BNY

iFlow

MACRO MORNING BRIEFING

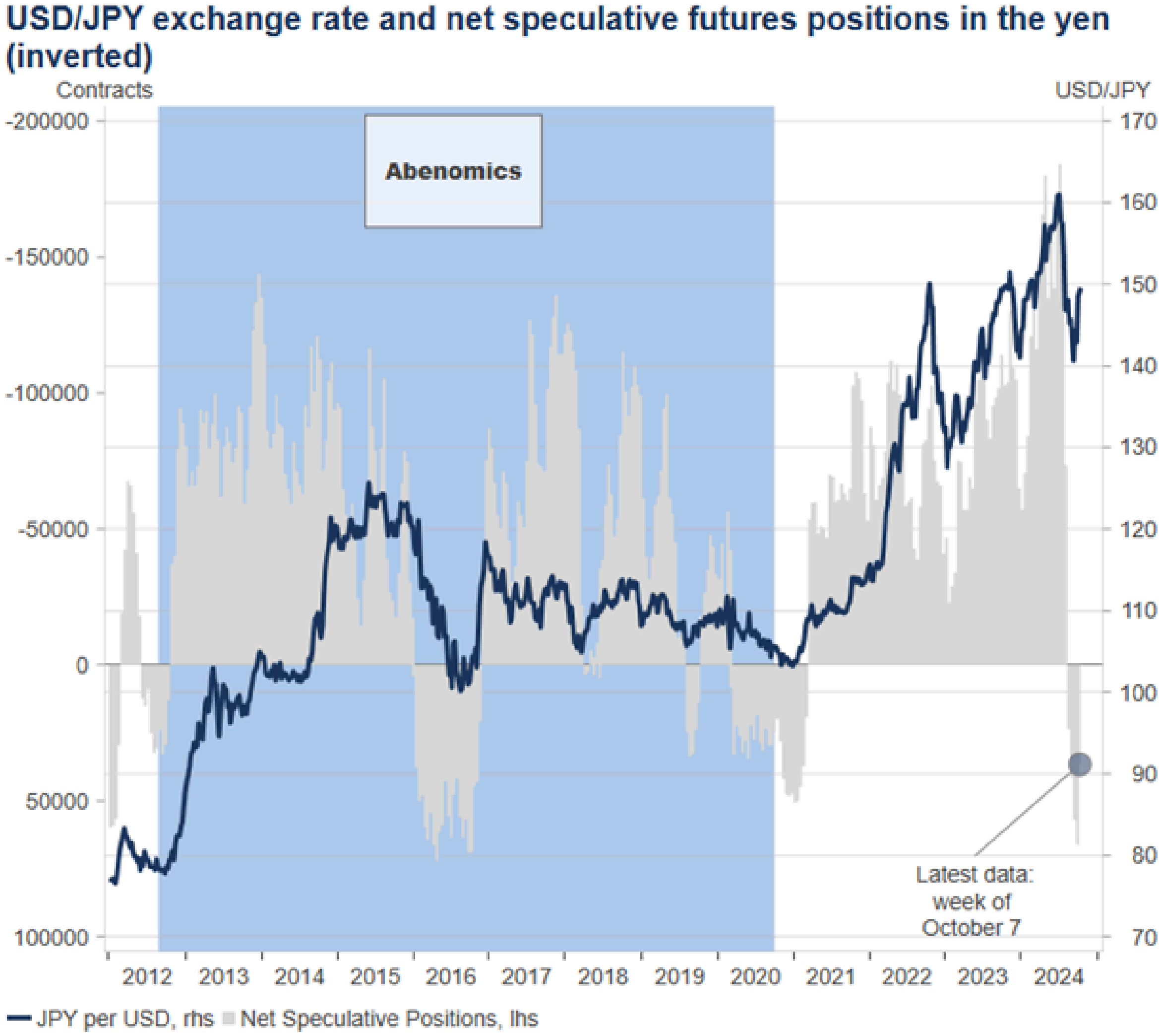
October 23, 2024

Japan, the Elections and the BOJ

- USD/JPY runs the risk of trading at 155 again as the BOJ backs away from the sense of urgency surrounding a rate hike and the Japan election threatens to reveal further political uncertainty
- The LDP is expected to lose 50 seats and rely more on coalition partners to rule. One of those partners wants to return to easier monetary policy
- The risk of opposition positions on crypto and other measures will keep less money flow returning to Japan – leading to continued JPY weakness and risk to growth – and add to BOJ's reluctance to hike faster
- iFlow positioning shows less concern about the BOJ and more about the JPY clashing with the IMM data

