2% in both FY2019 and FY2020.

That said, the BOJ board is sending a clear message to global markets: Japan is openly committed to decoupling from the U.S. rate cycle. For markets, this creates a welcome new tension and opportunity: the BOJ is encouraging long-term investors to build up global carry trade positions, i.e., funding in zero-rate yen and investing in higher-yielding U.S. fixed income. At the same time, shorter-term speculators are bound to test the BOJ's resolve from time to time. The result of this, in our view, should be rising liquidity in both JGB and global markets, as well as a structural depreciation of the yen against the dollar.

All data and quotes are sourced from the Bank of Japan announcement on July 31, 2018

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DEFINITIONS

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Basis point : 1/100th of 1 percent.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Nikkei 225 Stock Average Index : A price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Tokyo Stock Price Index (TOPIX) : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Inflation : Characterized by rising price levels.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.