

FX Pulse

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Different reactions for JGB yields, forex rates at start of Takaichi Administration

- On guard for short-term yen depreciation overshoot
- US-Japan finance ministers' meeting: Focus on not only BOJ rate hike but also discussions on capital flows

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Is Takaichi administration reflationary?

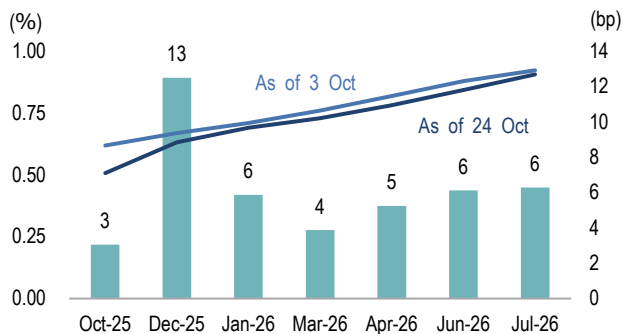
In the elections to nominate the prime minister in upper and lower houses on 21 October, Liberal Democratic Party (LDP) President Sanae Takaichi obtained the votes required to become Japan's 104th prime minister. As the Takaichi Cabinet was formed that same evening, the so-called "Takaichi trade" became a focus in the forex market, rekindling yen depreciation pressure. On 24 October, the yen temporarily depreciated to the USD/JPY153 level, approaching the recent high set on the 10 October.

Given Takaichi's history of advocating reflationary policies, the market strongly assumes that a Takaichi administration will lean heavily toward such policies. If the Takaichi administration prioritizes a simple "expansionary fiscal policy" while neglecting the "responsible" aspect of her stated "responsible expansionary fiscal policy," and if she also hinders the normalization of the BOJ's monetary policy, yen depreciation will undoubtedly accelerate. However, looking at the lineup of party officials and cabinet ministers, it appears that minimal fiscal discipline will be maintained and that there will be no reckless opposition to the BOJ's normalization efforts to normalize policy.

Of the four LDP executives appointed by Takaichi, Secretary-General Shunichi Suzuki and General Council Chair Haruko Arimura are both members of the Aso faction. Taro Aso himself became Vice-President of the party, and the economic policies of the Takaichi administration are likely to be strongly influenced by Aso. Also, among the cabinet ministers, Takaichi appointed Satsuki Katayama as Finance Minister, which is seen as the most important post. Even though she came from MOF, Katayama can be viewed as a proponent of expansionary fiscal policy. That said, she is cautious about consumption tax cuts and places importance on fiscal soundness, thus drawing a line from extreme expansionary fiscal advocates. The LDP's coalition partner, the Japan Innovation Party (JIP), is also a party that prioritizes fiscal discipline.

Given that the LDP will remain a minority ruling party, it will likely be forced into populist fiscal expansion (handouts), unable to ignore the opposition's wishes. However, looking back at the results of the prime ministerial nomination vote in the Lower House, the LDP and JIP, along with support from independent lawmakers, allowed Takaichi to secure 237 votes to exceed the majority threshold. In the Upper House she secured 123 votes in the first ballot, falling just one vote short of a majority. The LDP-JIP coalition government currently falls short of a majority by two seats in the Lower House and five seats in the Upper House. However, the Lower House may now be able to conduct more stable parliamentary operations as compared to the LDP-Komeito coalition government. Considering the outcome of the election to nominate the prime minister, the risk of fiscal discipline becoming excessively lax may have decreased compared to before.

Chart 1: Pricing in of BOJ Rate Hikes



Source: Bloomberg; compiled by Daiwa.

Chart 2: JGB Forward Yields



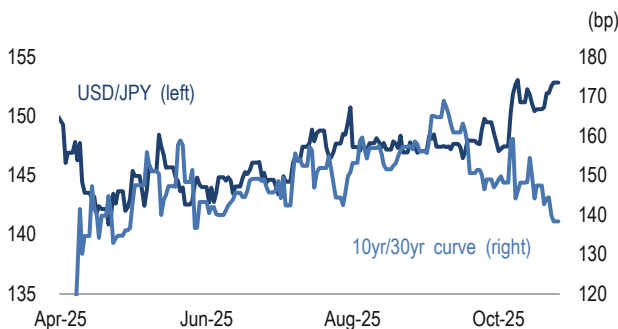
Source: Bloomberg; compiled by Daiwa.

