

The Bank of Japan's new path ahead

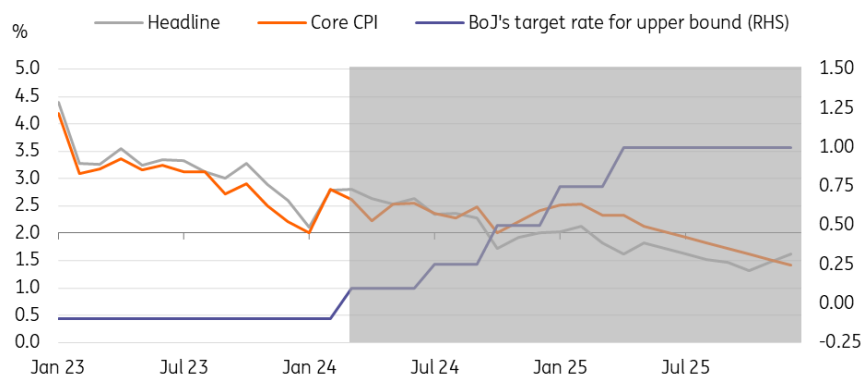
The Bank of Japan is set to normalise monetary policy when certain conditions are met, namely inflation, positive real cash earnings, and a recovery in domestic demand growth. We expect the window for normalisation to open from July for about a year before inflation begins to fall below 2%



Bank of Japan
Governor, Kazuo Ueda.

Back in March, the Bank of Japan made a big decision to raise rates for the first time in 17 years in the hope that higher wage growth would lead to a recovery in consumption and, therefore, keep inflation at the central bank's target in a sustainable way. The BoJ justified its decision by reiterating that monetary conditions will remain accommodative despite the end of negative interest rate and yield curve control policies. We think Governor Kazuo Ueda's post-meeting comments were more neutral rather than dovish. The minutes of the BoJ's meeting in January also quite clearly showed its actions would depend on upcoming data.

The BoJ to bring forward rate hikes while inflation remains above 2%



Source: CEIC, ING estimates

The market seems to be focusing on the dovish part of the BoJ's policy action for now and pricing in a 25bp hike by the end of the year as the central bank pledged to remain accommodative for a considerable time in its new policy framework. We expect that inflation and earnings data will turn out to be favourable to the BoJ towards the middle of the year, and then the BoJ will shift its policy stance quickly to normalisation as early as July. The latest developments since the March BoJ meeting are already supportive of the BoJ shifting.

Household consumption is likely to recover and support growth in 2024

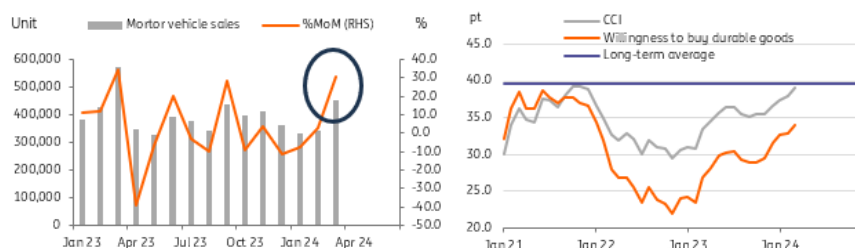
The contribution of domestic demand to GDP growth has been negative for the past three quarters, which has been the weakest part of the economy. But we have already seen this start to change this year. Despite the major earthquake at the beginning of January and production disruptions due to a safety scandal at a major car manufacturer, we have seen some resilience in the monthly data and a more meaningful recovery is expected.

The year started on a positive note for retail sales, marking a turnaround from the sharp decline in the fourth quarter of last year. Despite a significant drop in car sales over the past three months, retail sales have shown resilience, rising on a monthly basis in the first two months of the year. This positive trend is expected to continue, with Japan's Automobile Association's March vehicle sales data showing a 30.9% MoM nsa increase, supporting our view of stronger retail sales in March.

Both hard and soft data indicate that a consumption recovery is underway. A leading indicator for household consumption, the consumer confidence index, has been rising for the past six months. People are optimistic about the general economic conditions and employment, while their willingness to buy durable goods has also advanced meaningfully.

