PICTET WEALTH MANAGEMENT

Japan: 2024 macro and government bond outlook

Time for policy normalisation

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AUTHORS

DONG CHEN
dochen@pictet.com

LAURÉLINE RENAUD-CHATELAIN
lchatelain@pictet.com

MILÈNE DUMONT
mdumont@pictet.com

FLASH NOTE

SUMMARY

- Japan could see another year of moderate economic expansion in 2024, supported by the government's fresh fiscal stimulus, a consumer recovery and corporate capex in selected areas. We expect Japanese GDP to grow by 1.1% in 2024 following 1.8% expected in 2023.
- Inflation in Japan will likely continue to decline in 2024 but may turn stickier. With improved wage growth as well, we expect the Bank of Japan to formally exit yield curve control in the second half of 2024. The central bank will also likely remove the negative interest rate policy in 2024.
- We expect Japanese investors to continue to withdraw from the foreign bond market as domestic bond yields become more attractive and the cost of hedging currency exposure remains elevated. Along with the removal of the yield curve control (YCC) policy, this should contribute to the progressive normalisation of the Japanese government bond (JGBs) market by enhancing trading and liquidity. In this new era of normalisation, we would expect the 10-year JGB yield to trade above 1% and we have an end-2024 forecast of 1.2%. This means that JGBs are one of the rare segments of the fixed income market where we expect total returns to be negative in 2024. As such, we maintain our underweight stance on JGBs.

GROWTH TO MODERATE BUT INFLATION TO REMAIN ABOVE BOJ TARGET

Looking back at the Japanese economy in 2023, it could be seen as a year of two halves. The first half was characterised by strong growth powered by post-covid consumption, solid corporate investment, and resilient exports. But momentum weakened in Q3 as external demand continued to decline and corporates turned more cautious on capital spending. Consumption also softened as inflation eroded households' real purchasing power.

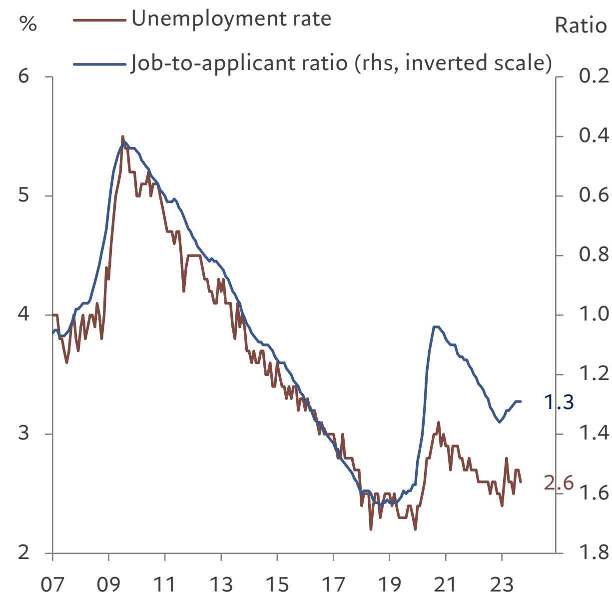
Looking ahead, we expect Japan's growth momentum to continue to moderate in the first half of 2024 before a possible rebound in the second half as the global economy recovers. For the full year of 2024, we **expect Japanese GDP to expand by 1.1%, down from 1.8% expected in 2023**.

While headline growth in 2024 will likely be lower than in 2023, several factors could support the economy continuing to expand at a pace above its potential, which is estimated at about 0.5% per annum for the time being.

First, the recent fiscal stimulus package announced by the Kishida administration, which includes cash handouts and cuts to income tax and residents' tax. These measures amount to about JPY5 trn (or nearly 2% of annual aggregate disposable income) and could provide some meaningful support to the household sector in 2024.

