THEMATIC REPORT

Authors:
MIDF Economics & Policy

Pragmatic End to Japan's Negative Interest Rate

KEY HIGHLIGHTS

- **On 19 March 2024, the Bank of Japan (BOJ) hiked the interest rate for the first time in 17 years, ending the negative interest rate policy (NIRP) which started in Jan-16.**
- **After the pandemic, Japan's economy has shown signs of recovery with inflation consistently exceeding +2% since Apr-20, while GDP has remained expansionary since 2021, with growth averaging at +1.9%yoy between 2021 and 2023.**
- **Together with the elevated inflation, the sustained rise in Japan's GDP also provided the opportunity for BOJ to finally exit from the NIRP last week.**
- **The ringgit is +1.4% stronger the Japanese yen by end-2023 as compared to end-2005 since the ringgit's depegging from the dollar on 21 July 2005. This is despite the ringgit depreciating against most currencies of Malaysia's trading partners within the MIDF Trade Weighted Ringgit Index (TWRI).**
- **The ringgit is expected to strengthen by 4.2% against the Japanese yen, closing 2024 at RM 3.124 (2023: RM3.255). Meanwhile, MIDF TWRI is expected to rise by +7.2%yoy to 91.50 at year-end (2023: 85.34).**
- **The slowdown in bond buying by BOJ will drive the JGB yields progressively higher. Hence, we project 10-year JGB yield to end 2024 moderately higher at around 0.80%-0.85% level (end-2023: 0.61%).**
- **MGS 10-year yield is expected to end the year at 3.60% (2023: 3.73%), benefitting from the reversal of fund flow back into EM's following interest rate cuts by the Fed.**
- **At this point, we foresee no further tightening by BOJ in 2024, in view of keeping the interest rate accommodative for domestic demand and overall economic growth.**

BACKGROUND

Japan ended an over 8-year run of negative interest rates. On 19 March 2024, the Bank of Japan (BOJ) hiked the interest rate for the first time in 17 years, ending the negative interest rate policy (NIRP) which started in Jan-16. The hike to 0.00-0.10% from -0.1% was also accompanied by the abandonment of its yield curve control (YCC) policy.

Decades of economic stagnation. The 1990s was dubbed the "lost decade" in the Japanese economy. The burst of speculative real estate and stock market bubble in 1991 marked the start of a prolonged period of economic stagnation and deflation. During the 1990s, Japan's annual GDP growth averaged at a mere +1.6% while inflation averaged at +1.2%. Japan's economic growth slowed even further after the Asian financial crisis, as GDP growth average lower at +0.9% between 2000 to 2015, the lowest among developed nations. Meanwhile, inflation averaged at 0% between 2000 to 2015, making it the only advanced economy to consistently face the threat of deflation.

Negative interest rates were introduced to bolster the economy. After a period of low-interest rates and a series of quantitative easing failed to jumpstart the economy, the BOJ decided to implement a negative interest rate to achieve its +2% inflation target. The implementation of NIRP by the BOJ in 2016 effectively charged financial institutions for holding excess reserves to encourage lending to the economy, thereby stimulating inflation and economic growth. However, economic expansion remained tepid, averaging at +0.7% between 2016 to 2019 while the impact on inflation has been marginal with inflation only rising to an average of +0.5% in the 4-year period.

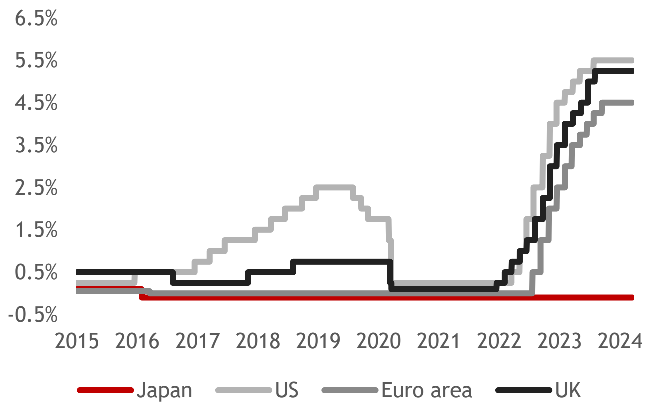
Pandemic-induced inflation and timely recovery gave way for the BOJ to end its ultra-loose monetary policy. After the pandemic, Japan's economy has shown signs of recovery with inflation consistently exceeding +2% since Apr-20, while GDP has remained expansionary since 2021, with growth averaging at +1.9%yoy between 2021 and 2023. Domestic demand condition markedly improved as retail sales rose +5.6%yoy in 2023, the fastest annual expansion since 1992 (2000-2019 average: +2.7%yoy).