Heading into the Japanese election investors are reacting to three risks: 1) the LDP losing its majority and reigniting political uncertainty; 2) BOJ policy stalling on rate hikes and allowing more JPY weakness; and 3) US election risks with some sectors and the trade relationship. The last week showed a notable rise in profitability for short JPY positions. The USD rally back to 150 did not lead to further unwinding of USD longs by the fast-money accounts as the overall net longs by non-commercial accounts remain at elevated levels (see chart with IMM holdings in Exhibit #1). Further capitulation of longs in fast-money accounts is still very much a risk. The speculative positions in JPY are long, not short with room to correct more should the election or the BOJ add to negative sentiment.

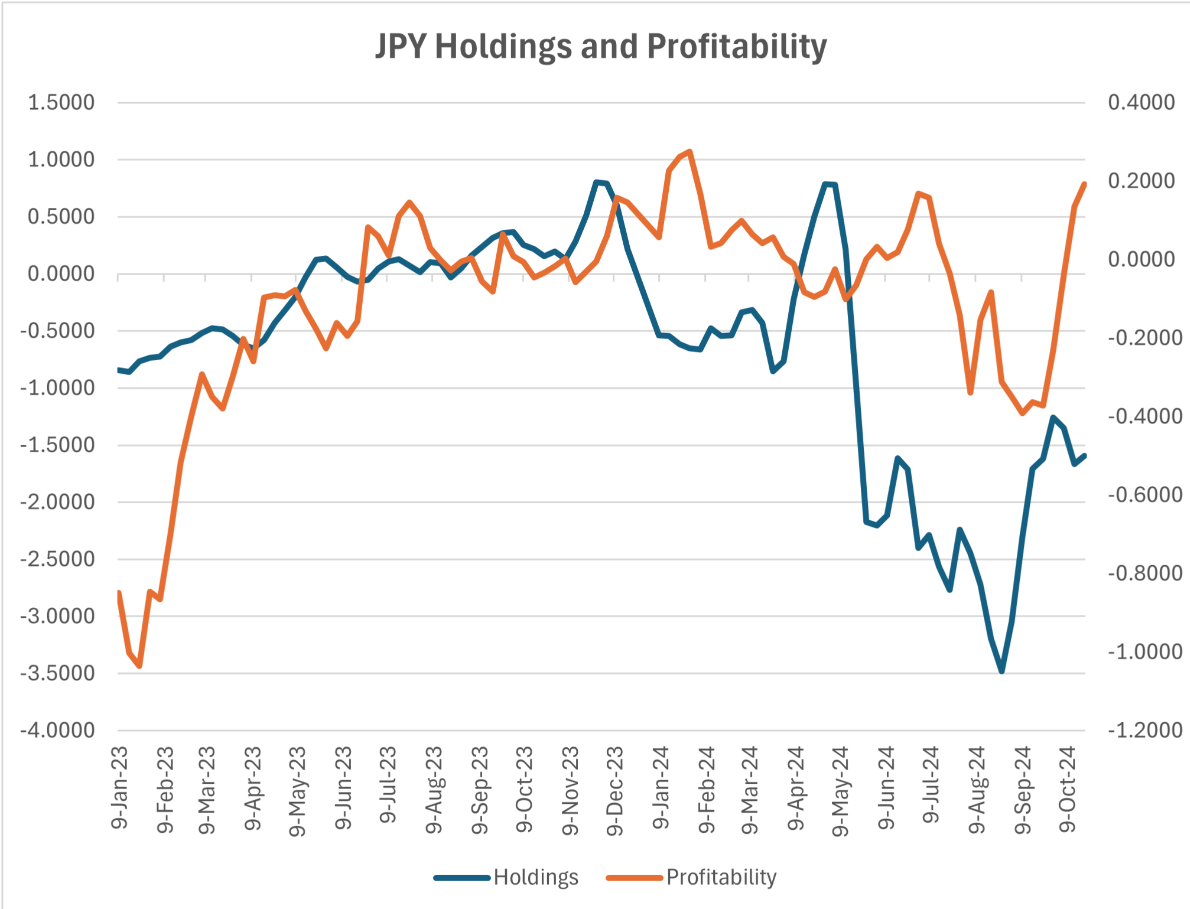
Exhibit #1: IMM Data Show JPY Speculative Positions Are Long



