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New Japanese PMs surprise dovishness flags upcoming uncertainties

21 October 2024, 07:43 am CEST, written by UBS Editorial Team

Japan's new prime minister and government begin their term amid an ongoing shift in the broad monetary policy regime, and structural reforms that should manifest over the coming months. Ishiba's election win is likely neutral for Japanese equities in the near term but key structural changes should start to gain investors' attention in 2025. The USDJPY, meanwhile, is likely to be pressured lower over the coming months as the Fed embarks on a sustained easing cycle, with the BoJ adding impetus at the margins via its gradual normalizing of its loose monetary stance.

After Shigeru Ishiba's unexpected election win, the TOPIX and the USDJPY fell 3.5% and 3.0%, respectively, from Friday's intra-day highs on 30 September, erasing earlier gains. The TOPIX had earlier risen due to expectations that Sanae Takaichi, a female dovish candidate, could be elected prime minister (PM); these expectations had also weakened the yen. TOPIX only returned to the pre-election level from early last week, as did the USDJPY.

Since then though, Ishiba has abruptly adjusted his policy stance as the parliament officially confirmed his elevation to the role of PM. Just one day later, after a meeting with Bank of Japan Governor Kazuo Ueda, Ishiba said explicitly that Japan is not in an environment for an additional rate hike. This came hot on the heels of his cabinet appointments that strongly indicated political continuity with previous administrations. Over the course of the week, the TOPIX subsequently rose 2%, while the USDJPY rose over 4.5%; it is now back above 148. However, he again corrected his speech on 4 October and said his view was in line with the Bank of Japan (BoJ).

We think that Ishiba is still trying to find a good balance with his earlier hawkish stance, which he realized is fairly unpopular. Ahead of the general election and the Upper House election next summer, we expect the new government's policy focus to be on shoring up support for the ruling Liberal Democratic Party (LDP), mainly by softening the party's hawkish fiscal and financial stance and advancing popular policies.

Ishiba leaves monetary policy to BoJ. Although Ishida and the BoJ seem firmly committed to keeping policy accommodative for now, we think that strong consumption and corporate inclination toward stronger wage growth will lead the BoJ to bring forward its next policy rate hike of 25bps to December (from 1Q25 previously). This in turn is likely to be followed by another 25bp increase in June 2025. There is also scope for further rate hikes in the second half of 2025 if the economy and financial markets remain stable.

We also see the BoJ's quantitative tightening (QT) program proceeding at a slower pace than expected, and the upward pressure on the 10-year Japanese government bond (JGB) yields should be limited. Given the current US economic and policy outlook, we expect the 10-year JGB yield to remain around 1.0% at the end of this year.

Maintain a medium-term investment horizon for Japanese equities. We see Ishiba's election win as being neutral for Japanese equities, with a sustained recovery only likely to begin closer to the end of 2024. We remain Neutral on Japanese equities in our global strategy. Amid short-term uncertainty, we recommend diversifying stock selection across both domestic and exporter stocks to capture the recovery phase. Although we expect Japanese equities to be range-bound and volatile until the US presidential, structural reforms could start to manifest in 2025. On that note, we 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.

Position for medium-term USDJPY downside. As for the USDPJY, the latest rebound makes it attractive to position for a longer-term decline toward 138 by September 2025. We continue to see the Fed's easing cycle weighing broadly on the USD. At the margin, the BoJ's gradual normalizing 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 around two standard deviations below its 10-year average, and this lends the JPY some medium-term fundamental support.

Key reports

- Japanese politics update: Regime shift? The Ishiba administration is expected to prioritize growth over fiscal reconstruction, along the lines of the economic policies of the previous Kishida administration. It looks set to focus on wage increases and eradicating deflation, accelerating the shift from savings to investment.
- New Japanese leader unlikely to speed yen's rise (published on 30 September). Stocks fell and the yen rose amid concerns that Ishiba may add pressure on the BoJ to raise rates faster. Such worries are exaggerated, in our view. We expect only a gradual rise in Japanese rates and the yen. We also advise against reducing exposure to Japanese stocks below long-term benchmarks.
- USDJPY: Ishiba won, but hawkish bias has been toned down. Ishiba is supportive of monetary policy normalization, but we don't think he will (or aims to) accelerate the speed of yen appreciation.

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