Japan barely escaped technical recession in the last quarter of 2023. Japan avoided a technical recession after an upward revision of its 4QCY23 GDP growth to annualised +0.4%qoq (preliminary release: -0.4%qoq). Previously, Japan's GDP contracted -3.2%qoq in 3QCY23, ending 3 consecutive quarters of expansion. The stronger expansion in 4QCY23 was mainly underpinned by external trade which saw exports expanding faster by +10.7%qoq (3QCY23: +3.8%qoq). Meanwhile, private consumption remained a drag on growth for 3 consecutive quarters, with a continued decline by -1.0%qoq in 4QCY23. From a year-on-year perspective, Japan's GDP grew slower at +1.2%yoy (3QCY23: +1.6%yoy). Despite the moderate growth, Japan's economy grew faster at +1.9% last year (2022: +1.0%). We believe, together with the elevated inflation, the sustained rise in Japan's GDP also provided the opportunity for BOJ to finally exit from the NIRP last week.

Sustained increase in wages underpinning positive inflation. The tighter supply chain due to the pandemic and Russia-Ukraine war has been the trigger for the rising inflation. However, aggressive wage increases have been supporting positive inflation even after the moderation in import inflation. Post-pandemic, nominal wage has seen a consistent increase, rising since Feb-22. Real wages also finally registered growth in Jan-24 after contracting since Sep-21. The rise in wages has been supporting demand-driven inflation which has remained above +2% since Apr-22. The largest companies in Japan have agreed to raise wages by +5.28% in 2024 which is the steepest wage hike in 3 decades. The positive outlook on wage growth signalled continued positive inflationary pressure for BOJ to finally consider normalising its interest rate.

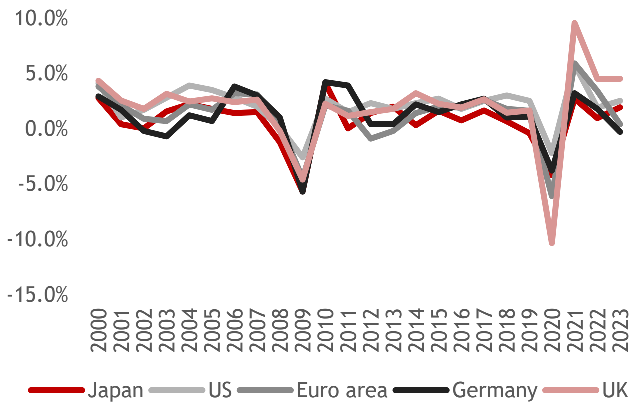
A cautios tone accompanied the hike. Despite ending its run of negative interest rates and ending its yield curve control policy, BOJ stated it will continue to actively control its long-term interest rate. The central bank will continue buying Japanese Government Bonds (JGB) at around the same amount to allow for quick responses to rapid rises in long-term interest rates. BOJ remained cautious on the labour market and inflation outlook and would like to first ascertain that inflation can sustainably remain around the +2% target level before proceeding with another hike.

Chart 1: Interest Rates of Advanced Economies (%)



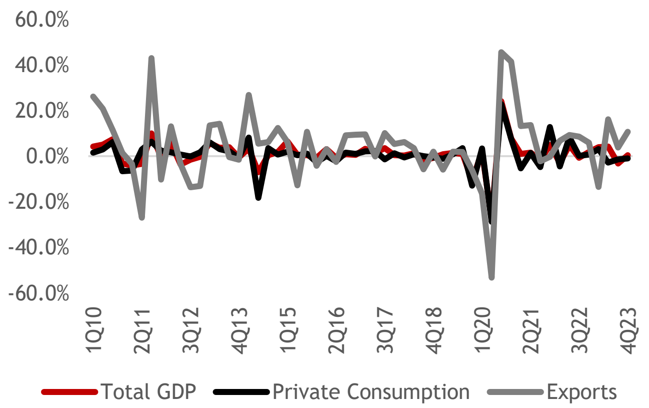
Source: Macrobond, MIDFR

Chart 2: GDP Growth of Advanced Economies (YoY%)