Auto sales and consumer confidence

Auto sales showed a rebound in March while consumer confidence improves for six consecutive months



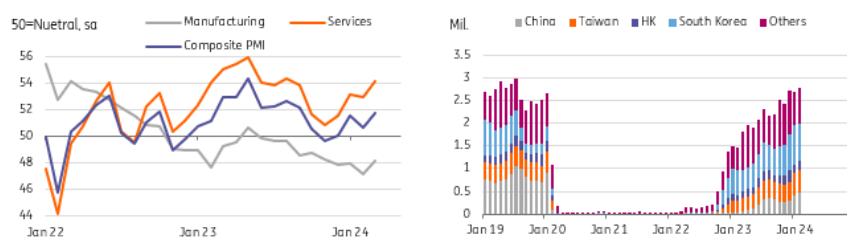
Source: CEIC

Service activity has been regaining momentum since the end of last year

Service sector growth momentum softened in the middle of last year as reopening effects gradually faded. But the PMI and Tankan surveys for the services sector regained strength in recent months, probably boosted by strong tourism and outperformance of asset markets.

The tertiary industry activity index has gained for two months in a row with notable gains in tourism. Tourist arrivals in the first two months of 2024 have already recovered to pre-Covid levels; Asian tourism, including those from South Korea and China, surged during the Lunar New Year holiday. The number of Chinese tourists increased more significantly at the beginning of this year than last, and this will continue throughout the year. As we expect the JPY appreciation to be modest for a considerable time, we expect the tourism windfall to continue.

Service and tourism will lead growth



Source: CEIC

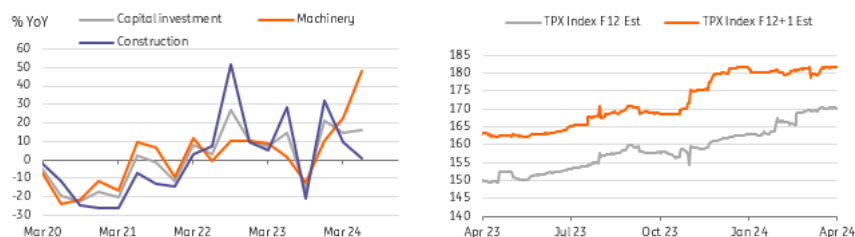
Investment also is expected to improve

We believe that the strong performance of Japanese companies will lead to more capital investment. Facility investment is likely to increase the most, driven by solid demand for semiconductors, electrical machinery, and automobiles. According to capital investment data, spending on machinery (48.2%), civil engineering (34.8%), and factories & warehouses (26.0%) will increase the most in the first half of 2024, while residential and office & retail construction will lag.

This was echoed in the latest Tankan survey that manufacturing companies plan to increase capex in FY2025 by 8.2%. We expect earnings to continue to improve, as suggested by the upward

revision of the 12-month forward EPS consensus trend. Subsequently, many Japanese companies will hold a significant amount of cash reserves. As a result, solid investment will be supported over the next few quarters.

Strong performance of corporates to support future capex



Source: CEIC, Datastream

Real cash earnings are soon expected to turn positive

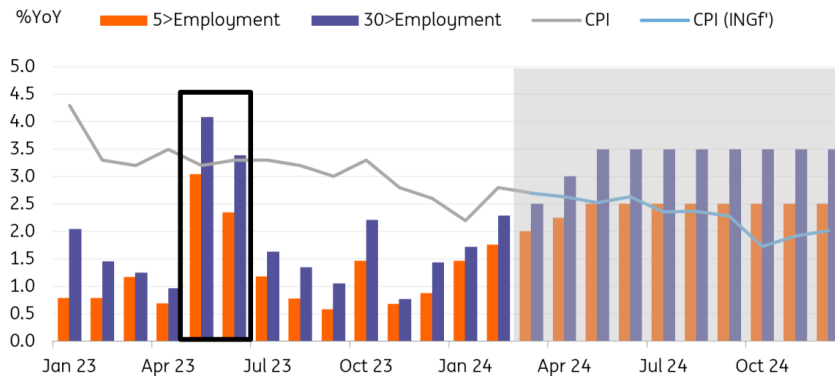
In 2023, Shunto-agreed wage growth (negotiated by unions and companies) was 3.6% YoY against a consumer inflation growth rate of 3.2%, so real wage growth really made few advances. But this year, we expect wage growth to exceed well above consumer prices.

The Japanese Trade Union Confederation, Rengo, has announced the wage growth is estimated at 5.2% (down from 5.28% including a base salary rise of 3.7% in the first round). The results of the third round will be released by the middle of April, but we expect the overall average wage growth for FY24 to be slightly above 5%. Given the complicated pay system in Japan, with irregular bonuses and other benefit payments, the key to watch is base pay growth, which is estimated to be at least 3%.

