Global Insights

Is a Weak Yen Hurting Japanese Households?

In our May 18 Global Insights, “Tokyo Drift: What’s Driving the Yen?” we explored the Japanese yen’s historic weakness. Since then, the European Central Bank (ECB) has confirmed its rate hike plans, which will leave the Bank of Japan (BOJ) as the sole G-10 holdout with ultra-easy monetary policy.

The BOJ has demonstrated a willingness to tolerate yen weakness in pursuit of its 2% inflation target via yield curve control. We worry that rising prices could hurt household and business sentiment, clouding Japan’s economic outlook.

This edition of Global Insights updates readers on the BOJ, which is lagging global peers on monetary policy normalization, and considers the role that a weaker yen and the recent price trend could have on consumer spending and business sentiment.
Diverging interest rate policies have contributed to the yen’s weakness. As central banks around the world rush to tackle inflation, the BOJ has come under fire for continuing its ultra-easy monetary policy. In our May 18 Global Insights, “Tokyo Drift: What’s Driving the Yen?” we considered the impact of yen weakness on the nation’s economy. Since then, the ECB has confirmed its intention to hike rates at its July 21 policy meeting, which would leave the BOJ as the only major developed market central bank committed to keeping bond yields near zero (see Exhibit 1).

Contrasting US and Japanese monetary policy, in particular, has contributed to yen weakness, resulting in its lowest level versus the US dollar (USD) in over two decades, consistent with a year-to-date decline of nearly 20%. Unsurprisingly, foreign exchange traders have wasted no time testing the BOJ’s resolve to defend its 0.25% 10-year yield cap. In fact, when the 10-year Japanese government bond (JGB) yield came under pressure last week the BOJ spent a weekly record 10.9 trillion yen in an attempt to defend the cap.

Exhibit 1: BOJ Has Maintained Its Yield Cap Even as Most Major Central Banks Hike Policy Rates

Rising prices could squeeze Japanese consumers. By keeping monetary policy easy, the BOJ has demonstrated that it is willing to tolerate yen weakness in pursuit of its 2% inflation target. To that end, the BOJ has seen some success. In fact, in May Japan’s consumer inflation topped 2% for the second consecutive month. However, it may be too soon to cheer policymakers, as a weak yen could worsen the pain felt by Japanese households grappling with rising costs. This is especially true when prices of items like energy and food, which are mostly imported given the island nation’s limited natural resources, have risen to records across the globe.

According to the Federation of Electric Power Companies of Japan, the nation depends on imports for 94% of its primary energy needs. Therefore, should oil prices remain elevated, Japan’s trade deficit has ballooned, and companies worry that a weak yen is harmful. In addition to sharply higher energy and food prices, Japanese policymakers also have to contend with a ballooning trade deficit. The total value of Japan’s imports has already jumped nearly 50% from last year, resulting in the largest trade deficit since 2014 (Exhibit 3). Notably, this is not the first time Japan has struggled with trade deficits. Japan recorded annual trade deficits from 2011 to 2015 amid the loss of a key domestic energy source following the Fukushima power plant disaster. Although economic stimulus during that period was supportive, we worry that this time around monetary and fiscal stimulus may not be enough to offset the substantially weaker yen. In fact, in a recent survey by Tokyo Shoko Research, when asked about the yen’s decline, nearly 50% of companies responded that the impact on their business would be negative.
Exhibit 3: A Weaker Yen Is a Major Factor Behind Japan’s Record Trade Deficit

Investment Implications

All else equal, a weaker currency should make a nation’s exports more attractive. In Japan’s case, however, COVID-19 production restrictions and supply chain challenges have weighed on activity. In fact, the Jibun Bank Japan Purchasing Managers’ Index slid to 52.7 in June from 53.3 in May, which is down from January’s cycle high of 55.4 (see Exhibit 4). As inflation accelerates and the yen’s purchasing power declines, investors should consider the impact on Japan’s consumers and overall business sentiment. In our view, for investors who are overweight Japanese equities, near-term headwinds warrant moving closer to benchmark levels within global portfolios.
Charts You Can't Miss

Exhibit 5: Survey Results: Perceived Impact of a Weak Yen on Business

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Note: Responses based on a June 6, 2022, survey by Tokyo Shoko Research. Source: Reuters, Morgan Stanley Wealth Management Global Investment Office

Exhibit 6: Japanese Companies Have Thus Far Been Unable to Pass Higher Costs to Customers

Note: Base year is 2015. Source: Haver Analytics, Morgan Stanley Wealth Management Global Investment Office as of March 31, 2022

Exhibit 7: Yen Slips to Lowest Level in Over 20 Years as BOJ Remains Outlier With Easy Money Policy

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 26, 2022

Exhibit 8: Japanese Inflation Tops 2% for Second Straight Month

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of May 31, 2022
Current Readings From Our Quantitative Framework

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Ongoing Development Spotlight

Yen positioning is less stretched now than in May. Investors are debating whether the BOJ will stand pat as global interest rates rise. However, with 88% of economists surveyed by Bloomberg seeing intervention as unlikely, a weaker yen could be in the cards. Although yen weakness could persist given the BOJ’s commitment to ultra-easy monetary policy, US recession concerns could halt the yen’s rapid slide against the dollar.

Exhibit 9: Yen Traders Less Bearish Than Early 2022 but Still Bracing for Losses

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 24, 2022
GLOBAL INSIGHTS

Disclosure Section

Index Definitions

CORPORATE GOODS PRICE INDEX BY STAGE OF DEMAND AND USE measures the price developments of goods traded within the corporate sector.

CITI FX PAIN JPY index measures active FX traders’ positioning in the Yen.

JIBUN BANK JAPAN MANUFACTURING PMI measures the activity level of purchasing managers in the manufacturing sector.

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

Glossary

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Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

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Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

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