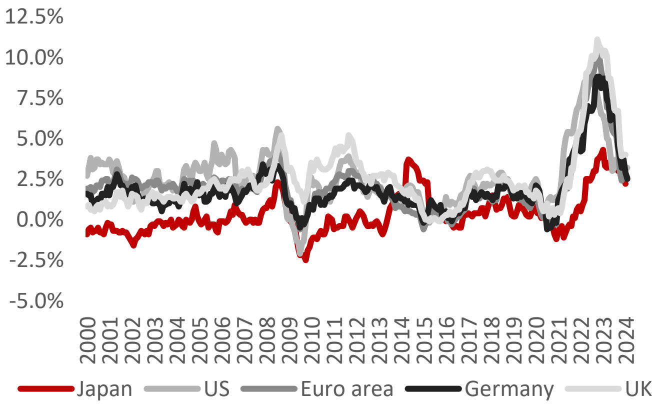
Source: Macrobond, MIDFR

Chart 3: Japan's GDP Growth (Annualised QoQ%)



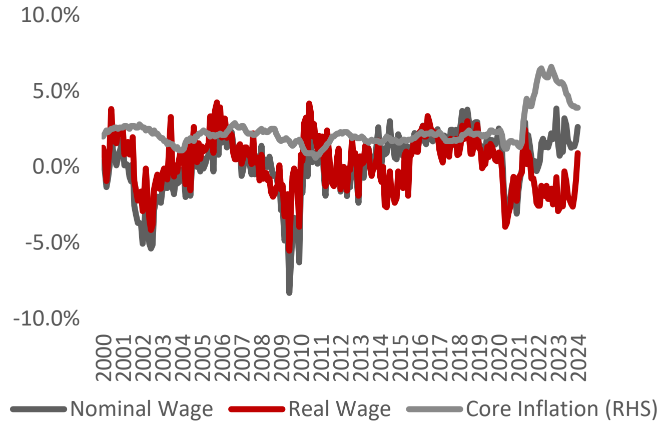
Source: Macrobond, MIDFR

Chart 4: Headline Inflation in Advanced Economies (YoY%)



Source: Macrobond, MIDFR

Chart 5: Japan's Wage Growth vs Core Inflation (YoY%)



Source: Macrobond, MIDFR

Chart 6: Japan's Retail Sales and Exports Growth (YoY%)

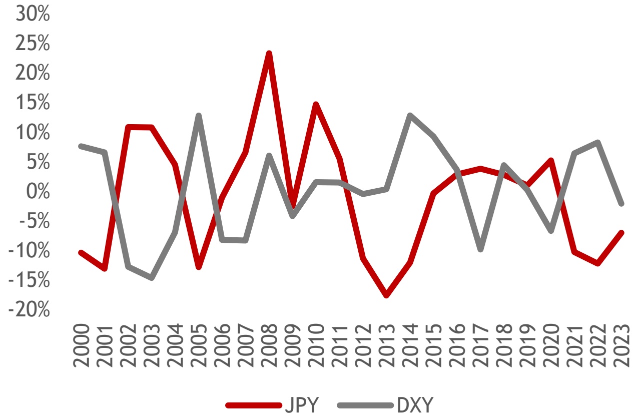
Source: Macrobond, MIDFR

CURRENCY OUTLOOK

Japanese yen is the worst-performing currency vs. US dollar. Japanese yen has been the worst performing currency versus US dollars within the DXY US dollar index, having depreciated by -27.3% in 2023 as compared to 1999. In comparison, GBP depreciated by -21.3% while SEK weakened by -15.5%. Being the 2nd largest component of the DXY US dollar index, which carries 11.9% of the weight, the yen weakening is one of the main contributors to weaken index. Notably, between 2012 and 2014, the yen depreciated steeply due to a combination of low interest rates and various other monetary and fiscal easing implemented under "Abenomics" to revive Japan's stagnant economy. In the post-pandemic period, a series of rate hikes by the US Fed widened the interest rate differentials (IRD) between US and Japan which saw JPY depreciating further for 3 consecutive years from 2021 to 2023.

