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Macro + FX Strategy

Japan: Specter Of Normalization Re-Ignited Ahead Of July MPM

Tuesday, 24 July 2018

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- An 'exclusive' Reuters report (20 Jul) said that the BOJ could debate policy changes at the upcoming July monetary policy meeting (MPM), sparking a JPY rally and higher JGB and UST yields.
- The report was subsequently denied by BOJ Governor Kuroda and that it is "inappropriate to say anything predictive on outcome of July BOJ policy meeting."
- Despite the report, we (and most economists covering BOJ) expect BOJ to leave monetary policy unchanged in July. Weak domestic inflation continues to hamstring BOJ from tweaking policy while the increasingly difficult US trade policies will further deter the central bank from making changes for now.
- But the specter of normalization will linger on unless the BOJ finds a way to reassert its "easy monetary policy" credentials which has not been helped by the fact that the BOJ's projected annual pace of JGB buying remains well off the official target.
- Overall, we expect the recent JPY strength to be short-lived. Especially when 10-year US Treasuries yield is back targeting the 3% level. USD/JPY should find support above 110, while gradually trade higher towards 113 by end 2Q19.

Last Friday (20 Jul), Reuters wrote a piece quoting unnamed sources as saying that the BoJ is likely to debate potential policy changes at this month's MPM on 30/31 Jul. The article said that the BOJ may debate modifying yield-curve target to allow for natural rise in long-term rates, and may also discuss tweaking way it buys JGBs, ETFs to mitigate market distortions while concurrently, it would portray any change as step for policy sustainability, to reduce negative side effects and not [policy] tightening. The report even went as far as noting that the BOJ may consider changing its interest rate targets. After the Reuters report, BOJ Governor Kuroda (who was in Bueno Aires, Argentina for the G20 Fin Min meeting) said he knew nothing about the basis for those reports and that it is "*inappropriate to say anything predictive on outcome of July BOJ policy meeting*."

The Reuters article was subsequently carried by major Japanese and international news agencies and together with US President Trump's criticism of the US Dollar's strength (20 Jul), sent the Japanese yen (JPY) rallying to a 2-week high against the USD and the benchmark Japanese Government Bond (JGB) 10-year yield hitting a 6-month high (up by as much as 6bps to 0.09%) on Monday's (23 Jul) Asian trading session. The 10-year JGB yield and USD/JPY are currently at 0.082% and 111.31 respectively (as of 24 Jul 2018, 12pm SG time). The intense market debate over "potential" BOJ policy changes also led to 10-year US Treasury yield jumping 6 bps higher to 2.95%, putting the 3.0% handle back in play again.

BOJ’s MPM Outlook – Tweaking Policy Is Difficult On Back Of Weak Inflation And Increasingly Difficult US Trade Policies But Specter Of Normalisation Lingers On

Notwithstanding the latest news reports, we (and most economists covering BOJ) expect BOJ to leave monetary policy unchanged in the upcoming July monetary policy meeting (MPM). Inflation in Japan remains disappointingly low and still far away from its 2% inflation target (June headline CPI inflation at 0.7%y/y while core inflation is slightly higher at 0.8%, core-core inflation is much lower at 0.2% in June). Thus, it was not surprising when the BOJ removed the timeframe to achieve the 2% price target during the April (2018) MPM and further downgraded its view on CPI inflation to a range of 0.5% to 1.0% in its June MPM (compared to its April’s view of moving around 1%).

The other factor is the increasingly difficult US trade policy developments, specifically the potential US tariffs on autos and auto parts which is a key downside risk to Japan’s trade outlook in the near term and could spark retaliatory tariffs from the Japanese government. Japan had previously refrained from responding to the US over the steel and aluminum tariffs, but it is unlikely to stay silent on cars. Thus, this could be a very “inconvenient” time for BOJ to normalize or tweak policy as the subsequent strengthening of the yen could add more pain to Japanese exporters.

Beyond next week’s BOJ MPM, the markets may still re-ignite speculation about “BOJ normalization” in the medium term unless the BOJ finds a way to reassert its “easy monetary policy” credentials which has not been helped by the fact that the projected annual pace of JGB buying remains well off the official target of JPY80trn per annum. From JPY58trn at end-2017, the pace eased to a low of JPY42.9trn (as of 30 Jun 2018). And while the pace has since stabilized and hovered just below JPY 44trn in the weeks of July, it is still well off target.

