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Japan Stays The Course

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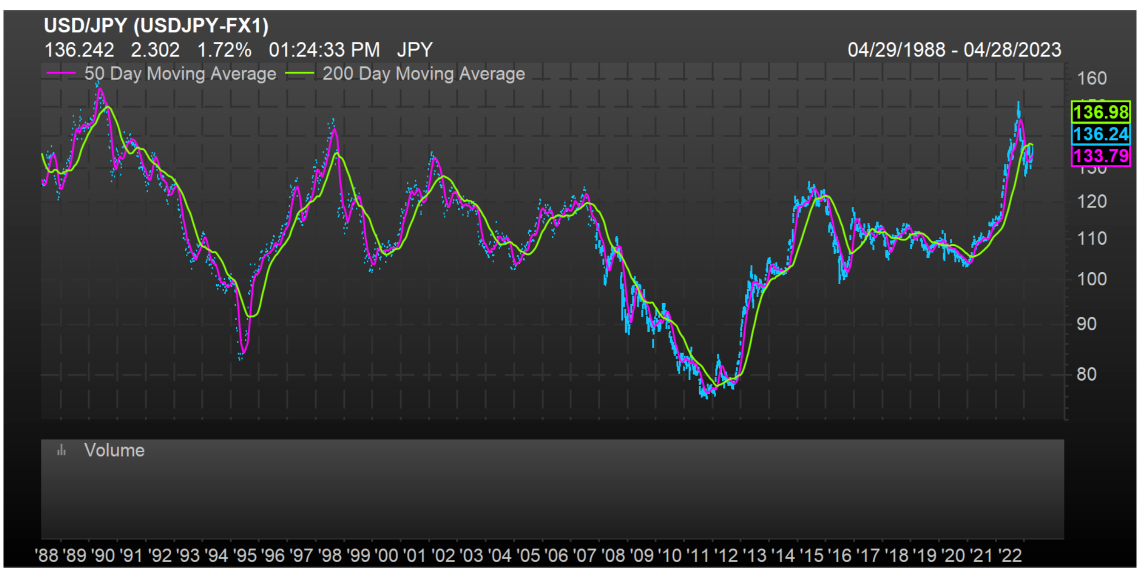
Steady As She Goes At The Bank Of Japan

In his first official meeting as the new governor of the Bank of Japan (BoJ), Kazuo Ueda maintained the ultra-loose monetary policy experiment of his predecessor Haruhiko Kuroda who spent ten years as BoJ governor. Ueda began his new five-year term with expectations that Japan needs to change its monetary stimulus program, especially as other major central banks have shifted course.

Although some economists had expected Ueda to make changes to the Bank's yield curve control (YCC) mechanism and make signals to begin to normalize monetary policy at this April meeting, consensus remains that changes are more likely to come at the July meeting of the Bank of Japan.

The Japanese Yen reacted negatively, depreciating by more than one percent versus the U.S. Dollar following the announcement. The 35-year graph of the USD-Yen exchange rate (below) demonstrates that the BoJ's ultra-loose policy against a backdrop of hawkish major central banks had an outsized effect on the yen starting in early 2022 as major central banks began their interest rate hiking cycle, reversing years of monetary stimulus while the BoJ did not budge. These interest rate differentials have led to yen depreciation.

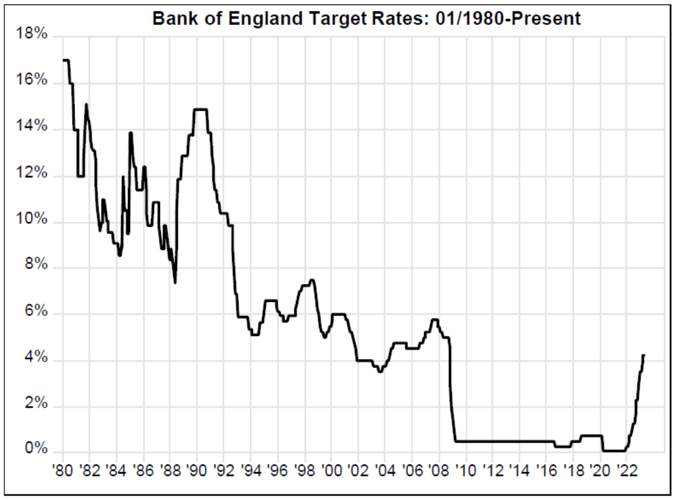
USD-Yen Exchange Rate (35 years)

