Daiwa Securities

Daiwa's View

FICC Research Dept

Updating FY24 US-Japan monetary policy/yield outlook

- Fed to begin cutting rates in Sep; expect 5 - 10 cuts through end-Mar 2025 (depending on scenario)
- Changes/caveats have emerged for BOJ's "on track"/"upside risk" assumptions that drove July rate hike; further hike in 2024 now less likely
- Key change is market's recognition of potential for hard landing (but impossible to definitively assume either soft or hard scenario at this point)

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We revise our Japan and US monetary policy and interest rate forecasts to factor in recent market upheaval. In this report, we limit ourselves to presenting our conclusions and discussing the key points; we intend to follow up with details at a later date.

US monetary policy outlook

Following last week's release of US employment data, the market abruptly began to focus on a hard landing scenario. Our impression is that investors have finally begun to shift from their overly optimistic expectations for a soft landing to acknowledging both hard and soft landing scenarios. That said, with both a soft or hard outcome possible depending on incoming data and the Fed's (and other central banks') response, we think undue conviction about a hard landing scenario would be overly pessimistic, just as the current undue conviction about a soft landing is overly optimistic.

For reference, we republish our current house view on the outlook for Fed policy below. In the near term, we will be watching the pace at which the Fed unwinds monetary policy tightening; market volatility could readily increase as sentiment swings between pessimism (hard landing) and optimism (soft landing). Assuming that market prices are determined by (the distribution of) expectations, we would also expect the 10-year US real interest rate to remain anchored below 2%.

US Monetary Policy Outlook (Chief Economist Yamamoto, Economist Inoue)

FF rate (Upper limit of target)			FY24		
		7-Aug-24	Jul-Sep	Oct-Dec	Jan-Mar
(%)		Current level	Term-end	Term-end	Term-end
US	Soft landing	5.50	5.25	4.75	4.25
	Hard landing	5.50	5.00	4.00	3.00

Source: Compiled by Daiwa.

Japan monetary policy outlook

For Japan (the BOJ), the megatrend of structural changes in the labor market ("this time is different") remains intact, but market conditions have clearly changed versus Jun-Jul, when optimism dominated. The key drivers BOJ Governor Kazuo Ueda cited for its recent rate hike at the July MPM were "on-track" economic activity and prices, and "upside risks" to inflation, but caveats have now emerged regarding both.

We think the market is now closely monitoring the depth of a potential cyclical pullback in the US economy and its impact on the Japanese economy (whether economic activity and prices remain "on track" with the BOJ's outlook).

The BOJ also indicated (for example in the Summary of Opinions from the June MPM) that a weaker yen would increase the possibility of an upward revision to its inflation outlook, and outlined a risk-management approach whereby "the appropriate, risk-neutral level of the policy interest rate should rise in reflection of the increased upside risks to prices".

BOJ Deputy Governor Shinichi Uchida reiterated yesterday in a speech in Hakodate, Hokkaido that economic activity and prices are "on track" with the BOJ's outlook and that with the CPI remaining above 2% for more than two years, it raised rates given that "the year-on-year rate of change in import prices has turned positive again, reflecting the yen's depreciation" and "the Bank assessed that a policy interest rate of around 0.25 percent would be more appropriate than one of around 0 to 0.1 percent in terms of balancing upside and downside risks" (echoing Governor Ueda's use of "on track" and "upside risk").

Either way, a risk-management approach suggests that if the recent rally in the yen caused by market volatility continues, this would have a commensurate downward impact on the appropriate policy rate. Mr. Uchida noted yesterday that "movements in stock prices affect corporate investment and private consumption, through factors such the wealth effect, and ultimately the outlook for economic activity and prices, and they are therefore a key factor in determining the conduct of monetary policy," and that "as a result of the correction of the yen's depreciation, the upside risk to prices arising from higher import prices has decreased accordingly."