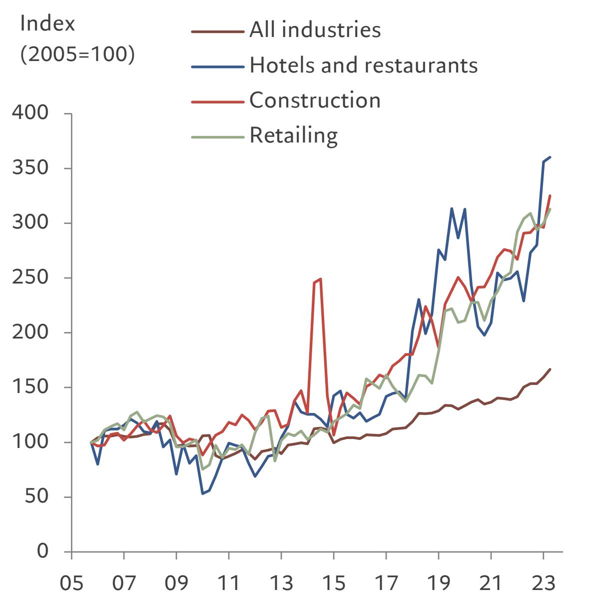
Second, wage growth, which picked up pace in recent years, may stay on an upward trend and add some support to consumption going forward. As we argued in an earlier publication (*Japan at an inflection point?*), structural changes seem to be happening among Japanese corporations in terms of their price- and wage-setting behaviours. The spring wage negotiation in 2023 resulted in an average pay increase of 3.6%, which was significantly higher than the average of below 2% since 2000. We expect the pay increase out of the 2024 spring negotiation to be even higher. In our view, the forces that are currently driving wage growth in Japan are mostly structural in nature, including an acute labour shortage (*see chart 1A*) and structurally higher inflation. Such forces will likely stay despite a cyclical slowdown in growth momentum in the near term.

Chart 1A: Unemployment and job-to-applicant ratio in Japan



Source: Pictet Wealth Management, Bloomberg Finance LP, 04.12.2023

Chart 1B: Investment in software in Japan by selected sectors



Source: Pictet Wealth Management, Bloomberg Finance LP, 04.12.2023

Third, while corporate capex as a whole is moderating, investment in digital technologies that are aimed at reducing labour cost continues to rise strongly, especially

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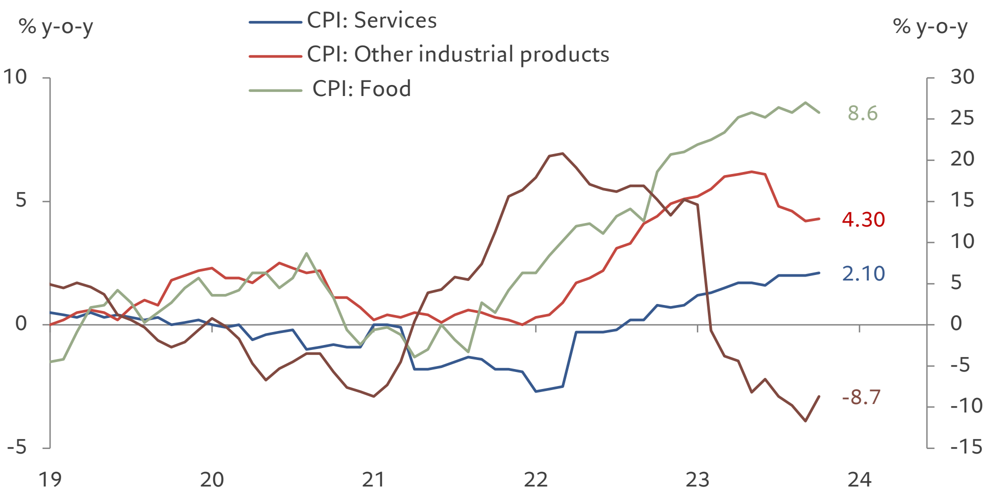
in sectors with acute labour shortage (*see chart 1B*). Such investment will likely boost labour productivity and provide another support to growth.

On the inflation front, we expect core inflation (all items excluding fresh food) to continue to decline in 2024. However, the main drivers of inflation will likely turn increasingly from imported sources (like food and energy) to domestic sources such as services (*see chart 2*). As a result, inflation will likely become stickier. **Our full-year core inflation forecast for Japan in 2024 stands at 2.0%, after 3.0% expected in 2023.** If our forecast turns out to be correct, 2024 will be the third consecutive year when Japan's core inflation stands above the Bank of Japan's (BoJ) target.

