TRUMP FORCED BOJ POLICY CHANGE?

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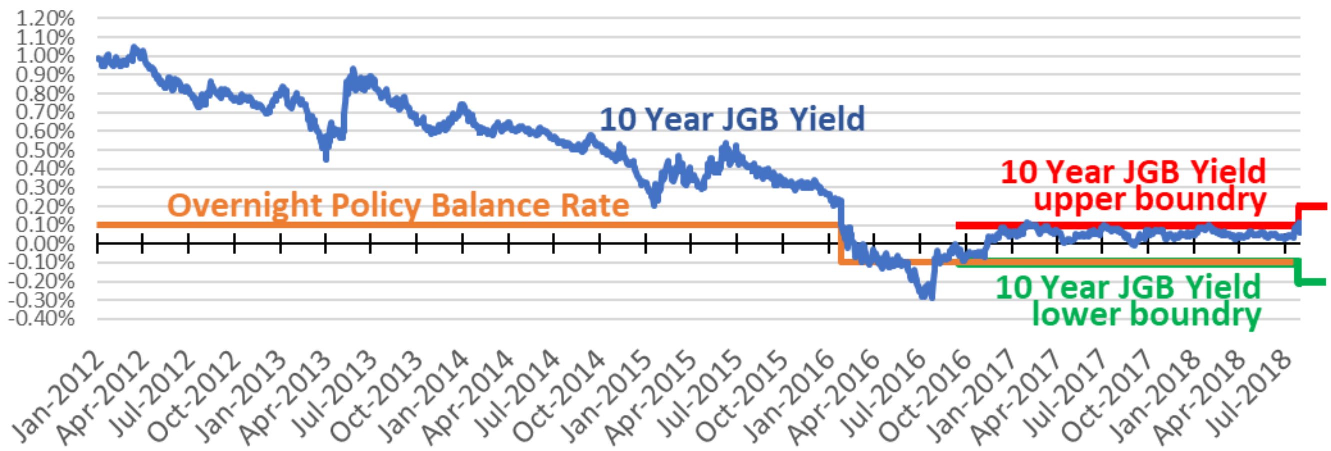
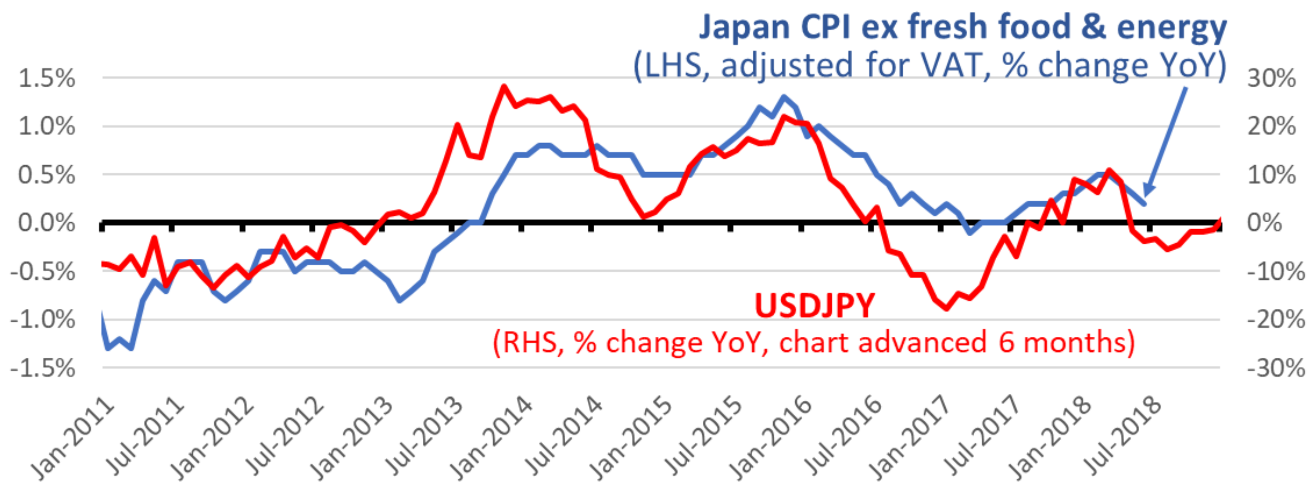
Market Views

"There is one logical reason for the BOJ action, Trump. On the very day the BOJ first leaked its policy change Trump had complained other countries *"manipulate currencies and interest rates lower"*. Trump has said *"look at what Japan has done. They play the money market, they play the devaluation market and we sit there like a bunch of dummies". He wouldn't be happy with USDJPY +7% since his election".*

