Monthly Insight

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Sweet Home Sweet

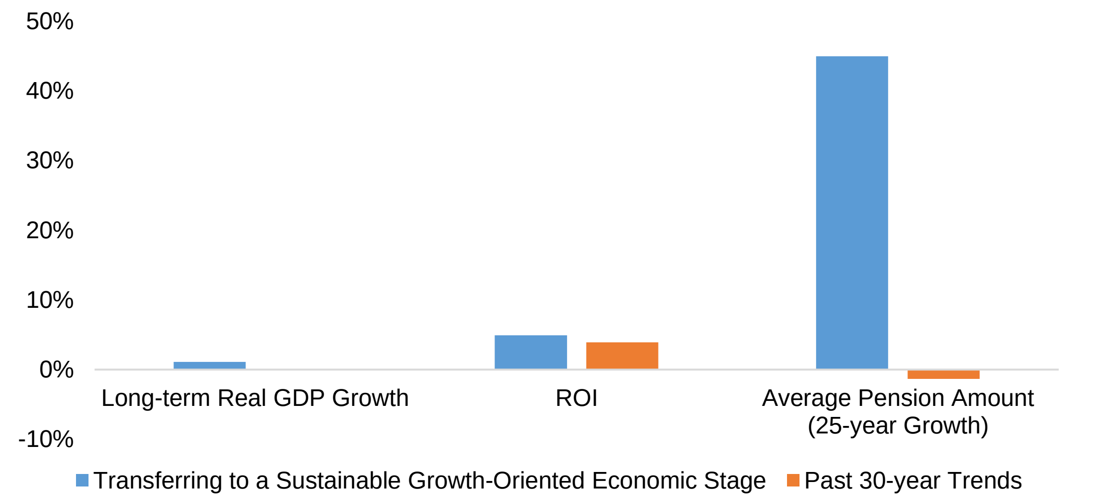
- **Japanese Finance Minister Katayama floated the trial balloon about directing pension funds as a price setter of the JGBs.**
- **Coming on the heels of a breakout of the 30-year sovereign yield to 3.8%, odds are Katayama's repatriation plan can provide without jeopardizing future pension benefits.**
- **If the GPIF were to increase its JGB holdings by 5 percentage points to 32%, such a creeping rotation could entail JPY15trn in yen-buying. This is equivalent to 1.5 times the BoJ's intervention during the Golden Week holidays (JPY11.7trn). Our instinct is that investors are too skeptical.**
- **The buying pressure from the private sector may not be as strong as the Takaichi administration wished, in the shadow of the fast-approaching end of BoJ's rate-hike cycle and the ongoing QT.**
- **While the rebalancing flows historically begin about a quarter before the official announcement, merely playing for time does little to dissuade yen rally-sellers.**

Japan has hosted many of the great turnings of history. Japanese manufacturing signifies widely-acclaimed just-in-time inventory management and six-sigma quality control processes, the Bank of Japan was also among the first to tiptoe into quantitative easing. Recently, Japanese Finance Minister Katayama floated another trial balloon, about directing pension funds as a price setter of one of the most important sectors in the financial world – JGBs.

In more than one way, Katayama's comments are significant. In Japan, capital flows drive FX more than political, inflation, and rate differentials. Above all, Katayama's proposal isn't a wager on whims and hunches, as she was often accused.

The Ministry of Health, Labour and Welfare lays out different scenarios for how pension funds fare. The long-term investment target for the pension fund is 3.9% even if the excessively pessimistic scenario of another lost decade pans out. If we accept IMF's long-term growth forecasts of 0.6%, the investment target for the Government Pension Investment Fund (GPIF) would be trimmed to 3.2% (Exhibit 1). Coming on the heels of a breakout of the 30-year sovereign yield to 3.8%, odds are Katayama's repatriation plan can provide without jeopardizing future pension benefits. So the blessings from the trio – GPIF board, the Pension Fund Management Committee, and the Minister of Health, Labour and Welfare – appear to be a low-hanging fruit to us.