Source: Macrobond, BNY #

In contrast to the IMM positions, our iFlow holdings suggest net short JPY positions from our slower moving "real money" clients. The short JPY positions are making money. The hedging of Japanese assets is one factor as it remains a positive "carry trade" despite BOJ hikes. Furthermore, the persistence of positions short JPY from April on stands out. The notable surprise of the July 31 hike caught positions off guard but that was followed by a significant JPY short covering, as Exhibit #2 highlights. The urgency to cover further has stalled and begun to reverse. Accordingly, the risk of BOJ surprises is higher. In terms of other asset class, iFlow data show broad outflows in equities (-0.89 weekly average, for the 10th week) and corporate bonds (-1.41 down for the 19th week). Sovereign bonds flow back into selling mode after three weeks of inflows and accelerated buying, with the weekly average scored flow there at -0.12.

Exhibit #2: iFlow Shows Short JPY Positioning and Profitability

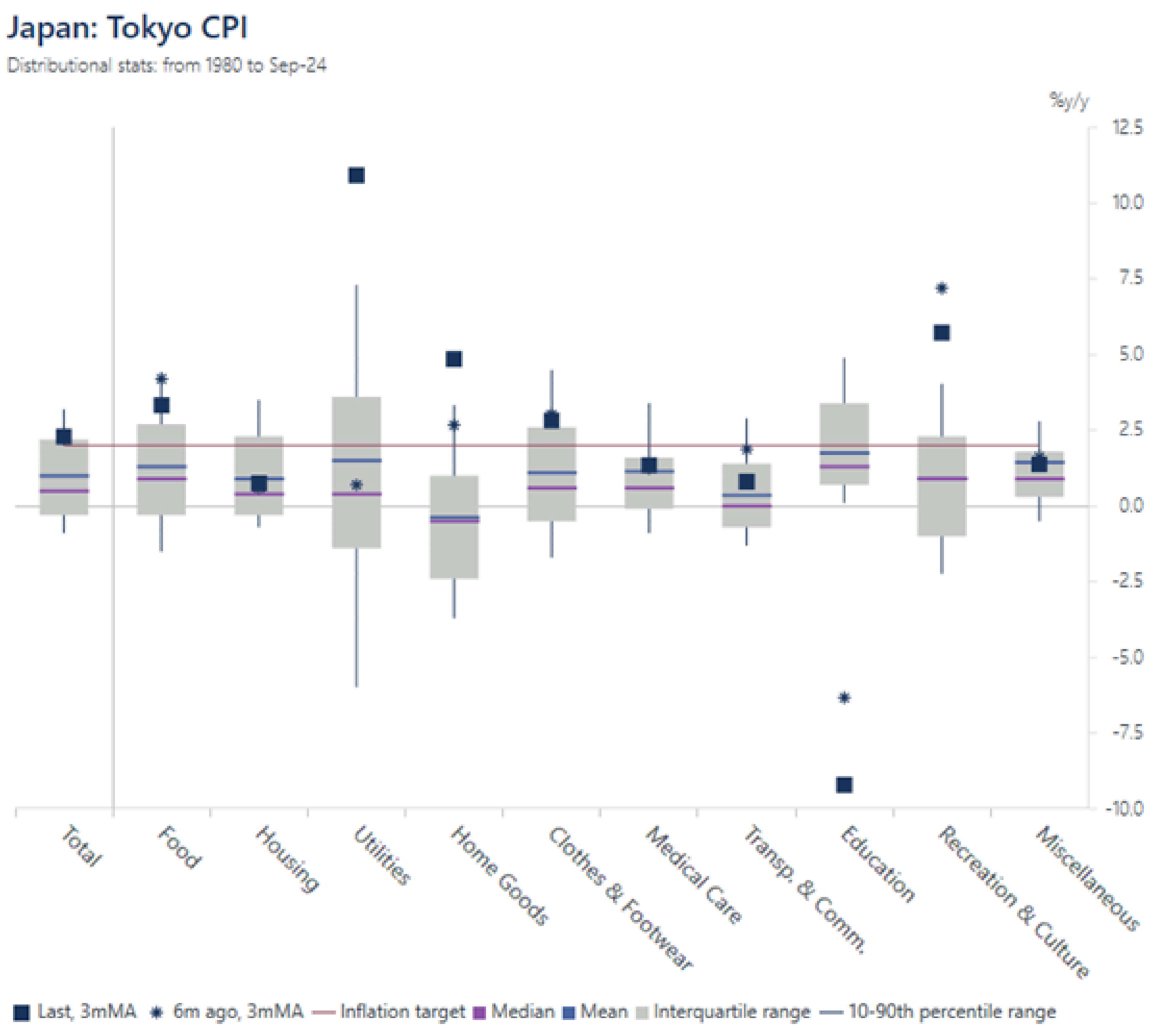


Source: iFlow, BNY

The October 27 election is widely expected to show losses for the ruling LDP in parliament. The LDP has ruled Japan for almost all the post-war era and holds a majority in the 465-seat lower house. Its long-time coalition partner is Komeito, a party backed by a large Buddhist lay group that has often lent crucial campaign support to the LDP. Although the LDP's popularity hit a low of 25.5% in June – the lowest since it regained