BoJ: Policy Transitions are Always Messy

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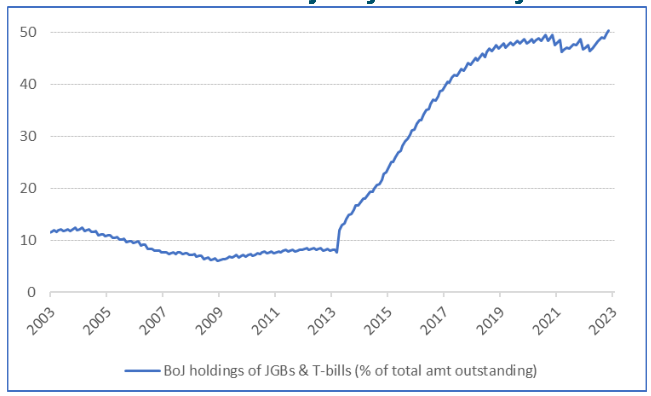
The Bank of Japan (BoJ) shocked markets on Monday by modifying its Yield Curve Control (YCC) policy (**Figure 1**). Consensus expected this to happen in 2024 or, at minimum, after the new Governor (TBD) takes over the helm in April.

FIGURE 1 – Yield Curve Control Band: Has Now Been Widened Three Times

Source: Bloomberg

The BoJ's move wasn't about policy tightening to subdue inflationary pressures, as CPI ex-food & energy is only 1.5% yoy, well below the 2% target. Rather, the concern is the Japanese government bond (JGB) market has become dysfunctional (**Figure 2**). The JGB market is so illiquid that on many days numerous JGBs do not even trade (the futures market is even worse). It has also become increasingly disconnected from the U.S. Treasury market.

FIGURE 2 – JGBs: Majority Owned by the BoJ

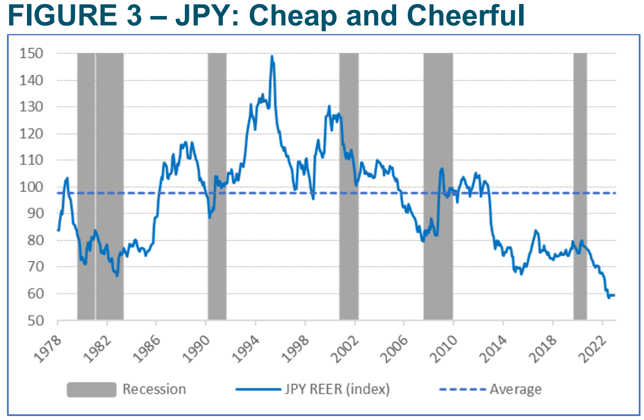


Source: Bloomberg

We Expect Higher JGB Yields and a Stronger JPY

Higher JGB yields mean a narrow spread between 10Y Treasuries and JGBs, a spread that has been the key driver of USD/JPY since 2010 (64% correlation). Further, the JPY is extremely undervalued (**Figure 3**).

FIGURE 3 – JPY: Cheap and Cheerful

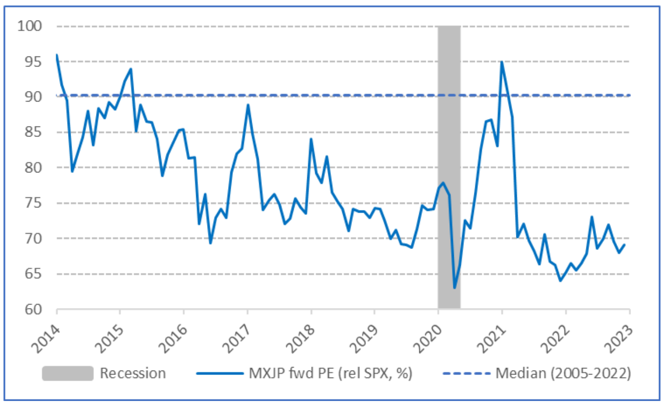


Source: Bloomberg. REER: Real effective exchange rate.

Japanese Equities Are Attractively Priced

Japanese stocks usually trade at a discount to America's, but lately the valuation gap has become extreme (**Figure 4**). However, cheap isn't necessarily enough, as Japan's equity market faces two potential headwinds – a stronger yen and higher yields. Regardless, this environment should favor financials and consumer staples over tech. More broadly, we believe it favors importers over exporters, and companies with strong balance sheets versus those that are highly leveraged.

FIGURE 4 – Japanese Equities: A Large Valuation Discount



Source: Bloomberg

Implications for Investors

We expect further JPY strength and higher JGB yields. Further, Japanese equities are cheap, but face two headwinds – a stronger yen and higher yields. However, these are huge markets, so the BoJ's surprise move is likely to impact markets not just in Japan but globally.