



Japan Equity Strategy – What Next For The Yen

Is it a revival, a temporary reversal, or is the yen forever rotten?

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KEY TAKEAWAYS

- Who says intervention doesn't work? Japan's Ministry of Finance appears to have engineered the start of a currency reversal.
- The owners of the ballooning carry trade have had weeks of warning, and are now unwinding at an accelerating rate.
- Does the Bank of Japan take the baton now to defend the economy given that practically everything is at stake as we head for winter?

Japan / EQUITY STRATEGY RECOMMENDATION

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Intervention does work

When the Bank of Japan (BoJ) first started to talk about intervention in the currency markets in 3Q 2022, economists, the press, and just about anyone who had something to say were telling us that intervention doesn't work.

Everybody from armchair experts to former US Federal Reserve Chief Larry Summers criticised the notion to the point where we were forced to wonder if they were right and the Ministry of Finance (MoF) was doing something dumb. Still, given that the MoF and BoJ are the best insiders in the forex market, with the most accurate information and, most importantly, a huge armoury of foreign currency reserves, we needed to give them the benefit of the doubt and so expect the currency and intervention bears to be silenced, at least for the time being.

Intervention between 2022 and 2024 has worked like this:

- An MoF official, often Finance Minister Shun'ichi Suzuki, is uncomfortably pushed out in front of the cameras to give a warning about the forex market not reflecting fundamentals, or something about excessive volatility. This is repeated a few times and is known as vocal intervention.
- Next, the BoJ is reportedly checking the market for prices. At this point the market moves. Neither the MoF or BoJ confirm or deny that any intervention is taking place until the press poke around in the accounts to reveal a large US dollar clip has been sold for yen.
- The market then bumbles around at higher levels until the yield differential tempts traders to come back in and borrow more yen to sell for Mexican pesos, or Aussie or Kiwi dollars, which weakens the yen and the whole thing starts again.

Meanwhile...

Japan's failing domestic crops will push imported food prices higher.



Supermarkets are running out of rice as panic buying returns due to a poor harvest. *Source: JAPANMACRO*

- Huge investments in Japanese assets by foreigners take place, for example TSMC building massive semiconductor plants, substantial investments in Japanese property, or simply the rally in Nikkei 225 stocks – the default foreign investment.
- Millions of foreign tourists run around Japan exclaiming “it’s cheap”, buy up everything they can and take selfies with everything that can’t. Inbound tourism in 2024 is Japan’s second largest export.
- New export businesses with substantial ticket sizes are being developed in defence, aerospace and infrastructure, such as high-speed rail lines, subways, energy and sanitation projects, and smart cities. Exports of defense equipment has major growth potential, as does civil aviation work and satellite launch services.

Killing the carry trade

Downsides

The downsides of a weak yen are a concern for the MoF and BoJ. And both have been vocal about it this year.

As Japan imports 94% of its base energy requirements, 63% of its food and much of the raw materials needed for manufacturing, the prolonged weakness will eat into corporate performance and weekly household budgets.

Meanwhile, the carry trade; borrowing cheap yen, selling it and buying high yielding overseas assets, exacerbates these import costs as the yen’s purchasing power declines. A multiplier effect then kicks in via the trade flows due to the ever-weakening currency, as the same amount of dollar based energy needs to be bought but with vastly more yen – energy imports went from 3% of GDP pre 2022, to about 6% of GDP.

Benefits

The benefits from this period of yen weakness – inbound investment and growth in exports, and a modest boost to inflation – have run their course. And the general public’s tolerance for the poor purchasing power of the yen is wearing thin. The yen remaining rotten is simply not an option.

The MoF appears to have done a very good job signalling to the market that the days of easy money from the carry trade is over. These positions are now being unwound at an accelerating pace.

What next for the yen?