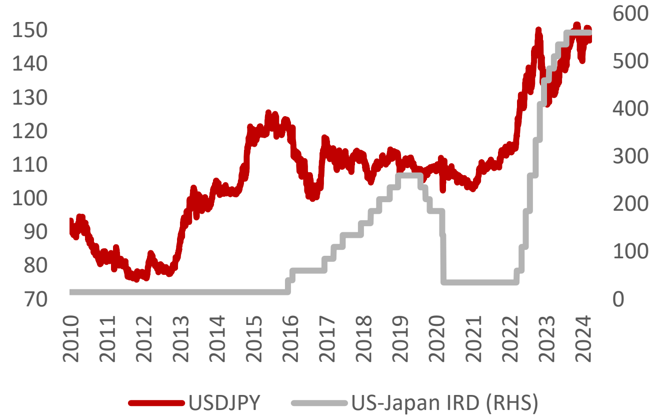
Ultimately JPY outlook against the USD will depend largely on the Fed's easing. Despite ending its negative policy rate, there is a relatively cautious tone by BOJ regarding further possible tightening. The central bank emphasized its goal of targeting only the short-term interest rates and will continue to actively control its long-term rate despite ending its yield curve control policy. The still lingering uncertainty on inflation outlook (to remain above its +2% target) remained a headwind for additional interest rate hikes by the BOJ. Nevertheless, despite the historic hike by the BOJ, the case for JPY to strengthen, like most other currencies will depend much on the US Fed's rate cuts which are expected to begin by mid-year 2024 at the earliest. This was seen earlier this month when yen appreciated and closed at JPY146.95 on 11 March 2024, the strongest closing in one month as the market priced in the possibility of BOJ exiting NIRP and ending the yield curve control. However, the gain was reversed in the following week as the market perceived the US Fed to be relatively more hawkish than most other central banks following its Mar-24 interest rate decision. The yen depreciated back to above the JPY150.0 mark on 19 March 2024 and even closed at JPY151.62 on 21 March 2024, the weakest closing since mid-Nov-23, few days after the BOJ's decision to exit NIRP. Going forward, we anticpate Japan will also gain from the reversal of fund flow which will come due to the narrowing interest rate differential (IRD), which leans heavier on the US Fed's decision to start cutting its interest rate, rather than BOJ hiking the rates further. On another note, we opine more encouraging wage growth, labour market data, and elevated inflation in Japan will also be positive for yen as we do not discount the possibility that BOJ will resort to more rate hikes subject to future economic and price outlook.

Chart 7: USDJPY vs DXY Index (YoY%)



Source: Bloomberg, MIDFR

Chart 8: USDJPY vs US-Japan IRD (bps)



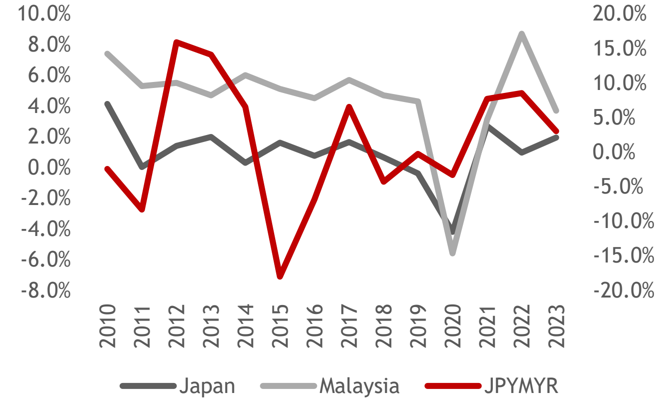
Source: Bloomberg, MIDFR

Ringgit has outperformed JPY. The ringgit is +1.4% stronger the Japanese yen by end-2023 as compared to end-2005 since the ringgit's depegging from the dollar on 21 July 2005. This is despite the ringgit depreciating against most currencies of Malaysia's trading partners within the MIDF Trade Weighted Ringgit Index (TWRI). The appreciation of the ringgit against the yen largely happened during and after the pandemic, attributable to Japan's unorthodox ultra-easy monetary policy, relatively slower economic recovery and continued deflationary risk. From the external trade perspective, Malaysia has remained a net exporter to Japan since 2010 with exports to Japan growing by a cumulative average of +4.3% between 2009 and 2022, while imports from Japan grew by a CAGR of +3.3%.