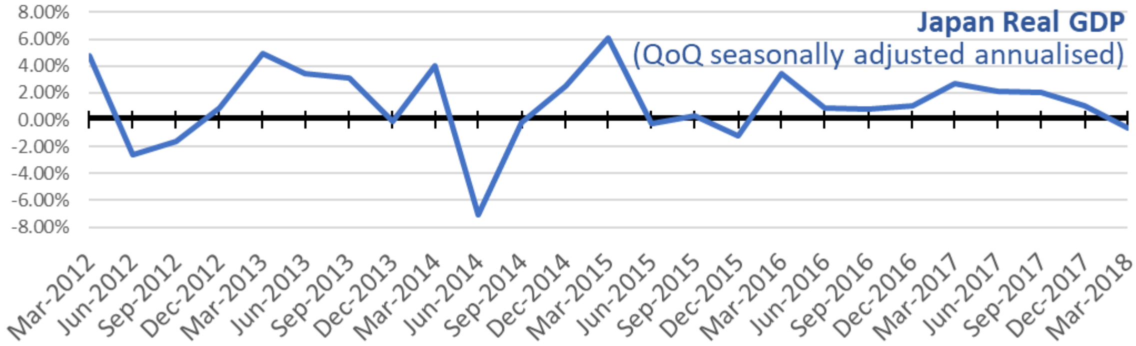
The Bank of Japan (BOJ) this week adjusted its Yield Curve Control for the first time since 2016. Increasing the range in which 10 Year Japanese Government Bond (JGB) yields can deviate around 0.00% from +/- 0.10% to +/- 0.20%. The yield rose above 0.10%, peaked at 0.14% and is currently trading at 0.11%.



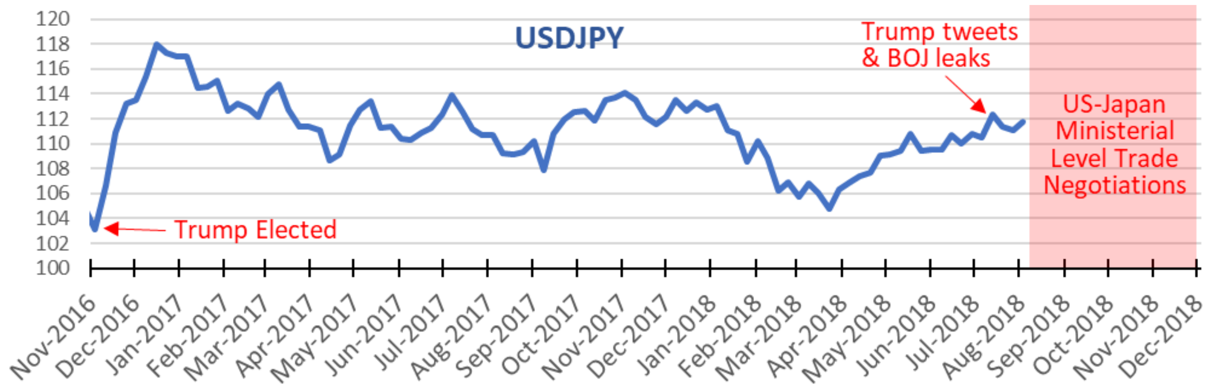
While these moves are rather small, allowing yields to rise at all is completely incongruous with the direction of inflation. The BOJ's prefered Consumer Price Index (CPI) ex-fresh food & energy has fallen to 0.2% and will face further downward pressure from currency effects in coming months, as shown below. The BOJ's own measures of underlying inflation show broad weakness, timely retailer point-of-sales data shows further weakness in recent weeks and a BOJ survey shows retailers see further price cuts to come in future.



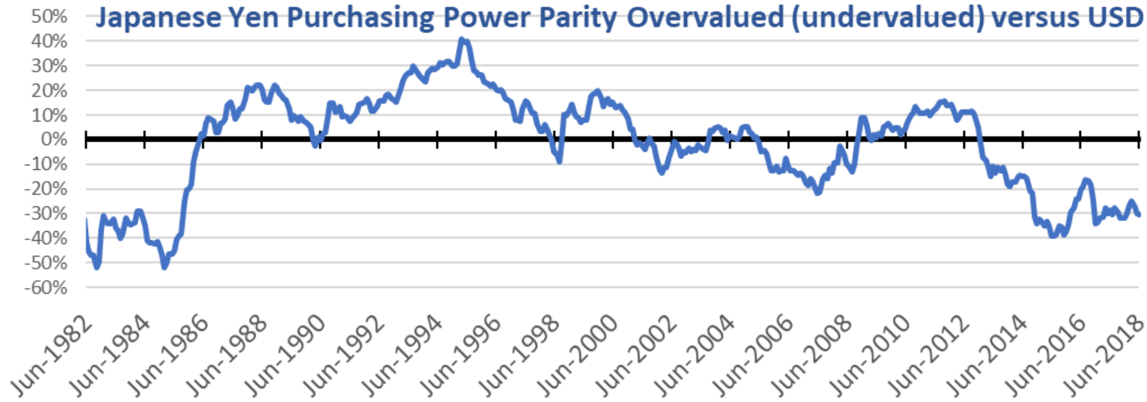
Allowing yields to rise is also completely incongruous with the direction of Japan's economy. Japan's GDP growth fell negative earlier this year. I wrote of the reasons for this late last year and higher interest rates will only further slow each of these already weak areas of ; private consumption, real estate investment and net exports (via a stronger Yen that comes with higher yields).