Stronger for longer

I am expecting a stronger yen that trends towards JPY130/USD over the next six months, higher interest rates, and the end of the carry trade:

1. The Bank of Japan meets this week today and Wednesday, July 30-31. With the threat to the domestic economy from rising import costs, upward pressure on inflation, a 0.25% interest rate rise to defend the economy is likely to be announced. This would strengthen the yen, possibly pushing it to the range of JPY140-150 against the US dollar. The BoJ will also meet on September 26th-27th and October 30th-31st. If the policymakers don’t see the desired effects by then, rates rise another 0.25%. Expect a policy rate of 0.5% as we enter 2025, which will considerably help the domestic banking industry’s margins.
2. There is a risk of further intervention if the yen weakens again, and such weakness may be seen in the euro-yen pair, as was flagged by Citigroup analysts last week. Investors need to bear in mind that the yen is weak against all of the major Asian currencies, which could spark an undesirable trade war in the region. The MoF will want to avoid that.

3. A stronger yen and the closing of the interest rate differential would please the Fed, which over the past few months has aired its concerns. The Fed is unlikely to adjust its own policy rates ahead of the US election. An overall weaker dollar would please the Republicans, who want to support American exports. This would position Japan more favourably should Donald Trump and JD Vance win the US election and start to unleash a slew of threatened protectionist measures.
4. By the start of winter, a dollar-yen rate near 130 is likely, and desirable to reduce the costs of imports, particularly energy to keep the lights on. As the chairman of the Japan Chamber of Commerce and Industry, Ken Kobayashi, said recently, much of Japan's manufacturing sector is struggling, with small and medium-sized companies (SMEs) at risk due to the weak yen. SMEs and small firms in general account for 99.7% of all businesses in Japan and employ approximately 70% of the total workforce. To do nothing and so further jeopardize the economic stability of such a large employer would be foolish, especially as there is increasing pressure on the government to again raise the minimum wage.
5. Despite the international view that Japan is cheap, this is certainly not the case if you earn yen. The cost of living has increased dramatically over the past two years thanks to the weakening yen, forcing the government to subsidize fuel bills. The cost of the weekly shop has also climbed and is poised to go higher with the threat of a rice shortage due to a poor harvest last year. Panic buying has started to clear shelves. The summer has barely started and once again the weather patterns for farming are looking grim.

There will be risks and opportunities in share prices:

1. Foreigners' snap reaction to a strong yen is to sell Japanese stocks. This stems from the notion that Japan's economy relies on exports. It does not, but exports do still play a large part in autos, electrical machinery (including robots), and electronics. The sell-off is likely to be temporary as a stronger yen would reduce the manufacturing costs of those that rely on imported inputs, which in turn should improve their bottom line.
2. Higher interest rates may cast a temporary shadow on housing and construction, but with mortgage rates coming from an extremely low base, this will have little effect on monthly payments.
3. Higher rates lead to a boom for domestic banking, which may be necessary to offset a potential sovereign debt downgrade, the rumblings of which have just started.
4. Japan's new second-largest export industry, inbound tourism, could be at risk of a slowdown – which is not necessarily a bad thing as capacity problems are surfacing. The cheapest package tour segment could slow, but the higher spenders have a taste for Japan now so their segment is less likely to be affected. Less may be more for that sector.
5. Local consumption could get a boost as the purchasing power of the yen improves. This summer, according to a recent survey by Nippon Life, 48.4% of Japanese are staying at home and saving money, blaming the extreme heat, the cost of going out, the tourists crowding the streets, and a hungry wild bear population that poses a higher risk of attacks. A summer of frugality could result in revenge spending this autumn, with a jump in consumption of clothing, durable goods and perhaps luxury goods and services.

In summary

In summary, buy what you like while the yen is weak as it will not last. Between the MoF pegging the downside of the yen and squeezing the carry trade and BoJ defending the economy with rate rises, we are seeing a revival, not a reversal.

Share prices may come under pressure, in which case welcome some bear attacks – in the financial markets at least.

Tourists – mass shopping tours may decline as prices rise, but trips for experiences will be less affected.
Pictures: Akihabara vs Kyoto.



Source: JAPANMACRO.com

Important Information

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- Neutral – shares will perform in-line +/- 10%
- Sell – shares will lag the market index by more than 10 percentage points.

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