The next BOJ MPM takes place on 30 and 31 July with the monetary policy decision due on 31 July (typically between 11am and 2pm SG time) followed by Governor Kuroda’s press conference (2:30pm SG time). The decision will be accompanied by the release of the latest Outlook Report (known as The Bank’s View). Please click on the link to access BOJ’s Monetary Policy Meetings for 2018.

FX Outlook: JPY Strength Likely To Be Short-lived, Expect USD/JPY To Stay Above 110

With the BOJ unlikely to contemplate any policy change in the near term, recent strength in the JPY is likely to be short-lived. However, price action is likely to be volatile as the rhetoric is digested and eventually downplayed, as it did during Jan – Feb when “BOJ tapering” first surfaced. Immediate and escalating concerns over global trade war with its negative impact on Japanese exports should keep the JPY biased on a weak note. Since the first major block of US-China tariffs went live in mid-June, the USD/JPY has been tracking the US Dollar Index (DXY) higher in increasing correlation (see Chart 1). A revival of the US 10-year Treasury yield towards 3% after a month-long slumber between 2.80% and 2.90% should provide an additional lift for USD/JPY. The JPY weakness also comes in a period where short JPY positions are gradually being rebuilt after being squeezed in 2Q18 (see Chart 2). Overall, we reiterate our view of mild JPY weakness ahead and forecast USD/JPY at 110 in 3Q18, 111 in 4Q18, 112 in 1Q19 and 113 in 2Q19.

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Chart 1: USD/JPY Increasingly Correlated To The Rising DXY

Source: Bloomberg, UOB Global Economics & Markets Research

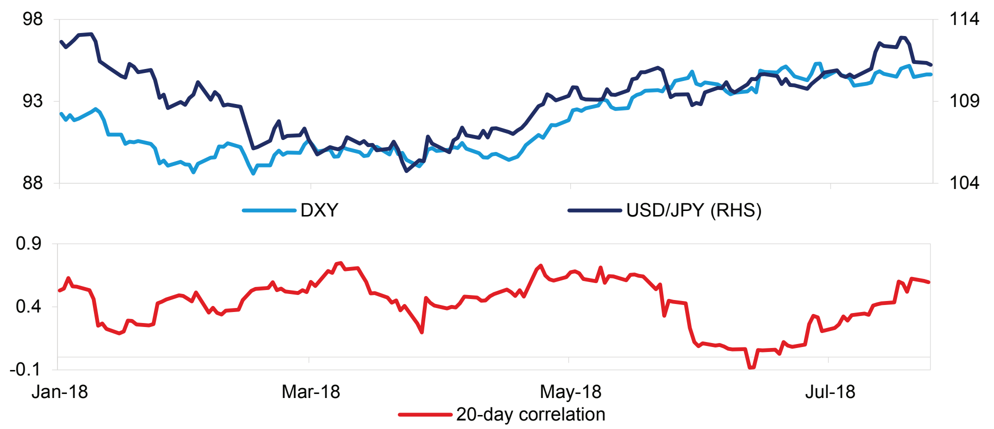
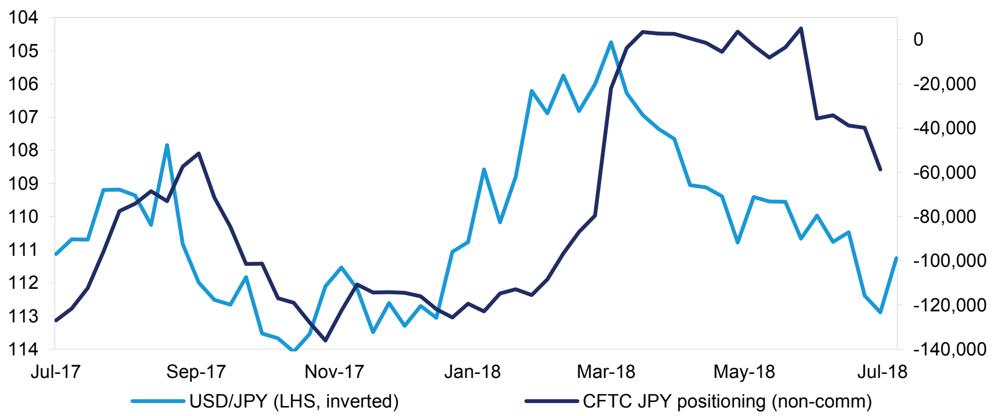


Chart 2: Short JPY Positioning Being Rebuilt Gradually

Source: Bloomberg, UOB Global Economics & Markets Research



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