

Bank of Japan Preview

On hold but action increasingly likely

- We expect the BoJ to keep its ‘QQE with yield curve control’ policy unchanged at the next monetary policy meeting ending on Thursday, 19 September.
- The economy is still going strong, which calls for patience considering the limited tools left at the BoJ’s proposal. The global economy is the most important driver of deflationary pressures in Japan.
- The VAT-hike and global political uncertainty pose risks to the economy and upward pressure on the yen. The probability of further easing has risen.
- USD/JPY has moved up to 107s as expectations have been building for positive outcomes in global fiscal policy, monetary policy, US-China relations and the global industrial cycle. We remain rather cautious of such pricing and expect USD/JPY will continue to stay in a downward drift. We target 105 in 3M and still see substantial potential for going below that target.

Strong economy

The state of the global economy and global monetary policy will be discussed heavily when the board members of the BoJ meet on Wednesday. On the one hand, Fed easing could add pressure on the BoJ to ease in order to avoid a further strengthening of the yen. On the other hand, easing abroad could give some relief to the global economy, which would ease the pressure on the (Japanese) manufacturing sector and on the safe-haven yen. There is no doubt that the BoJ will follow market reactions to the Fed’s decision on Wednesday closely.

Manufacturers have struggled but the sector PMI index has held up, hovering between 49 and 50 since the beginning of the year. Industrial production is down 1% yoy, a minimal contraction in a global perspective. However, the domestic economy has been solid and GDP growth has surprised on the upside in H1 with an average annual growth rate of 1¾%.

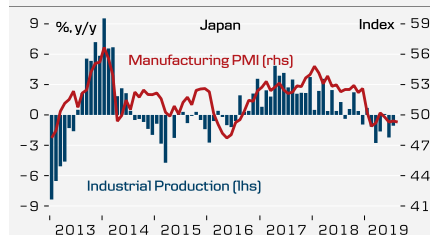
Like the Fed, the BoJ has to consider whether the good fortune could be turning. The nominal effective yen is up 8% yoy, which continues to add pressure on Japanese exporters by eroding competitiveness and it weighs heavily on prices of imported goods. So far, the deflationary pressure has not materialised, but it is likely to do so in coming months if the surge in the yen is not broken and global deflationary trends continue.

Signals from board members still indicate some patience

At the last policy meeting in end-July, Kuroda mentioned the possibility of pre-emptive easing and said, “We will take policy action without hesitation, if necessary to avoid the risk of prices losing momentum”. Since then and after the trade war intensified and the yen surged, we have seen three board members, including Kuroda, on the wires.

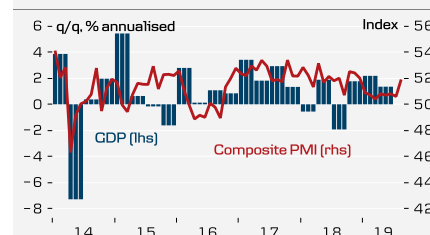
Goushi Kataoka, the board’s super dove, gave a speech where he stressed that the need for additional easing is heightening – no surprise here. He also mentioned the side effects of further easing as something to watch for and he has not decided whether he is going to put a proposal to cut the short-term rate to a vote. Hitoshi Suzuki, a former commercial banker who is probably the most hawkish in the nine-member board, sees no need to ease further. He is afraid that if bank deposit rates effectively turn negative, it could hurt the economy by cooling consumer sentiment.

Manufacturing sector has slowed but only to a standstill...



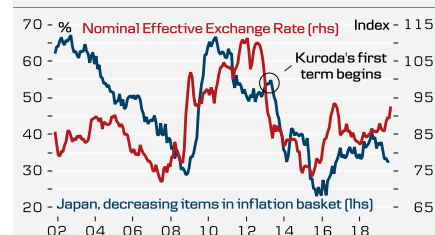
Source: IHS Markit, Japanese Ministry of Economy and Macrobond

... and overall the economy is strong



Source: Japanese Cabinet Office, IHS Markit, Macrobond Financial

Strong yen increase deflation risk but not materialised yet



Source: Bank of Japan, JP Morgan, Macrobond

Analyst

Bjørn Tangaa Sillemann
+45 45 12 82 29
bjsi@danskebank.dk

Senior Analyst

Lars Sparresø Merklin
+45 45 12 85 18
lsm@danskebank.dk

Kuroda has been quoted as saying that cutting rates further into the negative zone is always an option. He still stresses that the side effects of further easing must be assessed. According to “sources”, BoJ policymakers are growing less confident about an early pick-up in global growth and may be more open to debating additional easing. Overall, the net-takeaway from the communication over the past month does not indicate a strong sense of urgency. This indicates to us that the BoJ is still leaning towards a wait-and-see mode, but the board is likely to be more divided from now on. We could see the dovish deputy governor Wakatabe call for easing.

