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Daiwa's View

Strategist's perspective of possible BOJ rate hike in Jan

- Cautious ≠ unmoving
- Costs for both raising and not raising rates; costs for latter gradually increasing
- From risk-reward perspective, Jan rate hike is most promising option (unless sharp risk asset drop that completely changes perception of financial conditions)

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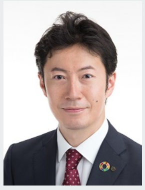


In this report, we want to express our opinions as strategists on the hot-topic issue of when the BOJ will make its next interest rates hike. We believe that the preconditions (preliminary tests) for determining whether the BOJ can again raise interest rates, this time to 0.5%, have already been met. For that reason, this report will focus on an examination of the best strategic "timing" for an interest rate hike, rather than the "existence" or "nonexistence" of such hikes. To get straight to the point, our main scenario is for a BOJ rate hike in January.

In our 11 December 2024 report we expressed the view that, while the BOJ still has a freehand to wait until March 2025, our main scenario still assumes a rate hike in January. Since then, even though the BOJ decided not to raise interest rates in December, the unexpected dovish stance taken by the Bank has had an impact and the market's current expectation for an interest rate hike has fallen to around 40%. That said, considering such factors as the Fed's interest rate cuts, the pace of BOJ interest rate hikes, the long-term/short-term yield spread, and yen depreciation (held in check by MOF), we believe that the risk-reward of a January interest rate hike is better compared to (1) before the BOJ's December 2024 meeting and (2) as of the March 2025 meeting.

Avoiding conflict with the Fed in terms of timing

The US employment data released at the end of last weekend almost ensures that the Fed will not lower interest rates in January. Meanwhile, the probability of a March rate cut by the Fed has also fallen to around 25%, but there is still a possibility that this will increase again depending on future data. In other words, the window (opportunity) for a January BOJ interest rate hike has opened up for the time being. However, if future data justifies a March rate cut by the Fed, there is the risk that the timing of the BOJ's policy decision could again collide with the Fed's timing for a March rate hike (window of opportunity for Mar BOJ rate hike could close).

Behind the curve

Since there is no need to hurry, there is also the idea that it would be better to again forgo raising interest rates. However, the Summary of Opinions for the December Monetary Policy Meeting (at which the BOJ stood pat), stated, "If economic activity remains on track, the timing of the adjustments of the policy interest rate should depend on two factors: (1) the pace at which the rate hikes need to progress, calculated backward from the time the goal is expected to be reached; and (2) the assessment of both upside and downside risks to prices observed at the time of each Monetary Policy Meeting (MPM). From this perspective, it is appropriate for the Bank to maintain the current monetary policy at this meeting." If in addition to January, the BOJ decides to also hold off on raising interest rates in March for some reason, there could be a significant correction (dovish surprise) for the rate hiking pace that is currently perceived by the market as "roughly once every six months." (Indeed, the March 2025 meeting would be eight months since the July 2024 rake hike.) We believe that such a decision (to delay hiking rates) could generate the risk of behind-the-curve concerns, while lacking a good risk-reward balance.

Naturally, the future is uncertain and each option will entail certain risks. Which risks to focus on and which to take are more a matter of instinct than theory. For that reason, we could be wrong, but it is our view that January seems like a relatively good risk-reward option in terms of avoiding head-on conflicts with the Fed and managing the risk of a "falling behind the curve" scenario.

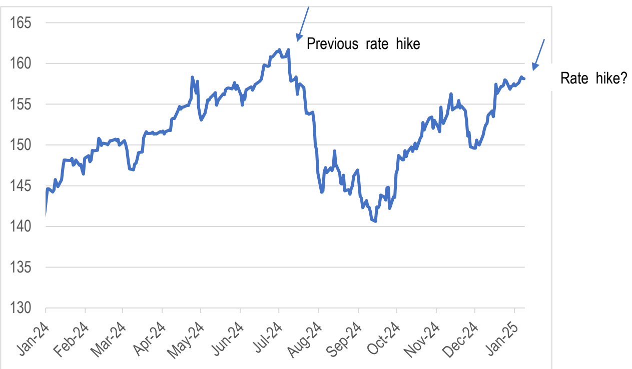
◆ Summary of Opinions at MPM on 18-19 Dec 2024 (released on 27 Dec 2024)