Chart 2: Changes in main components of Japanese CPI



Source: Pictet Wealth Management, Bloomberg Finance LP, 04.12.2023

BOJ: TIME TO EXIT YCC AND NIRP

Given the structural changes underway in the Japanese economy (especially higher inflation) and a drastically different global economic environment compared to a few years ago (interest rates higher for longer), it is becoming increasingly clear that the BoJ will need to normalise its monetary policy. The tricky part is when and how.

In our view, the BoJ has already started to dismantle its yield curve control (YCC) through a series of minor adjustments in 2023. In July, the BoJ effectively widened the trading band for the 10-year JGB to 1.0% from 0.5% previously and then in end-October announced it would regard the 1.0% limit on 10-year JGB yield not as a hard cap, but only as a reference. These moves, in our view, have made YCC much less restrictive in practice.

While the BoJ has gained temporary flexibility through these policy tweaks, the YCC, the centrepiece of the BoJ's ultra-easing monetary policy, still remains (at least in name) and continues to attract controversies in various policy discussions. But to officially remove the YCC, the BoJ needs the right justifications. According to the BoJ's policy statement, it needs to see "inflation sustained above 2.0% accompanied by wage increases". It appears to us that Mr. Kazuo Ueda, the BoJ governor, is still not fully convinced that this objective is about to be achieved. Or at least, the

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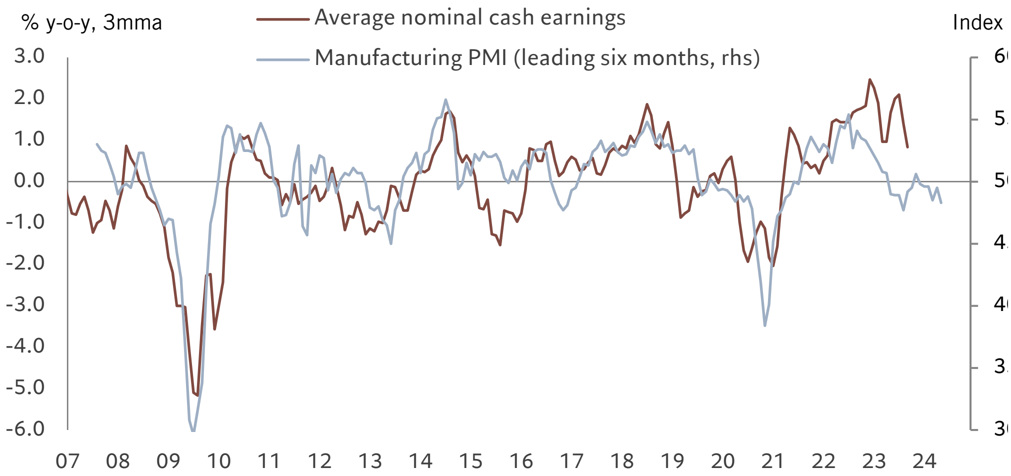
available data are insufficient to allow the Bank of Japan to draw a definite conclusion. After all, the notable wage hikes following the spring wage negotiation in 2023 have shown signs of softening (*see chart 3*), and it would be too early for the BoJ to claim victory without seeing the negotiation result in 2024.

Chart 3: Japanese workers' average nominal cash earnings and Japanese manufacturing PMI



Source: Pictet Wealth Management, Bloomberg Finance LP, 04.12.2023

Looking into 2024, we believe **there is a fairly high likelihood that the BoJ will remove the YCC in the second half of the year, possibly in Q3**. By that time, the trends of wage growth and inflation should be much clearer. Also, by that time the BoJ may have also completed its "review of the monetary policy from a broad perspective" that it started in April 2023. Alternatively, the BoJ could make such a move earlier, possibly in April, right after the spring wage negotiation outcome becomes available. But we think this is a less likely outcome as Mr. Kazuo so far has generally adopted a gradualist approach in his policy making, instead of resorting to hasty moves.

On top of the YCC, we believe **the BoJ's negative interest rate policy (NIRP), which applies to the short-end policy rate, could also be removed in 2024 by hiking the policy rate from -0.1% to zero**. This will likely happen at the same time as the removal of the YCC, or slightly afterwards.

JGB: A RETURN TO NORMALITY?