power in 2012 – it remains the most popular party in a fragmented political landscape, with backing from 31.3% of respondents in a mid-October poll by public broadcaster NHK and 31.8% in a poll by Kyodo News. While the LDP still has strong support, the main opposition Constitutional Democratic Party of Japan (CDPJ) is making inroads, with its share rising to 15.4%. The Asahi poll estimated the CDPJ could grab as many as 140 seats in the election, up from 98.

To understand what is at risk in Japan, you can look at the election polls and what voters say are their concerns – according to the NHK poll – first is inflation and second is corruption (from the slush fund scandal). In a sign of the pain of rising living costs, food and daily necessities topped the list of items on which respondents said they increased spending from a year ago, a quarterly survey by the Bank of Japan showed in early October. The role of CPI in the election puts the BOJ back into the political focus. PM Ishiba has told ministers to draw up a fresh economic package to cushion the blow to households from the rising costs of living. The opposition CDPJ has announced plans to increase welfare spending, including free university education. The recent Tokyo CPI report, which was lower than some expected, still highlights the role of higher prices for utilities, home goods and food, not to mention recreational activities.

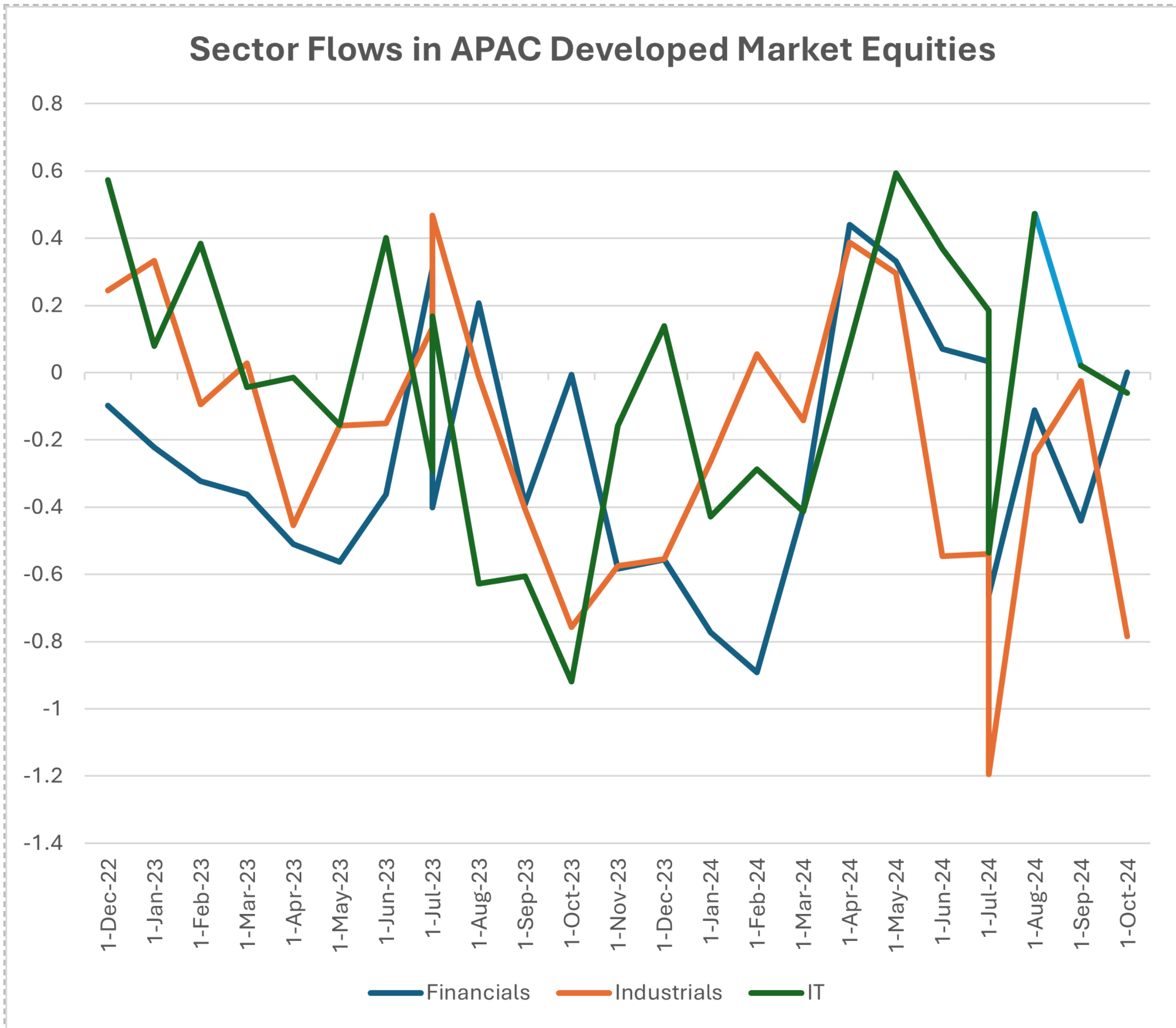
Exhibit #3: Tokyo CPI Highlights Food, Energy and Recreational Costs



