# YES, THE BOJ IS ALSO WORKING TO PUSH THE YEN DOWN (NOT JUST THE FED)

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The yen's drop back down toward ¥110 per US$ is driven not just by heightened expectations for a Federal Reserve (Fed) rate hike, but also by Bank of Japan (BOJ) action to enforce the "zero upper bound" on the Japanese 10-year bond yield. In coming weeks, the greater the visibility of rising U.S.-Japan rate differentials, the bigger the force pulling the yen down should get. In my personal view, a depreciation toward ¥120-¥125 per dollar over the next four to six months may be possible.

**BOJ Credibility**

This year, BOJ credibility has been seriously put into question. First, the adoption of negative rates at the end of January backfired and sparked further yen appreciation, and the latest board decision to change the policy target to a "zero yield for 10-year JGBs" target was also greeted with skepticism. Several pundits speculated that this meant the end of quantitative easing (QE) in Japan—the BOJ would be forced to sell its bond holdings to stop yields from falling further into negative territory. In fact, the BOJ never contemplated doing so, because the zero-yield target was always designed to be asymmetric: zero tolerance for yields above zero, but "flexible" on the other side. Governor Kuroda's speeches in September and October have made this clear, in our view.

**From Talk to Action—Fixed-Rate Bond Buying**

On November 17, 2016, the BOJ conducted its first fixed-rate operation, offering to buy bonds across the curve to counter rising yields. In our view, the BOJ will become more aggressive in micromanaging the yield curve by using the new unlimited fixed-rate operation tool to flatten the curve and cap 10-year yields at zero. Make no mistake: Japan will have the flattest yield curve among the major developed markets. The more credible Trump's reflation policies get, the harder the BOJ will work to assert its own credibility—the yen is bound to weaken further and further.

Two additional points: 1) The BOJ did make an additional change to its policy target at the August meeting. It is now looking to maintain the "zero yield" policy until CPI inflation overshoots the 2% target. With current CPI inflation negative, even the most aggressive forecasters predict it will take at least two years for the CPI to climb back to 2%. 2) Add to this the new "overshoot" policy, and you have reasonable prospects for Japan's zero rate cap to stay in place until the end of 2018.

**A Weaker Yen**

Of course, yen depreciation depends to some extent on the pull-up from dollar strength, which necessitates credible Trump U.S. reflation. But the yen's depreciation dynamic is now free of the month-in-month-out speculation about whether QE will be stepped up or not at the next policy board meeting. Targeting zero yield means that any upward pressure on yields will trigger "automatic" quantitative easing. This is different from current European Central Bank (ECB) policy, and once the market sees steadfast BOJ action, the downward pressure on the yen should outpace that of the euro, in our view.

**A Stronger Stock Market**

Finally, if we are right, the implication for Japanese equities is very positive: 10-year bond yields capped at zero should trigger more portfolio rebalancing into yen

equities. Private insurance- and pension portfolios are poised to buy more Japanese equities in coming months, as the BOJ's "zero upper bound" policy gains credibility.
***Unless otherwise noted, data source is Bloomberg, as of November 17, 2016.***

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## DEFINITIONS

**Federal Reserve** : The Federal Reserve System is the central banking system of the United States.

**Rate Hike** : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

**Japanese Government Bond (JGB)** : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

**Quantitative Easing (QE)** : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

**Yield** : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

**Yield curve** : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

**Flatten** : to effect a zero positio.

**Reflation** : The term is used to describe the first phase of economic recovery after a period of contraction. This period is typically characterized by the act of stimulating the economy through accommodative central bank policies and reducing taxes, to bring growth and inflation back up to the long-term trend.

**Consumer Price Index (CPI)** : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

**Inflation** : Characterized by rising price levels.