- There are high uncertainties over the course of discussions on tax and fiscal policy in Japan and over the policy stance of the new U.S. administration taking office at the beginning of 2025. Thus, from the perspective of risk management, it is appropriate for the Bank to maintain the current monetary policy at this meeting.
- If economic activity remains on track, the timing of the adjustments of the policy interest rate should depend on two factors: (1) the pace at which the rate hikes need to progress, calculated backward from the time the goal is expected to be reached; and (2) the assessment of both upside and downside risks to prices observed at the time of each MPM. From this perspective, it is appropriate for the Bank to maintain the current monetary policy at this meeting.
- Japan's economic activity and prices have been in line with the Bank's outlook as of March 2024. While there remain uncertainties regarding overseas economies, Japan's economy is in a state where the degree of monetary accommodation can be adjusted.
- Underlying inflation has been increasing steadily, while the risk of the Bank falling behind the curve is limited. The Bank will likely decide to raise the policy interest rate in the near future, but at this point it is necessary for the Bank to be patient and monitor the uncertainties over the U.S. economy until those uncertainties subside.

Yen depreciation

Recently, the USD/JPY rate has risen to around Y158, approaching the Y160 level seen in June and July 2024. Of course, foreign exchange is the sole responsibility of the Ministry of Finance (MOF), so we do not expect the BOJ to make the forex level a direct target of its policy operations. This is in line with Governor Ueda's remark that "from the central bank's viewpoint, we consider how exchange rates affect our price and economic outlooks when we conduct monetary policy management." However, there is no doubt that the BOJ and the MOF are on the same page when it comes to the nation's interests. Therefore, if, determining that the interests of the nation could be harmed by rapid yen depreciation, MOF officials are making an increasing number of statements aimed at restraining speculative investors, we should view that the balance of costs and benefits involved in maintaining excessively low real interest rates is deteriorating compared to before.

USD/JPY Rate



Source: Bloomberg; compiled by Daiwa.

Since the December MPM, there have been an increasing number of comments by the MOF aimed at restraining speculative investors as the USD/JPY rate has moved to the upper Y150 range. We should also keep in mind that the bond market is currently pricing in about a 40% probability of an additional rate hike in January, and that the current exchange rate has been established on the assumption that that rate hike will occur. If the BOJ were to forgo the rate hike at the January MPM with the current market pricing remaining unchanged, its decision to not raise rates would serve as a 40% dovish surprise for the market. Needless to say, the yen would very likely be weaker compared to current levels. Given these points, we think the potential cost of the BOJ putting off rate hikes at the January MPM has worsened slightly compared to the situation before the December 2024 MPM.

Information in the news based on people in the know

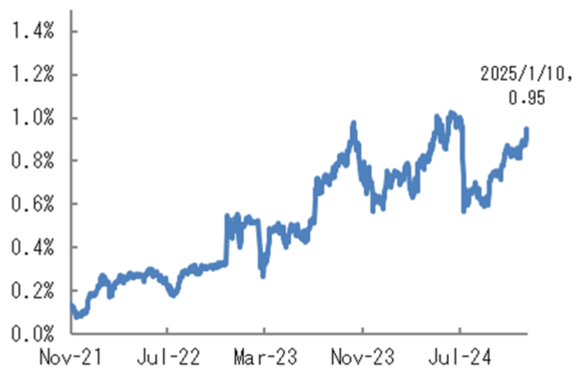
The above may not necessarily be the reason for this, but there was a report in the news during the weekend based on people in the know that the BOJ would likely raise its price projections due to the higher price of rice and the weak yen. While we do not think the BOJ will raise interest rates mechanically due to the rising price of rice, if, as I anticipate, the BOJ has already informally decided to raise interest rates, and January is a promising option regarding the timing for doing so, there should be an incentive to increase market expectations for a January rate hike from the current level of about 40% to at least 50%. The media report can be seen as intending to signal that the decision at the January MPM will be more of a close call than what the current market is thinking. Of course, the media report also mentioned that the BOJ planned to determine the appropriateness of a rate hike all the way up until just before the meeting, ensuring a free hand from March onwards by hedging properly, and that is the proper approach for a central bank that values infallibility.

Long-term/short-term yield spread

Currently, the long-term/short-term yield spread (gap between the policy rate and 10-year yield) has widened to +0.95ppt (with a policy rate of 0.25% vs. a 10-year yield of 1.2%). The long-term/short-term yield spread prior to the July 2024 MPM, when the decision was made to implement the previous rate hike, was also around +1ppt (with a policy rate of 0.1% vs. a 10-year yield of 1.1%).

With regard to the long-term/short-term yield spread, we should take note at this point of the level ranging from +0.25ppt to +0.75ppt (median of +0.5ppt) that was used as an assumption in trial calculations in the BOJ's Review report entitled "BOJ finances and trial calculations regarding the future outlook" (only published in Japanese as of this writing) that was released by the Policy Infrastructure Division of the BOJ's Monetary Affairs Department in December 2024. The BOJ can return the long-term/short-term yield spread to an appropriate level ranging from +0.25ppt to +0.75ppt by implementing an additional rate hike of 0.25%. In other words, the long-term/short-term yield spread of around 1%, which is currently observed in the market, may be a signal that the current policy rate is slightly too low.

