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Beware the bandwagons in the wake of the BoJ

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In the wake of the BoJ's September policy meeting, the USDJPY continues to climb and support Japanese equities. But investors need to be careful about how they position in both and avoid jumping on the bandwagon. We look for a further USDJPY bounce to provide better entry levels to sell the USDJPY for a medium-term decline over the next 12 months. On Japanese equities, we remain Neutral ahead of likely near-term volatility and position for medium-term outperformance into 2025.

The Bank of Japan's relatively dovish September meeting statement sent the USDJPY higher, which should in turn also prove supportive for Japan's equity market. BoJ Governor Kazuo Ueda adopted a notably less hawkish tone that suggested policy normalization will continue, but only at a gradual pace. Post-meeting, the USDJPY continued its rebound off its recent low of 140.60 to around 144, before coming off slightly. The TOPIX meanwhile has also risen 3.4% alongside the USDJPY, helped by the Federal Reserve's larger 50bp rate cut and generally growth-positive tone as well.

The tandem bounce might appear tempting, but we would caution investors against jumping on either bandwagon. Indeed, investors would do well to take note of the following twists.

Look to sell—not buy—the USDJPY. Despite near-term bullish momentum in the pair, we see this as more of a corrective move from oversold levels. We continue to see the Fed's easing cycle weighing broadly on the USD. At the margin, we think the BoJ's gradual normalization of its previously ultra-loose monetary policy stance will also add impetus to USDJPY downside. It is also worth noting that the JPY real effective exchange rate (REER) is at 2 standard deviations below its 10-year average, and this lends the JPY some fundamental support. We continue to see USDJPY moving gradually to 138 over the coming 12 months; but we also note that currently shorting the pair entails a carry cost of 3.7% per annum.

Wait for a better USDJPY entry level. Given the sizable carry cost on a short USDJPY position, it is crucial that investors remain patient and wait for better entry levels to sell the USDJPY. On that note, the less-hawkish tone from Governor Ueda—on the back of a reduced risk of a sharp acceleration in inflation, plus the BoJ's declared aversion to market instability—should lead to slight repricing of expectations. This in turn should see the USDJPY bounce extend into the 145-147 range, which we would see as a reasonable entry level for a short USDJPY position.

Retain medium-term investment horizon on Japanese equities. We remain Neutral on Japanese equities in our global strategy. Amid short-term uncertainty, we recommend diversifying stock selection with both domestic and exporter stocks to capture the recovery phase. Although we expect Japanese equities to be rangebound and volatile until the US presidential election, the selection of a new leader for the ruling Liberal Democratic Party (LDP) and a possible snap general election by the end of the year could provide potential positive catalysts. A "change candidate" might burnish expectations that the policy environment favors a continuation of the reform agenda, potentially enabling the likely late-2024 snap general election to cast a positive glow on Japanese equities. We also expect that the continuation of Shunto wage increases and new inflows from the Nippon Individual Savings Account (NISA) program to boost Japanese equities from early 2025. NISA is a savings program that incentivizes Japanese households to invest their savings in the stock market by making these tax-free.

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