The BoJ's recent adjustment to its YCC sent the yield on 10-year JGBs to an eleven-year high of 0.96% on 1 November (*see chart 4*). Nevertheless, the recent decrease in global core government bond yields, with the US 10-year Treasury yield moving from 4.99% on 19 October to 4.22% on 1 December, has relieved some upward pressure on Japanese government bond yields as well. The 10-year JGB yield currently stands well below 1%, at 0.69% (1 December), but the two-year JGB yield remains in positive territory to 0.03%, as market participants speculate that the central bank could potentially remove the NIRP in the coming months.

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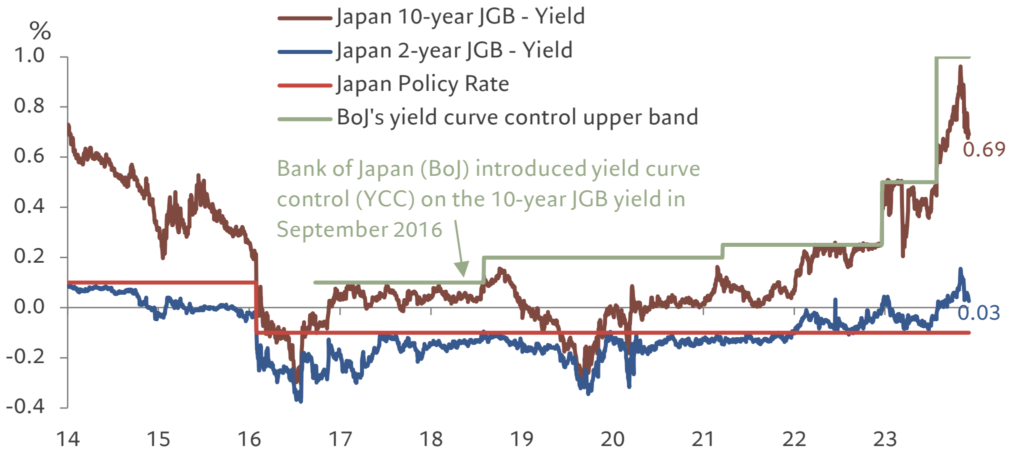
Looking at the year-to-date movements in the Japanese sovereign bond yield curve, the slope of the curve has steepened, with long-term yields moving up more than short-term yields, because these are still largely anchored by NIRP. By deciding to conduct YCC with more flexibility by widening the 10-year JGB yield trading range, the BoJ has sparked a slow normalisation of the JGB market. A normalisation that we expect to be fully completed by end-2024.

Chart 4: 10-year JGB yield and BoJ's yield curve control bands



Source: Pictet Wealth Management, FactSet, as of 1 December 2023

In a previous note (*see The Japanese monetary tanker is slowly turning*), we explained that the BoJ is the largest holder of JGBs (holding 48.5% of the total JGB market in Q2 2023), with pensions funds and insurers also structural holders, while Japanese banks retreated in the wake of the BoJ's quantitative easing.

Should the BoJ let go of its YCC policy next year as we expect, we believe Japanese banks could become one of the new marginal buyers along with other Japanese investors. In fact, the rising cost of hedging their foreign currency investments into yen, both due to the yen weakness against the main developed market currencies and the widening interest rate differential, makes hedged foreign bonds less attractive than domestic bonds. As of 1 December, the 10-year Japanese government bond yielded 0.69%, while the 10-year US Treasury bond hedged into Japanese yen was offering a negative yield of -1.50%, with -1.78% for the 10-year Bund. Similarly, euro and US dollar investment grade corporate bonds offer yields close to zero to Japanese investors when hedged into yen, while the yield offered by investment grade Japanese corporate bonds stands at 0.91% (according to the ICE Bank of America Japanese IG index on 1 December).

We expect Japanese investors to continue to withdraw from foreign bond markets as domestic bond yields become more attractive and the cost of hedging currency exposure remains elevated. Along with the removal of the YCC policy, this should contribute to the progressive normalisation of the JGB market by enhancing trading and liquidity. **In this new era of normalisation, we would expect the 10-year JGB yield to trade above 1% and we have an end-2024 forecast of 1.2%. This means that JGBs are one of the rare segments of the fixed income market where we expect total returns to be negative in 2024. As such, we maintain our underweight stance on JGBs.**

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