The ringgit's performance against the yen will be more influenced by economic fundamentals. The end of the negative interest rate by BOJ did not significantly narrow the IRD between Malaysia and Japan. Given expectations for BNM to keep the OPR status quo throughout 2024, JPYMYR's performance might be more influenced by economic fundamentals as IRD is expected to stay wide. Malaysia's moderate inflation and healthy domestic demand condition provided a sanguine economic outlook. On the external front, the expected rebound in external trade and higher commodity prices (i.e. crude oil, LNG and crude palm oil) will also bolster ringgit demand in 2024. As Malaysia remained a net exporter with Japan, the ringgit is expected to continue outperforming the yen. Nevertheless, faster Japan's inflation and wage growth are downside risks which might trigger a more aggressive tightening by the BOJ, supporting the yen rally.

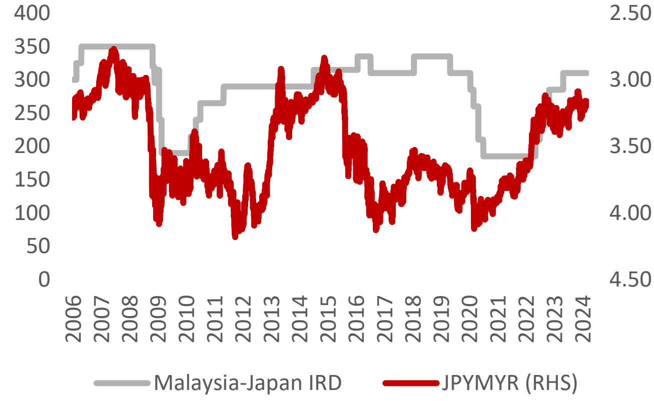
We foresee JPYMYR to end 2024 at RM3.124. BOJ mentioned that it will likely continue keeping its interest rate at an accommodative level for an extended period. With Fed rate cuts expected in the latter half of the year, the faster inflow of funds into EMs will be favourable for the ringgit. Hence, we can expect a broad strengthening of the ringgit against currencies of advanced economies, including the yen. We foresee the JPYMYR to end the year at around RM3.124 (end-2023: MYR3.255) as we anticipate ringgit to strengthen this year faster than Japanese yen. However, Feb-24 inflation data showed Japan's inflation ascended to +2.8%yoy, the highest in 3 months. If inflation accelerated at a more rapid pace than BOJ expected, the central bank might consider another rate hike in the latter half of the year, probably in Jul-24 or Oct-24. Another rate hike by BOJ might trigger a more significant demand for the yen, which might taper ringgit gains against the yen. If BOJ proceeds with another hike of +10bps in 2HCY24, we project the ringgit to end the year at around RM3.226, a slight gain from the 2023 closing. Meanwhile, if inflation happens to slow, it will compel the BOJ to reverse back to negative interest rate and yen will experience a steep depreciation. In that scenario, we foresee JPYMYR to end the year at around RM3.080 if BOJ makes a turnaround back to a negative interest rate.

Chart 9: Malaysia and Japan GDP vs JPYMYR (YoY%)



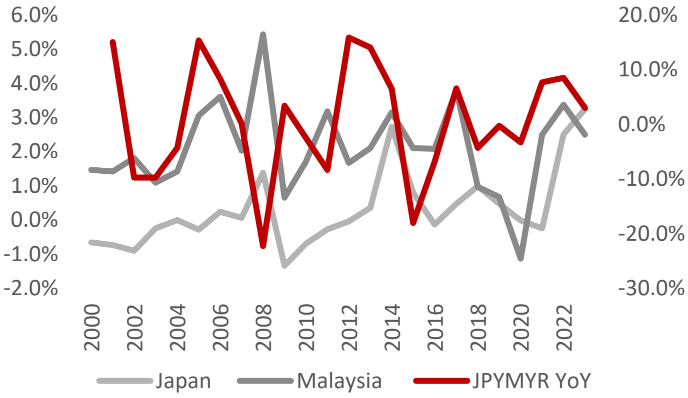
Source: Bloomberg, MIDFR

Chart 10: JPYMYR vs Malaysia-Japan IRD (bps)