Naturally, the BOJ's rate-hiking cycle would proceed on track if the economy remains on track, and we would not expect the BOJ to cut rates solely because the reversal of JPY weakness mitigates upside risk to inflation. However, if the need to rate rates due to “on-track trends” is partially offset by a decline in upside risks to inflation owing to recent appreciation of the yen, we would expect the BOJ to take somewhat more time before it raises rates again. US economic outcomes (soft vs. hard landing, presidential election result) will also be key external factors that determine whether Japan's economy remains "on track" in the first place.

The table below shows our current outlook (house view) for BOJ policy factoring in the above developments. Mr. Uchida noted yesterday that "Japan's economy is not in a situation where the Bank needs to raise the policy interest rate at a constant pace. It is able to choose the rate-hike timing when a moderate path is available." We think this signals the potential for the gap between rate hikes to widen at least compared with the relatively short interval between March and July. We conclude that an October hike is no longer on the table. We now see the BOJ as more likely to hold off on another hike to around 0.5% until Jan-Mar 2025, when the US presidential election result will be known and it will have data on how the spring labor negotiations are progressing (i.e., it faces no urgent need to raise interest rates). Naturally, a hard landing would mark the end of the current rate-hiking cycle.

Japan Monetary Policy Outlook (Chief Economist Yamamoto, Economist Minami)

Uncollateralized overnight call rate (target)			FY24		
		7-Aug-24	Jul-Sep	Oct-Dec	Jan-Mar
	(%)	Current level	Term-end	Term-end	Term-end
Japan	Soft landing	0.25	0.25	0.25	0.50
	Hard landing	0.25	0.25	0.25	0.25

Source: Compiled by Daiwa.

Yield Outlook for Japan and US (Chief Strategist Tani, Senior Strategist Kawahara, Strategist Sato)

		7-Aug-24	Jul-Sep			Oct-Dec			Jan-Mar		
	(%)	Current level	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
Japan	Policy rate	0.25	0.25	0.25	0.25	0.25	0.50	0.25	0.25	0.50	0.50
	2yr	0.27	0.25	0.55	0.45	0.40	0.65	0.50	0.45	0.75	0.65
	5yr	0.42	0.35	0.70	0.60	0.50	0.80	0.65	0.55	0.90	0.80
	10yr	0.89	0.75	1.10	1.00	0.95	1.15	1.05	1.00	1.25	1.15
	20yr	1.75	1.50	1.95	1.80	1.70	2.00	1.90	1.80	2.10	2.00
	30yr	2.19	1.90	2.30	2.20	2.10	2.40	2.30	2.20	2.50	2.40
US	FF rate	5.50	5.00	5.25	5.25	4.00	4.75	4.75	3.75	4.25	4.25
	10yr	3.79	3.80	4.40	4.10	3.70	4.30	4.00	3.60	4.20	3.90

Hard landing			FY24								
		7-Aug-24	Jul-Sep			Oct-Dec			Jan-Mar		
	(%)	Current level	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end	Lower limit	Upper limit	Term-end
Japan	Policy rate	0.25	0.25	0.25	0.25	0.10	0.25	0.25	0.10	0.25	0.25
	2yr	0.27	0.25	0.55	0.35	0.15	0.40	0.30	0.10	0.35	0.25
	5yr	0.42	0.35	0.70	0.45	0.25	0.50	0.35	0.20	0.40	0.30
	10yr	0.89	0.75	1.10	0.90	0.60	1.00	0.80	0.50	0.85	0.70
	20yr	1.75	1.50	1.95	1.75	1.30	1.85	1.60	1.15	1.70	1.45
	30yr	2.19	1.90	2.30	2.15	1.70	2.20	2.00	1.55	2.05	1.85
US	FF rate	5.50	5.00	5.00	5.00	2.50	4.00	4.00	1.50	3.00	3.00
	10yr	3.79	3.00	4.40	3.70	2.25	3.90	3.20	1.75	3.40	2.70

Source: Compiled by Daiwa.

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