Exhibit 1: Targeted Return of GPIF Under Different Scenarios



Source: Japan Ministry of Health, Labour and Welfare, Shanghai Commercial Bank

Paying what you can afford can hardly get what you want. Here's another framing: Assets under management of GPIF currently total JPY300trn. If the GPIF were to increase its JGB holdings by 5 percentage points to 32%, such creeping rotation could entail JPY15trn in yen-buying. This is equivalent to 1.5 times the BoJ's intervention during the Golden Week holidays (JPY11.7trn). Our instinct is that investors are too skeptical. If anything, this magnitude of buying can unnerve investors further, sapping whatever credibility Sanaenomics has remained. Private response adds another wrinkle. The buying pressure from the private sector may not be as strong as the Takaichi administration wished, in the shadow of the fast-approaching end of BoJ's rate-hike cycle and the ongoing QT.

Often, markets are a contest of virtue and honor. How did Alexander Hamilton turn the war-worn greenback into a functioning currency? He created a revenue stream from customs duties. He set up the federal sinking fund to retire war debt. That's the potency of sound finance and good credit. GPIF's reallocation can only work its magic as part of a credible package of fiscal discipline. While the rebalancing flows historically begin about a quarter before the official announcement, merely playing for time does little to dissuade yen rally-sellers.

UK

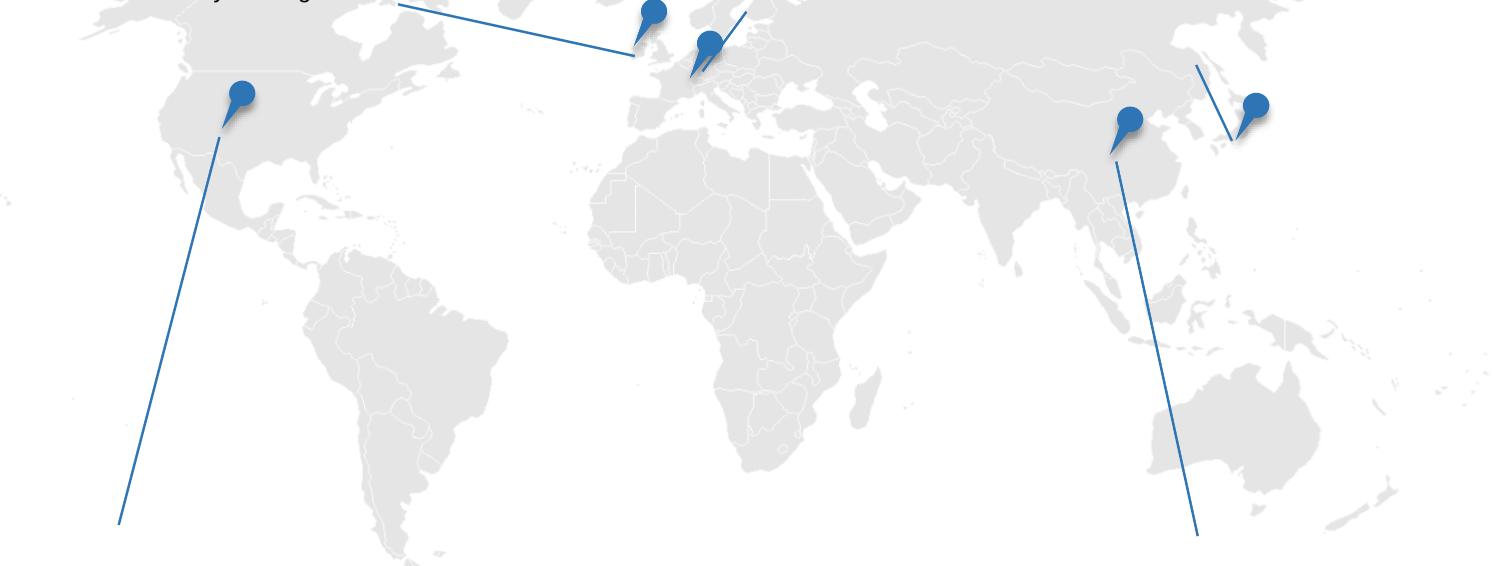
Tepid economic growth and a weak job market are easing rate-hike pressure for the BoE. Markets are more focused on Burnham's choice of Chancellor and the details of his fiscal policies, any unfunded spending risks renewed volatility in the gilt market.