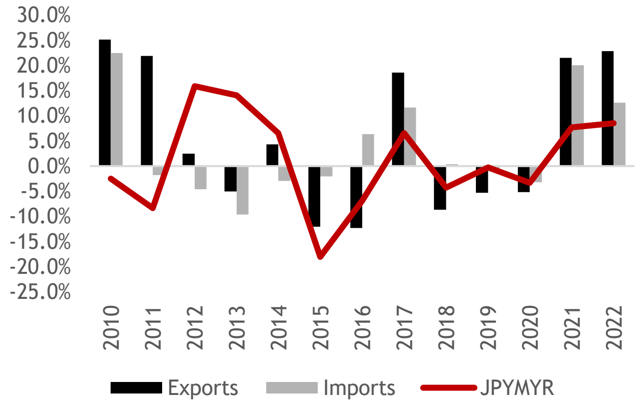
Source: Bloomberg, MIDFR

Chart 11: Malaysia and Japan Inflation vs JPYMYR (YoY%)



Source: Bloomberg, MIDFR

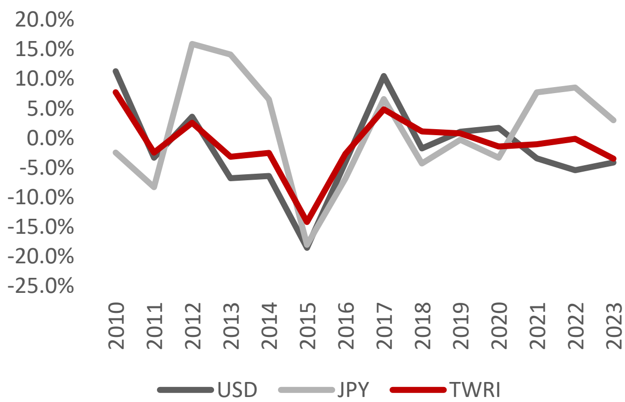
Chart 12: Exports & Imports vs JPYMYR (YoY%)



Source: Bloomberg, MIDFR

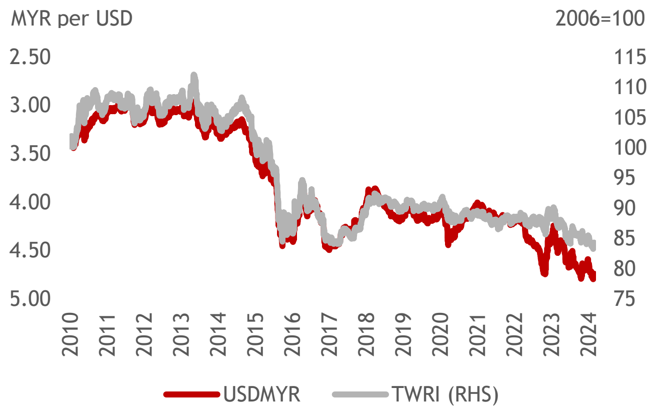
Ringgit to strengthen against the USD, closing the year at RM4.20. Despite our expectations of BOJ hike having little influence on USDJPY, we foresee US Fed rate cuts to benefit EMs more than developed economies. As appetites for riskier asset returns, EMs will experience a faster fund inflow compared to developed economies. Hence, although BOJ's monetary tightening is unlikely to lead to a broad USD weakening, the ringgit will still benefit from the narrowing FFR-OPR differential. In terms of ringgit performance against the currencies of major trade partners, the dollar is the 3rd largest constituent of MIDF TWRI at 10.6% weight, meanwhile, the Japanese yen is the 5th largest component at 6.6% weight. As the ringgit is expected to gain against both the USD and JPY we foresee TWRI also indicating the ringgit's appreciation, ending the year higher at 91.50 (2023: 85.34).

Chart 13: Ringgit Performance Against USD and JPY vs TWRI (YoY%)