On guard for short-term yen depreciation overshoot

The 30-year JGB yield hit a record high following Takaichi's victory in the LDP leadership election, but has since trended downward. Last week, the yield decline accelerated after Katayama was appointed Finance Minister. Looking at the degree to which the market is factoring in a BOJ rate hike (based on OIS market), the probability of a rate hike at the Bank's October meeting stood at 56.5% as of 3 October, before the LDP presidential election. By 24 October, it had fallen to only 11.2% (Chart 1). However, the probability of a rate hike stands at 48.0% for the December meeting and 83.5% for the January meeting, indicating little change compared to early October.

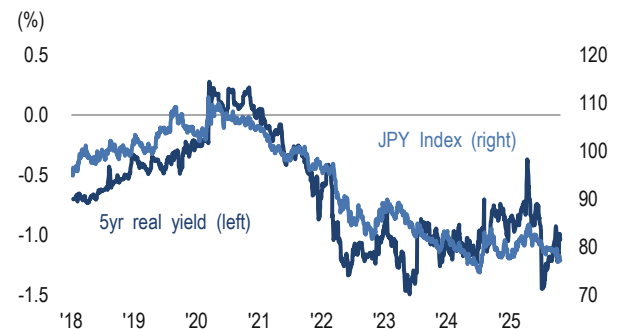
In the JGB yield market, the view that the BOJ will raise rates to 1% in one year and to 1.25% in two years remains unchanged (Chart 2). Meanwhile, as mentioned above, the yen has depreciated since the start of the Takaichi administration due to the "Takaichi trade," resulting in different reactions for JGB yields and forex rates (Chart 3). Of course, while JGB yields and forex rates do not always move in lockstep, if their respective markets interpret the Takaichi administration's economic policies differently, it is highly likely that one will eventually be forced to make a correction. The forex market appears to be anticipating a policy mix of significant fiscal expansion to accelerate inflation and continued monetary easing. However, considering the above appointments made by Takaichi, our current impression is yen depreciation driven by expectations.

Chart 3: 10yr/30yr JGB Yield Curve, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa.

Chart 4: 5yr Real Yield, JPY Index



Source: Bloomberg; compiled by Daiwa.

However, considering that Japan's real interest rate remains deeply negative and accommodative monetary conditions remain in place, if speculation about fiscal expansion and the BOJ postponing rate hike start to emerge, it is only natural that the market would ramp up yen selling. One reason for the persistent excessive yen depreciation since the COVID-19 pandemic is that the real interest rate is still too low (Chart 4). In this environment, there appears to be an asymmetry where the market reacts more strongly to yen depreciation factors than to yen

appreciation factors. However, the market is now entering an area where caution is warranted regarding potential overshooting of yen depreciation. Once the market enters an overshoot area, past experience shows there's no telling how far it might go. So, we should be on guard of further yen depreciation over the short term.

BOJ must exercise greater caution than usual regarding its forex rates

This week, the first BOJ meeting since the Takaichi administration took office is scheduled for 29-30 October. There are widespread expectations that the status quo will be maintained. The focus is on whether yen depreciation can be halted. Yen selling could intensify if the BOJ gives even the slightest impression of retreating from its interest rate hike stance or compromising central bank independence. BOJ Governor Kazuo Ueda appears wary of the risk that the impact of US tariff policies could manifest after a certain lag. However, should he fail to maintain these expectations for a rate hike ahead of the December meeting, yen depreciation could sharply accelerate. This meeting is likely to demand an even more cautious approach than usual.

The US FOMC meeting is scheduled for 28-29 October, with a 25bp rate cut viewed as certain. The US CPI for September, released on 24 October, rose 0.3% m/m, while the core CPI increased 0.2%, both falling short of market expectations. This outcome supports a rate cut at the October FOMC meeting. Even though the preliminary US PMI for October, released by S&P Global on the same day was higher than expected, the reason for a Fed rate cut is that, "Rising downside risks to employment have shifted our assessment of the balance of risks" (Fed Chairman Powell). With few economic indicators being released due to the US government shutdown, there is no reason to deviate from the path indicated by the Fed's policy rate projections (dot plot) as long as inflation remains subdued. As such, continuing rate cuts through December remains the baseline scenario.

