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Daiwa's View

FICC Research Dept.

Timing of next BOJ rate hike: Considerations from perspective of strategists

- Despite having free hand until March, main scenario is for January 2025 rate hike
- BOJ must consider (a) avoiding head-on collision with Fed, (b) restraining yen carry trades, and (c) timing of July Upper House election and its impact on formation of expectations for rate hike after next rate hike
- Current situation like shooting clay pigeons; bad risk/reward for moving in opposite direction of Fed

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In this report the author shares his thoughts on the hot-topic issue of when the BOJ will most likely make its next interest rate hike. The author believes that the BOJ has already passed its "pre-test" and has, for the most part, made its decision (to hike rates to 0.5%). As such, this report is not about whether or not interest rates will be raised, but rather the timing for such a move. Please refer to our separate report on views from the perspectives of economists (our house view).

Shooting clay pigeons: Bad risk/reward for moving in opposite direction of Fed

In describing the current situation, MOF's Atsushi Mimura (Vice Minister of Finance for International Affairs) said, "The relationship between the financial policies of Japan and the West is such that they move in opposite directions. So, just like shooting clay pigeons, it is not always possible to accurately gauge the distance, and therefore the daily volatility is high." While this is a point that economists generally don't pay much attention to, the risk/reward of deliberately clashing with the Fed's timing seems unfavorable from the perspective of avoiding market turmoil like that seen on 5 August 2024.

In this regard, if we check the current expectations on the US OIS market, the cumulative interest rate cut (25bp) forecast is 85% for the December FOMC meeting, 110% for the January meeting, and 175% for the March meeting. Accordingly, if such a scenario were to play out, January would be a desirable month for the BOJ to hike rates, rather than December or March, when there is a higher likelihood of the Fed cutting rates. In that manner, the Bank can avoid a head-on collision with the Fed. (Of course, there is also the possibility that the data from the January FOMC meeting will be incorporated more deeply, so the BOJ needs to maintain its free hand right up until the meeting.)

Background for unexplainable 5 Aug market plunge

The real cause for the unexplainable market plunge on 5 August (USD/JPY, Nikkei Stock Average, others) has probably not yet been fully clarified. Of course, specific movements such as unwinding of yen carry trades is a widely-held explanation. However, the author believes that one underlying cause was the radical change in expectations for the US/Japan interest rate gap.

When confirming the changing expectations for the US/Japan interest rate gap, we found that the end-year forecasts for these policy interest rates as of 22 July 2024 (about six months ahead) was 0.3% in Japan and 4.77% in the US, for a forecast interest rate gap of roughly 4.48%. While the BOJ was expected to raise interest rates one time before the end of this year, the Fed was expected to lower interest rates twice before the end of the year. After that, due to the BOJ's partial surprise additional interest rate hike at the end of July, the forecast for the year-end policy interest rate came to 0.42% in Japan and 4.65% in the US, with the expected interest rate gap dropping to 4.23%. Compared to 22 July, there has been a contraction of 25bp.

That said, at this point there has been no sharp market drop. The actual market plunge occurred after the release of US employment statistics on 2 August. If we check the forecast for the year-end policy interest rates as of 5 August, we can see that the difference between Japan (0.25%) and the US (4.21%) has narrowed sharply to 3.96%. Compared to 22 July, this is a narrowing of 52bp, which is rather large for a change that occurred in such a short period of time, between late-July and early-August. Moreover, during this time, there was movement towards factoring in a 50bp interest rate cut by the Fed. The timing of the Fed's radical change and the timing of the BOJ's interest rate hike coincided. This may have amplified the shock to the market. The author believes that, as much as possible, the BOJ should avoid overlapping its interest rate hikes with the timing for any Fed interest rate cuts, which significantly impact the global economy.

Significance of BOJ Governor Ueda's interview: Restraining yen carry trade, free hand

So, what was the significance of BOJ Governor Kazuo Ueda's 30 November interview? The author believes that one of the main objectives of this interview was not to signal a December or January interest rate hike, but rather to convey the message that an interest rate hike sometime before March 2025 is possible. It is important to think about this point in relation to the risk of a resurgence for the yen carry trade, which amplified the market pullback on 5 August. That is because, if the BOJ were to skip a rate hike in December, causing the market to speculate that the "BOJ is more dovish than expected," there could be the risk of a resurgence in yen carry trades. From the perspective of restraining the yen carry trade, it is desirable to make sure that people are aware that a BOJ rate hike will be carried out in the near future, even if the BOJ skips a rate hike in December.

Meanwhile, if the BOJ decides in advance to raise interest rates in December or January, there is a risk that the decision to skip December would leave the Bank unable to act in January. If BOJ is also on guard for an increased likelihood of a January interest rate cut by the Fed due to poor economic data (such as employment statistics), it may want to leave a certain amount of leeway here as well. On this point Ueda said, "As for wages, I would like to see what kind of momentum is created by the 2025 spring wage negotiations. It will take a little longer to confirm this, but we can still make a monetary policy decision without waiting for that." Of course, this is not a requirement, but rather a suggestion that there are some advantages to waiting until March. We think that the intention is for the BOJ to have a free hand regarding its options for January and March, even after it (likely) skips an interest rate hike in December.

Implications of Upper House election: Securing a window to restrain yen carry trade

The fact that the Upper House election is scheduled for July 2025 is another important consideration. There is a possibility that the political situation could become unstable. In that case, in order to avoid the risk of exacerbating market anxiety, the safest course of action would be for the BOJ to avoid raising interest rates at that time.

However, in that case, the next question to consider is whether the risk of a resurgence in yen carry trade can be managed by waiting until September. If we assume a gradual pace of interest rate hikes of about once every six months, then if the hike is in December or January, there is still the option of an additional hike in the April-June period, which is the window to act before the Upper House election. However, if the hike is in March, there would be a strong possibility that speculation will arise that the next hike will be after September. Here, there is no denying the possibility that it would be harder to restrain yen carry trades before the Upper House election. If the emphasis is on restraining yen carry trades by securing a window for raising interest rates before the Upper House election, then the preferable option for hiking rates would be December or January, rather than March.

Timing of Upper House election: Restraining yen carry trades

In conclusion, the BOJ will try to find the optimal timing for raising interest rates under the constraints of (1) avoiding a head-on collision with Fed, (2) restraining yen carry trades (avoid repeat of 5 Aug sudden market plunge), and (3) implications of the Upper House election. With Fed Board of Governors member Christopher Waller effectively signaling a rate cut at the December FOMC meeting, a December rate hike by the Bank of Japan seems unlikely. Based on the assumptions of the US OIS market at this juncture, a January rate hike by the BOJ seems like the most justifiable option.

However, if the US unemployment rate worsens to a figure of 4.4-4.5% in the December employment statistics (due out early next year), or if President-elect Trump announces tariffs on Japan, there is the possibility that assumptions held by the Fed and premises for the Japanese economy will change. While not the best option from the perspective of restraining yen carry trades, the March option will continue to remain as a means for securing a free hand in such cases, under the pretext of wanting to "confirm the 2025 spring wage negotiations."

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