Source Macrobond, BNY

Less clear is the US election effect on JPY and the dollar generally. While we have some evidence of a "Trump" trade in MXN and CNY shorts, the JPY isn't an obvious part of this trade. The Harris trade may be more about the "Green" push. However, both Harris and Trump might have a positive effect on Japanese automakers, which have strengths in hybrid vehicles, according to a recent analysis by S&P Global Mobility. Based on the current administration's policies and other information, the research firm projected that the share of EVs in the US market will be 40% by 2030. A more likely case would be that Harris is pressed to revise the pro-EV policy under a split Congress, which would result in the figure falling to 35%, according to the analysis. Japan is seen as the likely winner in such a case. When you look at investment flows in the industrial sector, this is not a position in focus for Japan. The July 31 rate hike by the BOJ and Nikkei washout trade saw only financials recover in positive flows while industrials have remained under pressure as a sector since the summer of 2023. Exhibit #3 makes clear that there is no US election trade in industrials from developed Asia.

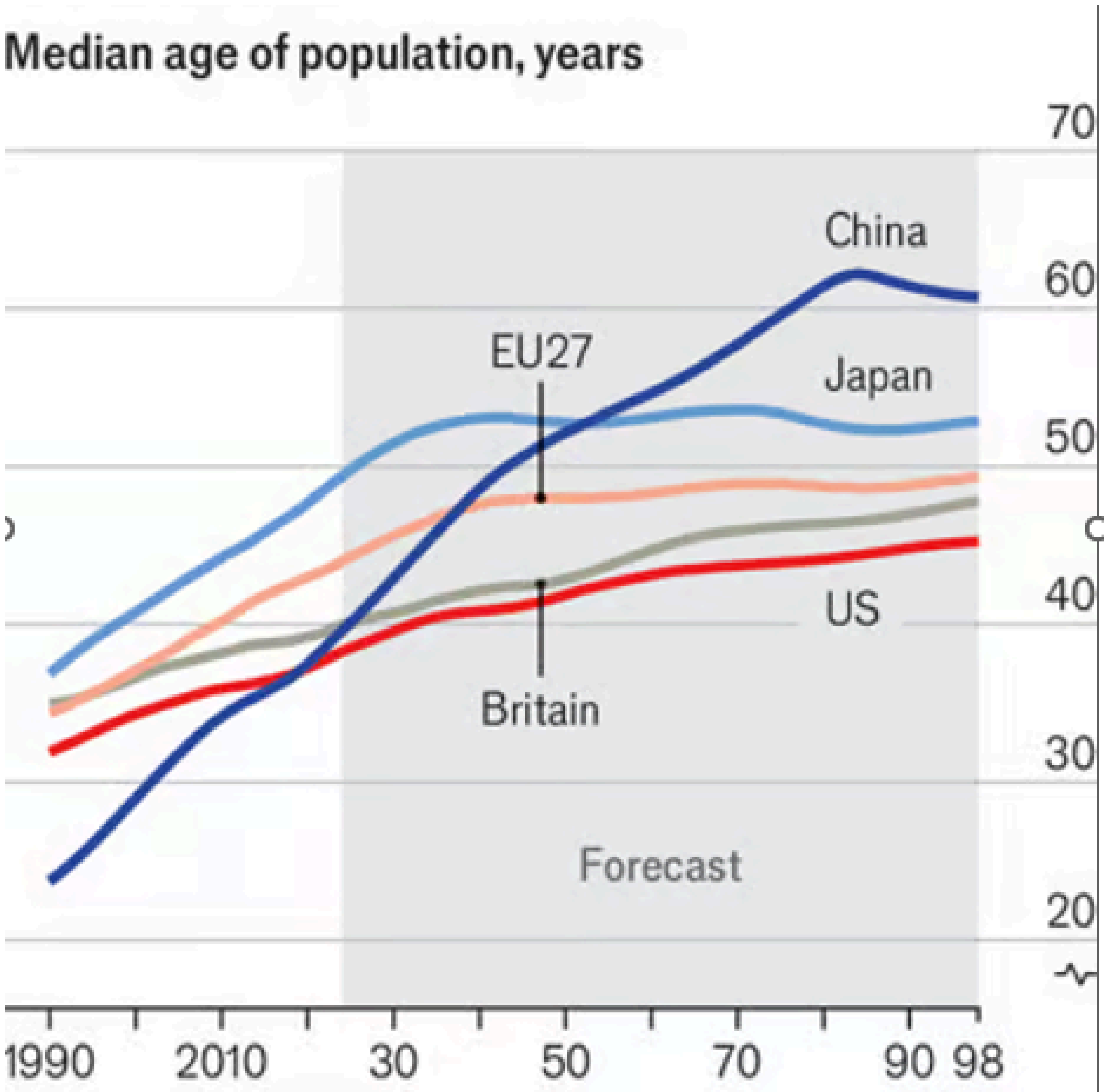
Exhibit #4: APAC Developed Market Sector Flows in IT, Financials and Industrials



Source: iFlow, BNY