Source: Bloomberg, MIDFR

Chart 14: USDMYR vs TWRI



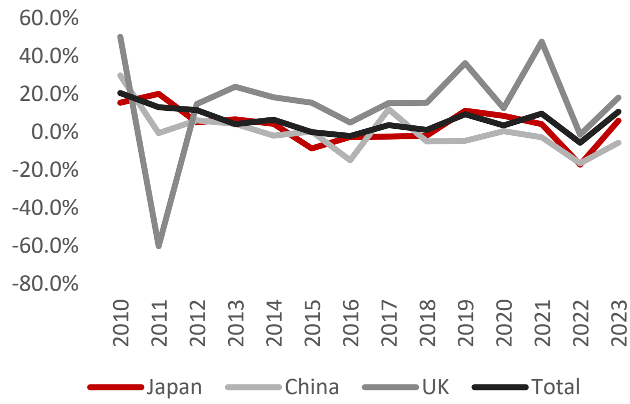
Source: Bloomberg, MIDFR

FIXED INCOME OUTLOOK

10-Year JGB yield will end the year at around 0.80%-0.85% level. BOJ's focus will be more on raising its short-term interest rate, hence despite ending the yield curve control BOJ has stated that it will continue buying JGB at around the same amount, at least in the near term. The continued quantitative easing by the BOJ is to allow for a nimble response in case of a steep acceleration in long-term interest rates. Looking at BOJ's cautious stance in scaling back its bond-buying activity, we opine that it is unlikely for JGB yields to experience a steep rise. Nevertheless, the slowdown in bond buying by BOJ will drive the JGB yields progressively higher. Hence, we project 10-year JGB yield to end 2024 moderately higher at around 0.80%-0.85% level (end-2023: 0.61%).

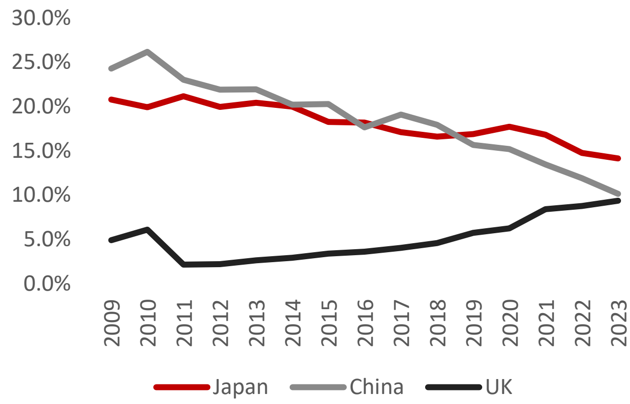
Japan to remain the largest foreign holder of UST, at least in the near term. Japan has been the largest foreign holders of UST since 2019, regaining back the spot from China due to the significant holdings reduction of UST by Chinese holders due to the US-China trade war. As of Dec-23, the Japanese held 14.1% of the USD8.06t UST holdings by foreigners, markedly lower than its peak of 39.5% recorded in Aug-04. The decline was owed to faster growth of holdings by other foreign holders, especially the UK. The amount held by Japanese investors rebounded in 2023, rising by +5.9%yoy after a steep -17.4%yoy decline in 2022 due to a rapid FFR hike by the Fed. As we have established JGB yields are unlikely to experience a steep rise due to continued quantitative easing efforts by the BOJ, the still elevated UST yields continue to remain more appealing towards investors. Hence, Japanese investors are unlikely to sell off their holdings of UST in bulk anytime soon, although, in the case of a more rapid hike by BOJ, we might see a decline in buying interest in the UST by Japan's investors.

Chart 15: Change in Among UST Foreign Holdings by Major Holders (YoY%)



Source: Bloomberg, MIDFR

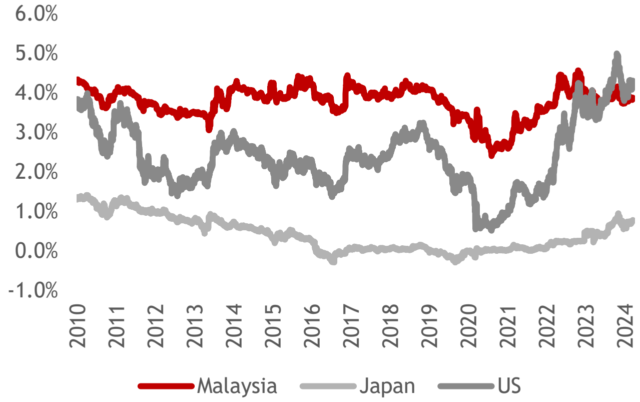
Chart 16: UST Foreign Holdings by Major Holders (% of Total Foreign Holdings)



