What's Hot: The Bank of Japan can't let go

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This week financial markets were dominated by central banks policy decisions. While the Federal Reserve (Fed) and Bank of England (BOE) kept rates on hold, the policy board of the Bank of Japan (BOJ) decided to further increase the flexibility in its yield curve control policy.

The BOJ previously set a strict cap of 1.0% for the 10-year Japanese Government Bond (JGB) yield. But it has now decided that 1% should be a “reference” (not a strict cap), which effectively allows the yield to rise above 1% when the BOJ thinks it is appropriate. The upper bound of 1% appears to be a level they can’t let go of. By doing so, the BOJ is choosing an exit path that gives them the maximum flexibility but minimum volatility around the Yen. We view this as a dovish move as consensus expectations were for the BOJ to move the cap to 1.25% rather than 1%.

Japan’s recovery remains on a narrow path

One of the reasons holding back the BOJ from normalisation of policy rates, is they still believe Japan’s recovery since the re-opening in October 2022 remains on a narrow path as it relies heavily on tourism, while the broader services sectors have yet to pick up significantly and manufacturing activity has been hampered by soft exports. Japan’s flash PMI readings1 for October showed us a bifurcated economy where the services sector is stronger than the manufacturing sector. Manufacturing PMI clocked in at 47.6, which is in contraction territory. Services PMI was 51.1, which is down from last month’s reading of 53.8 but is still in expansion territory, no doubt helped by fiscal stimulus and the accommodative monetary policy environment.

BOJ on the lookout for an intensified virtuous cycle between wages and prices

BOJ governor Ueda indicated that the BoJ will be monitoring the upcoming spring union-employer wage negotiations. A strong outcome could catalyse the earlier attainment of sustained inflation in Japan, but overall, Japan’s recovery isn’t strong enough yet for employers, especially small enterprises, to meaningful support wage hikes in the broad economy. While headline inflation bolted north of 4% in January 2023, it appears to have peaked and has begun receding. While core inflation remains around the 4% mark. The Producer Price Index (PPI) slowed to 2% annually in September suggesting a stabilization or even drop in CPI ahead.

Source: Bloomberg, WisdomTree, as of 31 October 2023 Historical performance is not an indication of future performance and any investments may go down in value.

The BOJ revised its outlook for core inflation (all items less fresh food and energy) to 3.8% in FY23, 1.9% for FY24 and 1.9% for FY25. The BoJ stated that the inflation uptick “needs to be accompanied by an intensified virtuous cycle between wages and prices”.

The Yen is unlikely to appreciate under BOJ’s policy change owing to the large gap in interest rates between the US and Japan. The direction of the Yen matters for Japanese equities owing to Japan high export tilt. The exporters stand to benefit amidst a weaker Yen.

Fire power abounds for Japanese equities

Japanese equities had a strong first half in 2023, attaining 33-year highs. Yet valuations at 15.7x price to earnings ratio (P/E), still trade at a 30% discount to its 15-year average providing room to catch up. More importantly, earnings revision estimates in Japan are currently the highest among the major economies. Earnings yield at 4.07% for the Nikkei 225 Index has been trending above bond yields 0.947% for 10 Year JGBs2, keeping the well-known TINA (There is no Alternative) trade alive in favour of Japanese equities.

Source: iQDatabase, IBES, WisdomTree as of 2 November 2023. Historical performance is not an indication of future performance and any investments may go down in value.

Tailwind from corporate governance reforms

Tokyo Stock Exchange’s (TSE) call for listed companies to focus on achieving sustainable growth and enhancing corporate value is beginning to bear fruit. The call was aimed at companies with a price to book (P/B) ratio below one. Those companies were asked to develop a plan for improvement, disclose and then implement and track its progress. The progress has been encouraging with 31% of companies on the prime market making a disclosure of their plan3.

Large companies with a price to book ratio below one have been more proactive with disclosure. Historically cash-heavy Japanese companies face increasing pressure to improve their numbers, possibly by funnelling historically high excess cash reserves into increased buybacks or dividends.

Source: FactSet, WisdomTree, as of 31 October 2023. Historical performance is not an indication of future performance and any investments may go down in value.

Conclusion

Inflation has been missing in Japan for more than a decade. So now that it has arrived aided by the post pandemic pick up of the Japanese economy, policy makers are not in a rush to obliterate it. With wage growth lagging behind inflation, the Bank of Japan does not appear ready to wean itself from Yield Curve Control until a more intensified virtuous cycle is observed between wages and prices. The BOJ’s policy decision this week is unlikely to allow the appreciation of the Yen, which should continue to provide a competitive advantage to Japanese exporters.

1 AuJibun as of 15 October 2023

2 Bloomberg as of 31 October 2023

3 Tokyo Stock Exchange as of 31 July 2023

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