The last issue for Japan concerns growth and how BOJ policy will deal with demographics and the ongoing deflationary impact of aging. The important point for investors to keep in mind is that the life expectancy trend will peak in Japan, but not for the rest of the world. The ability of the BOJ and the new government to manage the population dynamics and their policy to promote stable growth while taming inflation are important, and the BOJ seems to be on this path. The risk of higher-than-expected inflation in this cycle remains a complicated question of government spending, JPY weakness and energy against consumer wages and morale. We expect the Bank of Japan to increase rates again, but given the election uncertainty they are unlikely to act until January and the world could be a very different place by then. JPY weakness is likely to persist and be aggravated by the attractiveness of Japanese assets, and probably USD carry trade hedging, too. How the BOJ balance sheet roll-off and the level of global rates plays out will be a significant part of the central bank's decision. US rate cuts matter globally, as does the US election to the USD. The chart in Exhibit #5 showing UN population expectations in the coming decades highlights the risks of China against the US as well, with the caveat that immigration policy and politics will play a central role for all data presented.

Exhibit #5: Japan Life Expectancy Will Peak in the Next Decade



Source: UN Population Data, BNY

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Please direct questions or comments to: iFlow@BNY.com

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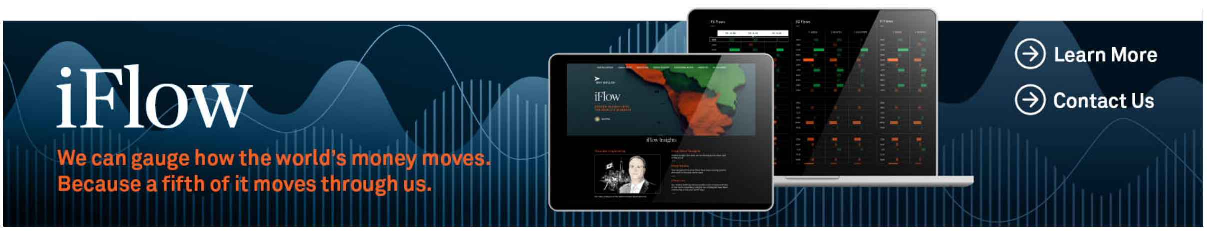

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