YEN'S GAINS LOOK CAPPED

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The end of an era

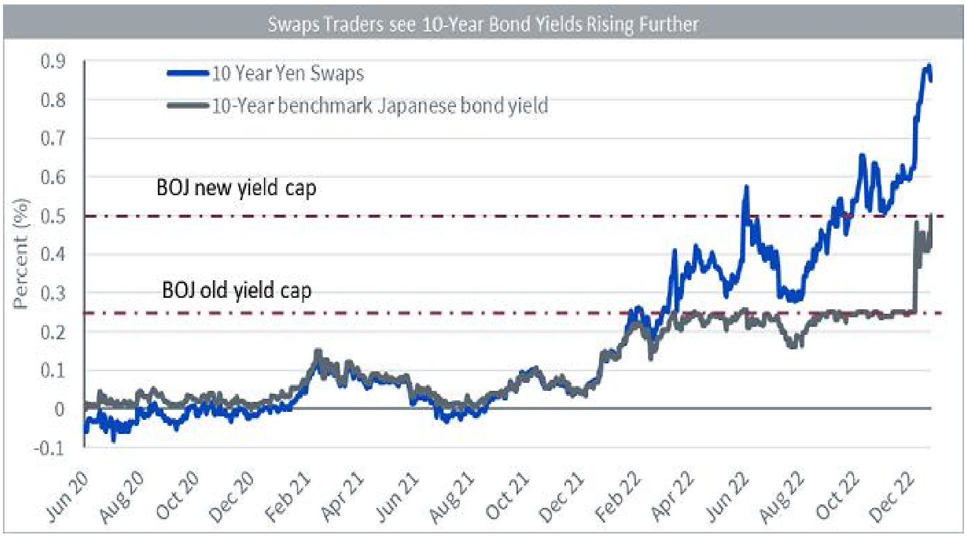
The global stock of bonds yielding sub-zero yields has been erased at the start of 2023, after peaking at US$18.4Trn in late 2020[1]. The fight over inflation has caused central banks from the US, Europe, UK and across the world to exit their low to negative interest rate policy. Even the Bank of Japan – the world's last dovish monetary authority- has left the sub-zero club and is inching towards normalisation.

Source: Bloomberg, WisdomTree as of 4 January 2023.

Historical performance is not an indication of future performance and any investments may go down in value.

BOJ policy shift

The Bank of Japan (BOJ) unexpectedly widened its target range for the 10-year Japanese Government Bond yields (JGB) from ±25Bps to ±50Bps at its December 20th meeting. Since then, the surge in 10-year JGB yields has caused a sharp rise of additional fixed rate and fixed amount purchases by the BOJ amounting to ¥17Trn. Market participants are speculating that BOJ will be forced to tighten policy even more in 2023.



Source: Bloomberg, WisdomTree as of 4 January 2023.

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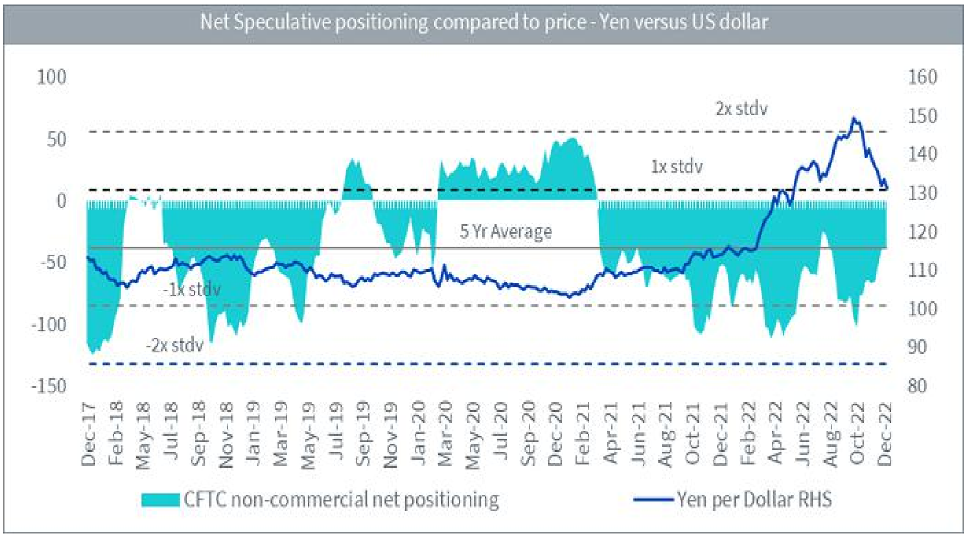
Political pressure alongside costly intervention forced the BOJ to tweak policy

In 2022 – despite the BOJ keeping the Japanese 0–10-year curve fixed, sharply rising yields globally led the Yen to depreciate to a 24-year low, thereby stimulating Japanese net exports. This placed direct upward pressure on Japanese inflation via higher import prices. Japan was no longer able to sustain its yield curve control policy against a backdrop of ever-rising global yields because the interventions it needed to make in its government bond markets to defend the rise in JGB yields were becoming too costly. In addition, pressure from the Kishida administration due to concern about Yen's depreciation pushing up prices and inflicting further damage on cabinet approval ratings.