10yr JGB Yield – Uncollateralized Overnight Call Rate



Source: Bloomberg; compiled by Daiwa.

Cautious ≠ unmoving

As a general rule, it is undesirable to raise interest rates too quickly in Japan, where people have become accustomed to low interest rates over the past 30 years. Indeed, sufficient time is needed to rehabilitate that way of thinking. For that reason, there is no denying that the BOJ must act with caution. That said, excessively delaying necessary actions can be risky behavior that is contrary to the safety measures that were originally intended. In a world with inflation, "cautious" is not necessarily equal to "unmoving."

From that perspective, the Summary of Opinions for the December 2024 meeting included such passages as "The Bank is in a phase where it should slightly ease off the accelerator of monetary easing, so that it can slow down when necessary while avoiding harsh braking," "Adjusting the degree of monetary accommodation in a forward-looking, timely, and gradual manner," and "It is necessary for the Bank to adjust the degree of monetary accommodation in a preemptive manner." It is clear that these passages contain the aspects of a warning about falling behind the curve.

◆ **Summary of Opinions at MPM on 18-19 Dec 2024 (released on 27 Dec 2024)**

- Underlying inflation has been increasing steadily, while the risk of the Bank falling behind the curve is limited. The Bank will likely decide to raise the policy interest rate in the near future, but at this point it is necessary for the Bank to be patient and monitor the uncertainties over the U.S. economy until those uncertainties subside.
- The Bank is in a phase where it should slightly ease off the accelerator of monetary easing, so that it can slow down when necessary while avoiding harsh braking.
- With economic activity and prices developing in line with the Bank's outlook, risks to prices have become more skewed to the upside. Thus, adjusting the degree of monetary accommodation in a forward-looking, timely, and gradual manner, based on data and anecdotal information, will contribute to the sound development of the national economy through achieving price stability.
- As price increases have continued for three years, the rise in import prices - mainly reflecting the depreciation of the yen -- will likely lead to a further increase in underlying inflation and thereby to the achievement of the price stability target. Given this, it is necessary for the Bank to adjust the degree of monetary accommodation in a preemptive manner.

Costs for both raising and not raising rates

Looking at the Summary of Opinions for the December meeting, we can see that the Monetary Policy Board had a lively debate about falling behind the curve. Also, in the 7 January edition of the *Nikkei*, economist Mohamed A. El-Erian said that his basic scenario is that the BOJ will successfully implement its policy of raising interest rates. He pointed out that BOJ rate hikes entail two risks, specifically, "hasty normalization of interest rates" and "being overly cautious about raising interest rates." He added, "Of the two, the more likely risk is that the BOJ will be too cautious and so delay raising interest rates."

During a panel discussion at the IMF in October 2024, BOJ Governor Kazuo Ueda said, "When there's huge uncertainty, you usually want to proceed cautiously and gradually. But a problem here is, if you proceed very, very gradually and create the expectation that rates are going to stay at low levels for a very long period, this could lead to a buildup of huge speculative positions — which could become a problem later." Taking these risks into account, if market concerns about "falling behind the curve" deepen, excessive speculation due to yen depreciation could arise and conditions similar to those that led to the sharp fall in Japanese stocks last August (when yen carry trade unwinding occurred) could fall into place.

◆ **BOJ Governor Ueda at the IMF Annual Meeting (23 Oct 2024)**

- "When there's huge uncertainty, you usually want to proceed cautiously and gradually. But a problem here is, if you proceed very, very gradually and create the expectation that rates are going to stay at low levels for a very long period, this could lead to a buildup of huge speculative positions — which could become a problem later."

Ultimately, there are costs to raising interest rates, but there are also costs to not raising interest rates. We can probably assume that the cost of not raising interest rates is gradually increasing. On that point, we want to focus on whether there is any kind of message in the 14 January speech by BOJ Deputy Governor Ryozo Himino. Of course, the major premises are (1) Trump's comments before and after his inauguration do not cause market turmoil and (2) there is no sudden fall in risk assets that would completely change the perception of the financial conditions. However, if these conditions are met and, based on the above considerations, we think there is a high possibility that an additional interest rate hike (from 0.25% to 0.5%) will be implemented at the January MPM. Indeed, we should note that Ueda said a comprehensive conclusion will be made at the January meeting.

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