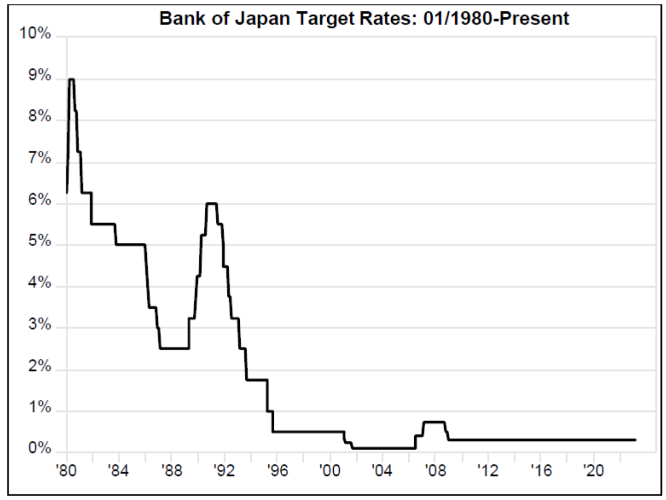


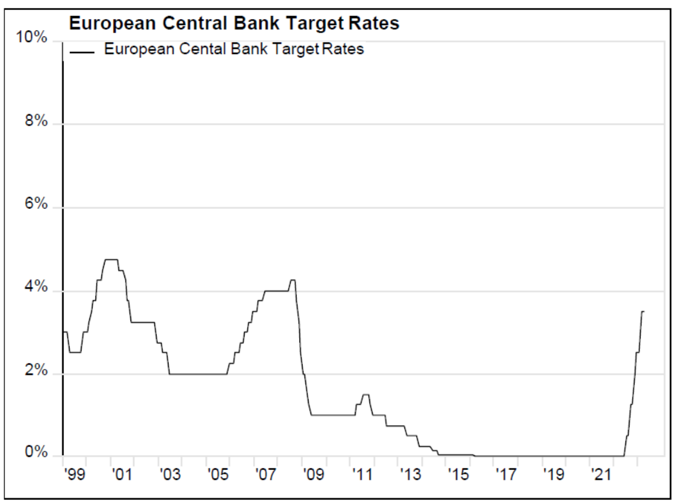
Source: Factset

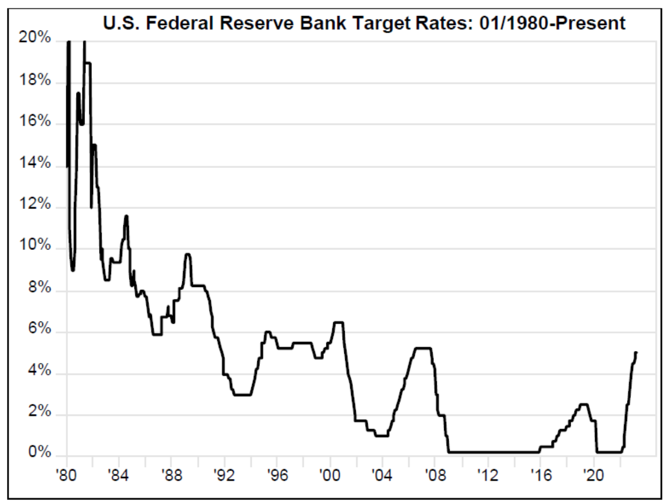
In late 2022, the yen began to appreciate as expectations rose that after ten years of Kuroda's ultra-loose policy, the new governor, to be picked in early 2023 may begin the process of normalization of monetary policy. As it stands now, the yen remains at the upper bands of its 35-year history versus the U.S. Dollar despite having appreciated since late 2022.

Moreover, as can be seen on the benchmark interest rate charts below of major global central bank interest rates, Japan stands alone having left its policy rate at zero during this inflationary period compared to other major central banks such as the Bank of England, the European Central Bank, and the Federal Reserve which have all raised rates aggressively over the last twelve months. Since the late 1990's when Japan's economy fell into a period of secular deflation, the Bank of Japan has tried many monetary experiments to create some inflation together with real wages in the country. While most of these efforts, if not all, have failed to bring the economy back to a more normal inflationary period, the Bank remains committed to try whatever it takes, including Kuroda's Bazooka approach which started ten years ago of bond purchases and yield curve control.









Source: Factset

With this backdrop in mind, new BoJ Governor Ueda has his hands full. Yet, the global inflationary environment has helped, pushing up inflation in the country for a prolonged period. Japanese inflation as of March 2023 stands at 3.2%, albeit lower than previous months, it is still well above what the country has seen in the last two decades. In its latest Outlook Report, the BoJ increased inflation expectations anticipating core inflation to average 1.8% in FY23, 2.0% in FY24, but fall back to 1.6% in its newly published FY25 estimate. This perhaps will give the BoJ room to begin to normalize its monetary policy beginning in the upcoming July meeting as some economist's suspect. But conversely, real wages have not followed suit and are still struggling to provide income growth for Japanese consumers.

If this is the case, those sectors which have been hurt the most from zero interest rate levels over the years, with banks in particular, should benefit with a normalizing yield curve. Bank stocks in Japan have outperformed since the Fall of 2022 when expectations grew following a change in policy.

We believe the odds have risen that changes could be coming to the Bank of Japan's policy in the coming months or quarters but are more cynical than to believe the country's troubles with deflation are a thing of the past. The BoJ did announce that it will be overseeing research over the next twelve to eighteen months to review the efficacy of its monetary policy over the past 25 years. Some believe this is a step towards exiting its ultra-loose policy. We will continue to monitor these developments as it relates to the positioning of the EGA International Equity ADR portfolio as we remain underweight Japan.

Disclosures