

Bank of Japan hikes interest rates by 25bp as markets focus on timing of next hike

As widely expected, the BoJ raised its target rate to 0.5% today. The surprise came from its latest inflation outlook, which was revised sharply higher throughout 2026. If the spring wage negotiations bring another solid wage increase, we expect the BoJ to deliver a 25 hike in May



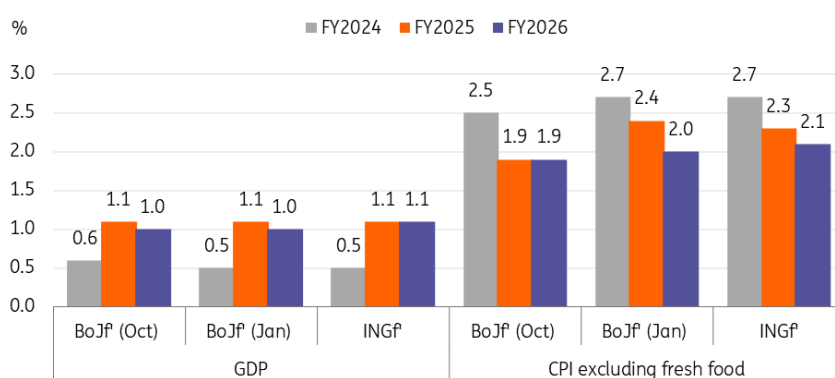
Bank of Japan building in Tokyo

0.5% Target rate

The BoJ upgraded its inflation outlook to above 2% throughout the forecast period

The BoJ's rate hike itself was already fully priced into the market, so it came as no surprise. But the Bank's latest quarterly outlook report sent a clearer message that further rate hikes would come sooner than the market had expected. The BoJ expects inflation to remain above 2% until FY2026. Governor Kazuo Ueda's communication at the press conference was rather ambiguous about the timing of the next rate hike and the terminal rate, but this was somewhat expected. Governor Ueda reiterated that the real interest rate remains negative, and monetary conditions therefore remain accommodative. Thus the market appears to be more closely following the projection of the sustainable inflation outlook.

The BoJ upgraded its inflation outlook quite sharply



Source: CEIC

3.6%

Consumer price inflation (year-on-year)

3.0% core inflation excluding fresh food

Higher than expected

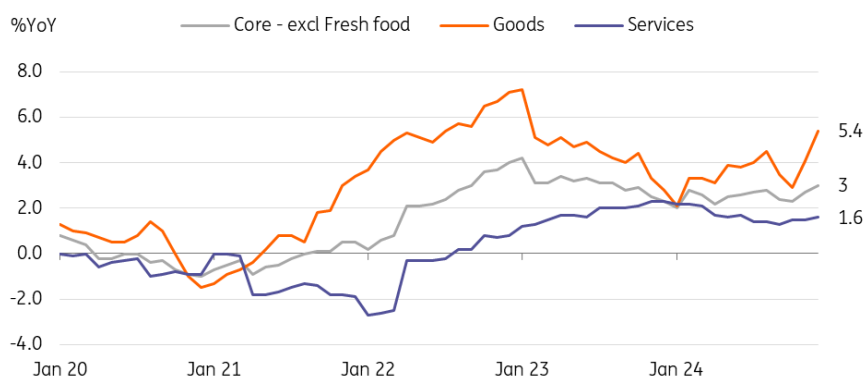
Solid wage growth underpins broad-based inflation gains

The December inflation results are mostly in line with market consensus. Inflation jumped to 3.6% year-on-year in December (vs 2.9% in November, market consensus 3.4%) mainly due to a pick up in utilities (11.4%) and fresh food prices (17.3%). Higher utilities are mainly due to the end of the government subsidy programme. Rice prices continued to rise sharply which will lead to service prices (eating out) rising with a time lag, thus the BoJ should be watching the price trend carefully.

Core inflation excluding fresh food also rose to 3.0% (vs 2.7% in November, 3.0% market consensus) while core-core inflation excluding fresh food and energy stayed at 2.4% (vs 2.4% in November, market consensus). In the monthly comparison, inflation growth accelerated to 0.6% month-on-month seasonally-adjusted (vs 0.4% in November) with goods and services up by 1.1% and 0.1% each. Apart from the end of energy subsidies and rising fresh food prices, service prices

are rising steadily, which in our view is more important than the rise in headline inflation.

Service prices rose steadily



Source: CEIC

BoJ watch

Governor Ueda's comments made clear that the Bank is not in a hurry to raise rates again. But we noted that his optimistic view on the outlook for spring wage negotiations is a signal that a May hike option is on the table. For the May hike to materialise, Shunto's results would need to be as strong as last year's, which is our base case scenario.

We expect inflation to cool down from January as the government renews its energy subsidy programme, but rising rice prices are likely to have a second-round effect in pushing up broader services prices.

If another solid wage negotiation and steady rise in service prices are confirmed, we expect another 25bp hike in May.

One of the major risk factors is President Trump's trade policy. So far Trump's trade policy has been mostly in line with market consensus and there has been no particular negative news for Japan. But, this may change in the future, and the BoJ's rate hike may be delayed.

JPY: Positive news, but US yields remain the key driver

As markets perceived the upward revision in inflation forecasts as a hawkish signal, there seems to be a bit more tailwind for the yen. Remember USD/JPY still has room to unwind extensive long positioning and the dollar has continued to lose momentum since Trump's inauguration as the threat of imminent tariffs is decreasing.

Two-year JPY swap rates have risen by only 3bp to 0.74% after the BoJ announcement, which signals there is more room for a hawkish repricing in the curve in the coming months if we are correct with our expectations for two more hikes in 2025. That bodes well for the yen, which however remains heavily dependent on the impact of Trump policies on US Treasury yields.

Our rates team retains a bearish call UST which makes us reluctant to switch to a downward-sloping profile for USD/JPY just yet. That said, should upside room for US yields end up proving limited, the case for USD/JPY to move to the 155-150 range this year becomes quite compelling

given the relatively hawkish BoJ and still significant medium-term overvaluation of the pair.

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