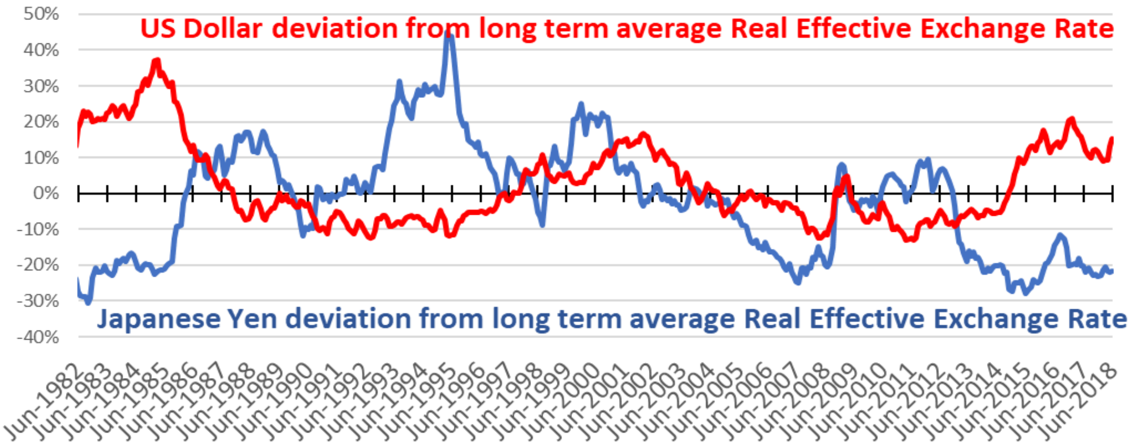
There is one logical reason however for the BOJ action, to placate Donald Trump. On the very day the BOJ leaked its policy change, 20th July, @realDonaldTrump complained other countries are *"manipulating their currencies and interest rates lower"*. Trump has previously said *"look at what Japan has done over the years. They play the money market, they play the devaluation market and we sit there like a bunch of dummies"*. Trump wouldn't be happy with USDJPY up 7% since his election, he includes currency in trade negotiations, he is enforcing harsh penalties believing *"tariffs are the greatest"* and is starting his first ministerial-level trade talks with Japan next week. Trump has implicitly requested, in the public domain, an adjustment to what he sees as the BOJ's currency devaluation policies and would likely explicitly demand it in private talks.



Critically, the BOJ showed all it takes to reverse the direction of the USDJPY is few vague leaks and some de minimis interest rate moves. This is because Trump has a point, the Yen is unreasonably cheap. Consider that the USDJPY exchange rate is at a similar level to where it started this century but over 18 years CPI and labour costs have risen by over +50% in the US while they actually have fallen in Japan. The BOJ's Amamiya argues *"while exchange rates fluctuate due to a variety of factors in the short term, their trend over a longer term of 5 or 10 years reflects the difference in inflation between two countries. This is the concept of purchasing power parity (PPP)"*. The Yen is currently 30% undervalued against the USD in PPP terms.



We prefer to look at the similar real effective exchange rate (REER) measure, which shows the Yen is 35% undervalued versus the US Dollar. The BOJ's Kuroda did in 2015 publicly put a line under Yen weakness on REER measures, due to political pressure, by saying that *"if you look at the REER, it shows that the Yen is already very weak. Even further declines on a REER basis are not likely to happen"*. Of course, it has harder for the BOJ to confirm this time that they have been forced to put a floor under the Yen for political reasons, it would make Abe look weak just ahead of his largest internal challenge of his second prime ministership.



It would seem there is limited downside to Yen, for fear of enraging Donald Trump, and large upside to fair value. It does not appear the BOJ would need to raise rates by much to contain any Yen weakness pressures.

INFORMATION

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