It is true that unionised workers account for 16.3% of Japan's workforce (according to the Japan International Labour Foundation), thus a larger share of workforce, mostly in small and medium-sized companies, won't benefit from the wage jump and there is a gap between the Shunto results and nationwide official earnings data. Looking at cash earnings data, it rose by 1.3% YoY, YTD (April 2023 to February 2024) and 1.9% YoY, YTD, respectively for 5+ employees and 30+ employees. It shows there has been a trickle-down effect that benefitted smaller companies, but the increases for smaller companies is on a lesser scale. If we estimate cash earnings for this year, it is expected to rise 3.5% for large companies and 2.5% for small and medium-sized enterprises.

More importantly, inflation, which affects the entire population, is expected to decelerate from 3.0% in FY 2023 to 2.1% in 2024, so real wage growth is likely to turn positive this year for both large and small companies. We believe that the newly agreed wage negotiations will start to kick in from May, and subsequent data will come out in early July, just before the Bank of Japan's meeting.

Cash earnings growth to accelerate while inflation decelerates



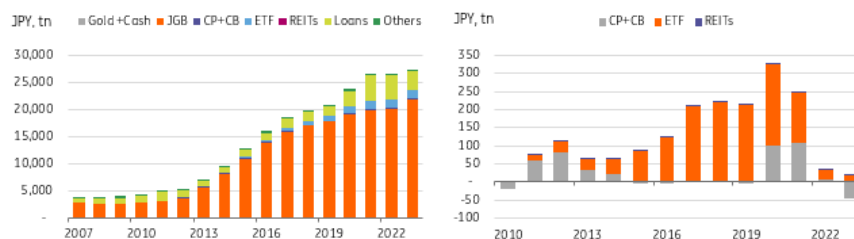
Source: CEI, ING estimates

What to expect from the BoJ on its asset purchase programme

The purchase of CP/other notes for one year simply means having a safety net option to respond to any sudden event risk. The Bank of Japan announced its discontinuation of the ETFs/J-REITs purchase programme in March, although it has to be said the BoJ hadn't bought any meaningful amount of these assets for more than 12-24 months.

As far as quantitative tightening is concerned, we believe that the QT plan will be better telegraphed than changes in policy rates itself and that the right time should be from next year when policy rates move towards 1.0%, and its CP/Notes purchase programme comes to an end. The announcement of the JGB operation could come by the end of this year, but this is quite uncertain at this point. We think it will depend on where the UST/JGB will be. We expect the BoJ to be cautious with its JGB purchase programme, at least until the policy rate rises to 1%. Even if the Bank raises its target rates to 1%, we believe that overall monetary conditions should remain at neutral levels rather than be somewhat restrictive.

BoJ's purchase of ETF, REITs, and CP have reduced since 2022



Source: Left chart: Gross, Right chart: Net change

Source: CEIC

FX: The undervalued yen needs some help

If Bank of Japan policymakers had expected the March rate hike to turn the yen around, they would have been sorely disappointed. At the time of the March hike, USD/JPY quickly reversed intra-day losses after the BoJ Governor promised to keep rates accommodative. Given the dominant trend of low volatility and carry trade strategies in FX markets this year, the BoJ's promise of continued low rates has failed to dent the yen's role as a funding currency.

In all likelihood, some further modest increases in the BoJ policy rate look unlikely to turn the USD/JPY trend around. And it seems quite likely that unless we see a sharp sell-off in the dollar near term, the BoJ will need to start intervening again and selling FX in the 152-155 region in USD/JPY. This looks like a clear and present risk for the second quarter.

Yet the yen is the most undervalued currency in our G10 medium-term fair value model, and - as was the case late last year - the yen should do well if and when the Fed is in a position to start cutting rates. Our house call of a Fed easing cycle for later this year remains in place, and given our call for US 10-year yields to correct to the 3.50% area by the end of the year - typically a weak period for the dollar - we see a window for USD/JPY to briefly trade sub 140.

In addition, the prospect of rising uncertainty into and around the US presidential election in November looks likely to drive higher FX volatility. That should prompt some unwinding of the carry trade and be another factor why USD/JPY trading in the 150/155 range may last only another quarter. We now have a year-end target for USD/JPY at 138.

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