Still not the time

We expect the BoJ to remain in wait-and-see mode. Japan’s economy is in good shape. The unemployment rate actually hit its lowest level since 1992 in July and the labour market is historically tight. Even if this does not spur inflation currently, it is nonetheless the channel that the BoJ is counting on to make it happen. Potential policy action depends largely on the outlook for the global economy right now. Our base case is that we get a “muddling through” scenario for the global economy and high level trade talks between the US and China do not escalate tensions further. But there is a likely scenario where it will be more risk off in markets. In that case we will see further yen strengthening and the BoJ will have to respond in October.

On 1 October, the VAT-hike is implemented. There is plenty of room for the economy to lose momentum if the global economy keeps souring. With limited tools left at the BoJ’s proposal, we think the BoJ will remain patient, though, also considering how fiscal policy continues to be heavily expansionary. We could see a tweak to the forward guidance. This would be a “cheap” way of doing something and once again try to signal that the BoJ is ready to act. However, there is a risk that coming to the table while not really delivering anything will backfire, as markets might interpret it as a confirmation that the BoJ is indeed powerless to counter a further escalation of the global downturn.

The 10-year rate target is another way to adjust the policy stance. The 40 basis point range around the target has already been breached and Kuroda has signalled that it should not be taken too literally. The range could be widened, but this would only open the door for the market to test even lower levels, which is probably not an attractive outcome for the BoJ considering recent tapering in the 5-10-year segment in an attempt to steepen the curve.

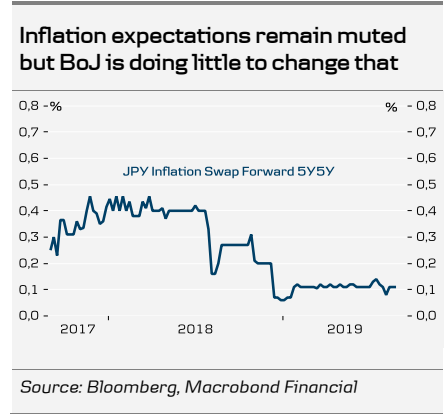
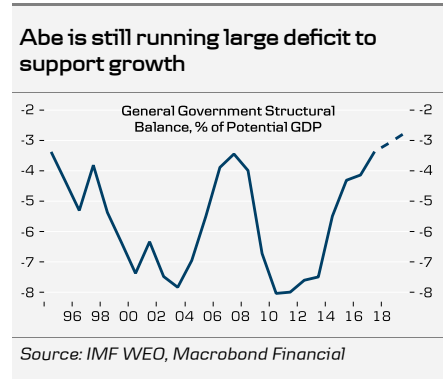
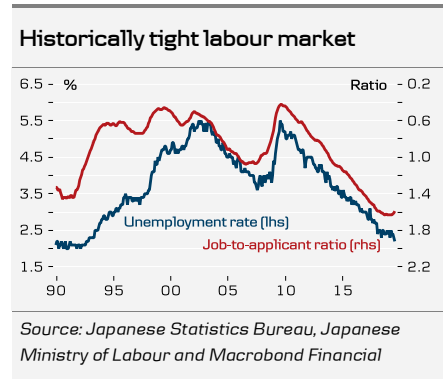
USD/JPY to be driven by external conditions, not BoJ

Once upon a time, we did see USD/JPY on a trend for higher levels. But that’s long gone these days. What did work, however, was the combination of Abe & Kuroda back in 2012-15, when they managed to depress Japanese real yields by over 200bp.

But since 2015-16, the BoJ has not been willing to compress real rates further. Today, USD/JPY is driven by US real rates. By extension, credit spreads and inflation expectations determine USD/JPY in the short run, see chart. In our view, the BoJ will not be coming back to the table to change that significantly.

The BoJ may be shifting towards a *discussion* of easing and action *may* be coming closer. In practice, we view any adjustment as something along the lines of a one-and-done rather than the beginning of continued easing which would need to be priced in the currency. In turn, USD/JPY would continue to be determined by global, rather than domestic, monetary conditions.

In our view, USD/JPY is headed towards 105 or lower in the coming months. To change that view, we will need to see a substantial change in external conditions.



Disclosure

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Bjørn Tangaa Sillemann, Analyst and Lars Sparresø Merklin, Senior Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

None.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research report has been prepared by Danske Bank (a division of Danske Bank A/S). It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 12 September 2019, 14:03 CEST

Report first disseminated: 12 September 2019, 18:10 CEST