Source: Bloomberg, MIDFR

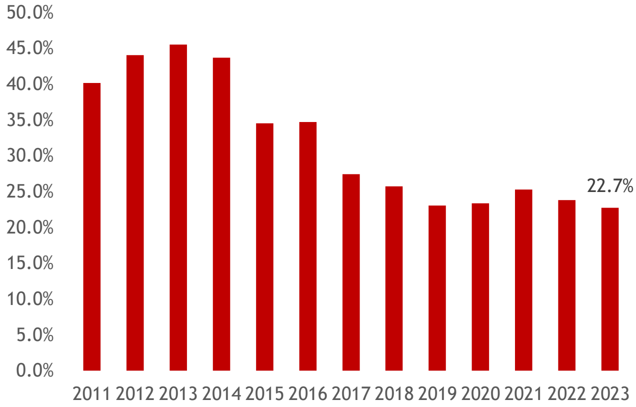
MGS to rally on moderating UST yields. As we have established BOJ's end to its yield curve control to unlikely trigger significant surge in JGB yields we continued to foresee MGS yields to move lower in returning interest in EMs. Domestic conventional government bonds have started to regain interest as of Feb-24, registering an inflow of RM567.4m, the first net foreign buying in 3 months. However, an outflow flow from the government sukuk market of -RM2.2b caused foreign holdings to continue declining. Nevertheless, following its Mar-24 FOMC Meeting, Fed stated that it is considering slowing down the pace of its quantitative tightening, a signal for UST to rally. We continue to foresee MGS rallying, reversing fund flows into EMs on moderating treasury yields from Fed's easing its monetary policy. Despite the expected moderate increase in JGB yields, we expect little to no impact on MGS yields as investors turn their interest towards higher-yielding EM securities. Moving forward, we maintained our projection for MGS's 10-year yield to close lower in 2024 at 3.60% (2023: 3.73%)

Chart 17: Benchmark 10-Year Government Bond Yields (%)



Source: Bloomberg, MIDFR

Chart 18: Monthly Average of Foreign Holdings (% of total outstanding)



Source: Bloomberg, MIDFR

CONCLUSION AND EXPECTATIONS

No further hike by BOJ in 2024. Despite the tightening of its monetary policy arriving much later than other major central banks, the sustained high inflationary pressure (i.e. above 2%) has allowed BOJ finally end its negative interest rate. The rising inflationary pressure which first started from the tight supply chain conditions due to the pandemic has been sustained by improving underlying inflation from the faster wage growth. Hence, further move by BOJ to tighten its monetary policy will depend on inflation outlook, wage growth and domestic demand conditions. At this point, we foresee no further tightening by BOJ in 2024, in view of keeping the interest rate accommodative for domestic demand and overall economic growth**.**

JPYMYR is expected to close stronger in 2024 at RM3.124. In the base case scenario, we foresee the ringgit strengthening against yen. Ringgit is expected to benefit from the returning inflow of foreign funds into EMs as the Fed set on easing its monetary policy. Hence we expect a broad strengthening of the ringgit against currencies of developed economies including JPYand USD. However, as the USD is expected to experience a broad depreciation from the Fed's rate cuts we projected ringgit will experience a steeper appreciation against the USD than the JPY. We project ringgit to appreciate by +9.4%yoy against the USD to end the year at RM4.20 (2023: RM4.594), while the ringgit is expected to also strengthen by 4.2% against the Japanese yen, closing 2024 at RM 3.124 (2023: RM3.255). On another note, our MIDF TWRI is expected to rise by +7.2%yoy to 91.50 at year-end (2023: 85.34%).

JGB 10-year yield to end the year higher at around 0.80%-0.85%. The end of yield curve control policy by the BOJ is unlikely to contribute towards a steep rise in JGB yields given the central bank will continue buying JGB at around the same amount, at least in the short term. However, a gradual increase in JGB yields can be expected once the BOJ progressively reduce the buying activity of JGB. Hence, we foresee the JGB 10-year yield to end moderately higher at around the 0.80%-0.85% (2023: 0.61%). In contrast, the MGS 10-year yield is expected to end the year at 3.60% (2023: 3.73%), benefitting from the reversal of fund flow back into EM's following interest rate cuts by the Fed.

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DISCLOSURES AND DISCLAIMER

MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <-10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.
ESG RECOMMENDATIONS* - source Bursa Malaysia and FTSE Russell	
☆☆☆☆	Top 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆☆	Top 26-50% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆	Top 51%- 75% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆	Bottom 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell

* ESG Ratings of PLCs in FBM EMAS that have been assessed by FTSE Russell in accordance with FTSE Russell ESG Ratings Methodology