US-Japan finance ministers' meeting: Focus on not only BOJ rate hike but also discussions on capital flows?

On the political front, US President Trump is scheduled to visit Japan from the 27 to 29 October and hold a US-Japan summit meeting with new Prime Minister Takaichi. The first telephone conversation between the two leaders on 25 October, which lasted about 10 minutes, seemed to go well. However, from the perspective of the forex market, the discussion about the \$550bn investment in the US is attracting attention. US Treasury Secretary Scott Bessent is also expected to accompany Trump and hold face-to-face talks with Finance Minister Katayama. On 22 October, Bessent pointed out that Takaichi is former Prime Minister Shinzo Abe's successor and expressed his expectation that she will work to build a good relationship with Trump.

After holding her first telephone conversation with Bessent on 24 October, Katayama said that Bessent is a "great admirer of Abenomics" and that as fellow members of the financial world, "I felt we got along well." On 15 October, Bessent stated regarding the yen exchange rate, "The yen will settle at an appropriate level if the BOJ continues to conduct the right monetary policy." While his remarks were more moderate than when he stated in August that, "the BOJ is falling behind the curve in addressing inflation," his view that yen depreciation would undergo a correction if the BOJ raised interest rates remains entirely unchanged.

In a March interview with Reuters, Katayama stated, "The USD/JPY rate had been in the 120-yen range for a long time, so many view the USD/JPY120-130 range as its true value." In this manner, she expressed her view that yen appreciation is desirable in terms of quelling high prices. She pointed out that while currency intervention can serve as a trigger for guiding the yen toward yen appreciation, over the long run the effects are not very large, so more fundamental measures are required.

As for the BOJ's conduct of monetary policy, she stated, "As chairperson of the LDP's Research Commission on the Finance and Banking Systems, I would prefer to refrain from commenting." However, on the question of whether to raise interest rates, she expressed the view that, "While corporate bankruptcies are now increasing, the housing market and capital investment remain relatively robust. It is not a situation where raising interest rates is absolutely impossible." At the

same time, she said, “While the US cannot unilaterally cut rates due to inflation, it also understands that Japan cannot unilaterally raise rates either and there are things it can and cannot do.”

In her Reuters interview, Katayama said that while avoiding explicit statements on monetary policy as a means to achieve yen appreciation, the LDP is considering expanding NISA (Nippon [Japan] Individual Savings Account), a tax exemption program for small investments by individuals, as one indirect measure for guiding forex rates. Katayama said that the LDP is considering partial inheritance tax exemptions for elderly investors’ long-held domestic stocks, aiming to have such measures included in the government’s basic policy and the tax commission’s year-end agenda. Katayama said that she hopes to offer incentives for long-term holdings of domestic equities as that would contribute to the nation’s growth, adding that she wants to create merits of long-term holding of Japanese stocks.

Regarding capital flows, the US Treasury’s semi-annual currency report released on 5 June raised the issue that, “Treasury also stresses that government investment vehicles, such as large public pension funds, should invest abroad for risk-adjusted return and diversification purposes, and not to target the exchange rate for competitive purposes.” Furthermore, a joint statement by the Japanese and US finance ministers released on 12 September included, “Other government investment vehicles such as pension funds continue to invest abroad for risk-adjusted return and diversification purposes, not targeting exchange rates for competitive purposes.”

In her interview, Katayama said that while there are differences between the “household yen selling” through NISA and the US currency report/joint statement by the Japanese and US finance ministers highlighting “yen selling by public pension funds,” there is a shared awareness that “yen selling by the Japanese” associated with capital flows is one of the reasons behind the yen’s depreciation. We should also pay attention to discussions about Japanese investors’ overseas investments, not just the BOJ rate hikes. This is an important point to consider when examining the medium/long-term supply and demand dynamics for the yen exchange rates.

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