EU

June inflation eased at a faster pace than expected. However, the ECB members' remarks before the quiet period were generally cautious and neutral.

Japan

BoJ's Tamura suggests hiking every few months, but finds little support. Two Takaichi-nominated board members stress wage- and demand-driven inflation has yet to take hold.



US

June inflation data came as a relief to the markets, but a single monthly reading is unlikely to convince the Fed that price pressures have abated, with Governor Logan still voicing a preference for further hikes. Indeed, AI has become a double-edged sword, with AI-driven inflation drawing widespread attention within the Fed. Centrist New York Fed President Williams made it clear that if AI-driven demand persists, the Fed would not be able to look through.

Chinese Mainland

A K-shaped recovery continues to weigh on China's domestic market. The upside has been largely confined to exports and AI-related sectors, and growth has yet translated into broad-based job creation.

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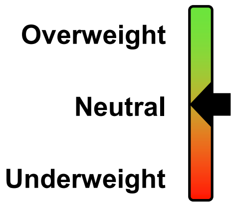
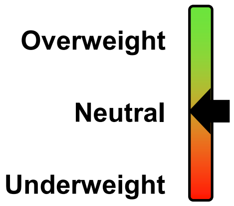
Foreign Exchange Outlook

USD



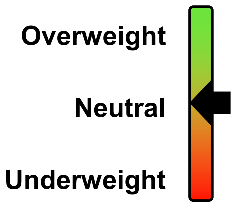
Oil prices are trading on the strong side again and elevated oil prices will provide fuel for the hawks. Equity jitters can keep the greenback supported on dips. And yet, markets' reluctance to reprice rate expectations aggressively higher following the soft jobs report and CPI reading would limit the topside.

EUR



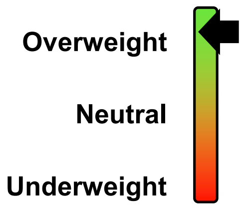
The renewed oil spike should dent Europe's economic recovery. The euro however holds up remarkably well, possibly due to the ongoing rate-hike cycle. Low volatility may be the name of the game given few inflation surprises or central bank inputs.

GBP



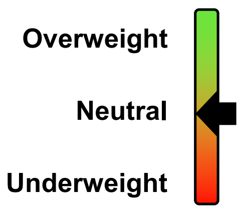
The new occupant of 10 Downing Street will be pushed by the coalition to depart from the incrementalism witnessed during the Starmer/Reeves years. The question of whether Burnham's arrival could cut red tape and unlock the private sector's cash buffers holds the key. Before the dust settles, the pound likely remains a currency that the investor holds for carry rather than owns for conviction.

RMB



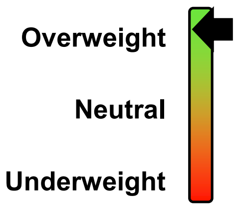
While export boom keeps current account surplus strong, the ongoing dividend season and concerns about new regulations on outbound investment may be dampening sentiment towards the RMB in the near term.

JPY



Takaichi's populist budget and perceptions that the BoJ has fallen behind the curve have again attracted attention. FX intervention has proven to be able to buy time, but it can't solve the underlying reasons for JPY weakness. It is hard to see that mindset being challenged.

AUD



The AUD's rally has come to a halt after a euphoric start. Still, high-yielding currencies can enjoy better insulation against the stronger dollar given the summer lethargy.

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NZD

Overweight

Neutral

Underweigh

The RBNZ had delivered a hawkish tone lately, and employment growth has returned to positive territory. The kiwi's post-hike rally looks more sustainable than most would believe.

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