Yen gains look capped as policy framework likely to be maintained for longer

The change in policy prompted the yen to appreciate to ¥130 versus the US dollar, a level last seen in early August. The Yen's current rally marks a sharp turnaround from last year where investors were shorting the yen owing to the widening interest rate gap between the US and Japan. As illustrated below, an unwind -63%[2] in net speculative short positioning helped drive the appreciation in the Yen towards the end of the year.

If the BOJ were to make additional adjustments, it could spur further Yen appreciation. However, we feel the BOJ probably wants to keep its modified framework in place for a longer time frame, especially now that Yen versus USD stands at more comfortable levels. This was evident from its announcement of expansion of JGB purchases to ensure yields stay in the new range.



Source: Commodity Futures Trading Commission (CFTC), Bloomberg, WisdomTree as of 27 December 2022.

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Signs that current inflation isn't sustainable

The more concerning reason is wages are failing to keep up with inflation. In November, inflation adjusted pay slide 3.8% which was far worse than October's 1.2% drop, marking the worst reading in 8 years[3]. 2023 wage growth depends largely on the results of annual spring negotiations between corporate management and labour unions. We expect bigger raises in base pay this year than in 2022, however its likely to keep up with inflation as the global economy slows.

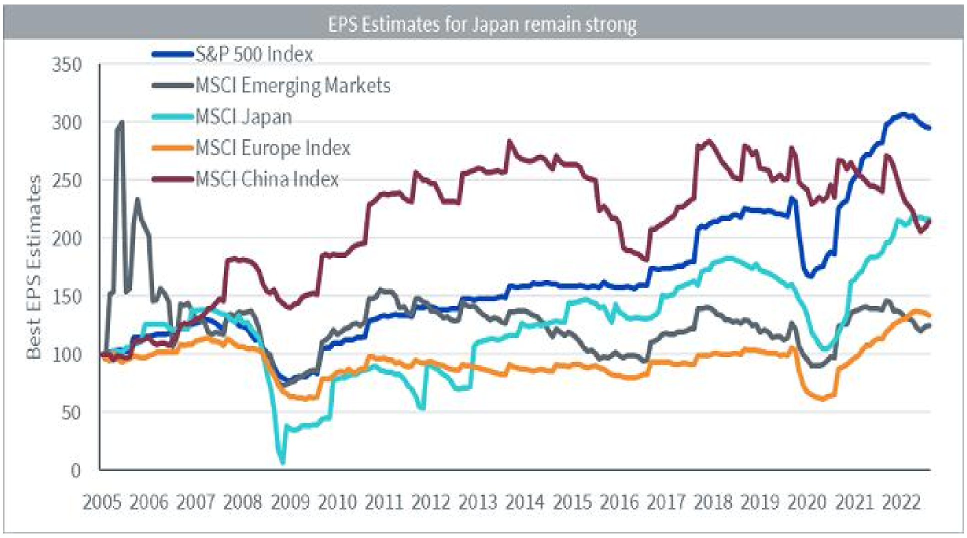
Japanese economy could avoid a recession in 2023

Japan's inflation is likely to remain low in 2023, resulting in less need to tighten policy further. Japan is likely to avoid a recession in 2023. As it has yet to benefit from the re-opening trade that the Western economies have witnessed over the last two years. Consumption is likely to benefit from the economic re-opening and capex intentions are likely to rise on the back of pent-up demand for goods and services.

While goods exports could soften due to the global economic slowdown, services exports are poised to steadily improve throughout the year, led by inbound spending following the lifting of border controls by the Japanese government in October 2022. The government also launched a new economic stimulus package in October to tame inflation and cushion the blow from rising raw material prices which should support the economic recovery in 2023.

Factors underpinning the resilience in Japanese equity market performance

In the face of the global equity market turmoil in 2022, Japanese equities[4] performance has been fairly resilient (-11% versus -20%[5] for global equities). Japan generates a large portion (nearly 52.7%[6]) of its revenues from global markets. So, a weaker Yen supported its profit outlook thereby making Japanese exporters more competitive than global peers. In 2022, a number of companies announced increased dividend pay-out ratios as well as share buybacks, with the intention of protecting shareholder returns amidst the global market volatility. Pay-out ratios rose to 63% from 40%[7] at the start of 2022.



Source: Bloomberg, WisdomTree as of 31 December 2022.

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Sources

[1] Bloomberg Global Aggregate Index of Debt as of 4 January 2023

[2] Commodity Futures Trading Commission (CFTC), from 25 October 2022 to 27 December 2022

[3] Bloomberg as of 3 January 2023

[4] Nikkei 225 Index (Ticker NKY Index)

[5] MSCI World Index performance as of 31 December 2022 (Ticker MXWO Index)

[6] Source: Factset, MSCI Japan Index, as of 30 September 2022

[7] Factset as of 30 November 2022

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