Sumitomo Mitsui DS Asset Management

Great expectations: what to make of the 'Takaichi trade' so far?

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Japan Equity Research Team
SMDAM

We are one of the largest investment management companies in Japan, offering discretionary investment management, investment trusts and advisory services to a range of institutional investors, pension funds, government agencies and retail investors worldwide.

The arrival of Sanae Takaichi as Japan's first female Prime Minister has been met with near universal enthusiasm, both within Japan and internationally. The election of a new leader with a clear vision of how to continue the ongoing rejuvenation of the Japanese economy and stock market has been received around the world as a welcome breath of fresh air in a time where positive news flow can be hard to come by.

We have already recently analysed the broad outlines of what to expect from Takaichi in power. In this article we summarize our view of the so-called 'Takaichi trade' and look ahead to what may lie ahead for the Japanese markets as Takaichi's administration hits the ground running.

Yen depreciation – friend or foe?

In the foreign exchange market, the depreciation of the yen has been a key early signal that Takaichi means a change of direction for Japanese equities. This weakening was welcome news for Japan's large-cap exporters, for whom the weaker currency gives a meaningful increase in how price competitive they can be in international markets. This phenomenon whereby the depreciation of the yen goes hand in hand with rising equity prices which in turn draw in more buyers to the market is already being termed the 'Takaichi trade'. Importantly, this trend seems to be progressing further, resulting in the yen weakening against all of the major 33 currencies.

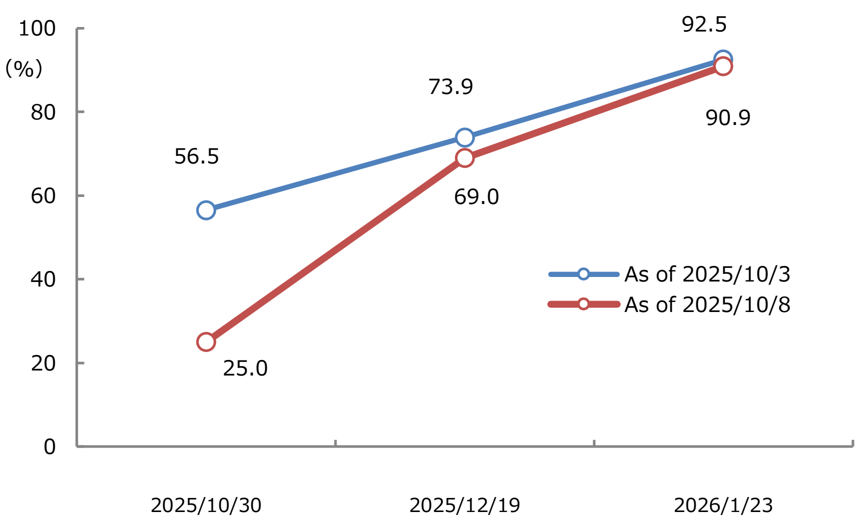
The market may have anticipated and already priced in a cycle of accelerated yen depreciation to some extent due to Prime Minister Takaichi's comments on fiscal and monetary policy. She is generally in favour of accommodative monetary policy, and the markets seem to be reading this as likely to create the conditions for further yen weakening if rate rises or other quantitative tightening measures are postponed.

However, speculative capital flows might also be reflected in the movements in the foreign exchange market to some extent. If the yen's depreciation progresses further, attention will likely turn to the actions of the Ministry of Finance and at what level they might signal that they are uncomfortable with this slide.

How low is too low?

As these momentous political developments unfolded, the USD/JPY exchange rate has rapidly progressed towards a stronger dollar and weaker yen, and on October 8 the foreign exchange market saw the rate approach 153 yen per dollar at one point. Given that Takaichi is known for her strong inclination towards fiscal expansion and monetary easing, this has intensified the pre-existing movement to sell the yen. As can be seen in the chart below, expectations for an early rate hike by the Bank of Japan have now vanished. On October 3, there was a 57% probability priced in for a 25 basis points rate hike this month, but by October 8, this probability had declined to 25%.

The probability of a Bank of Japan rate hike priced in by the market



Note: The dates on the horizontal axis represent the second day of the Bank of Japan's Monetary Policy Meeting. The probability of a 25 basis point (bp, with 1bp = 0.01%) rate hike is based on the overnight index swap (OIS) rates, which reflect the expected uncollateralized overnight call rate.

Source: Prepared by Sumitomo Mitsui DS Asset Management based on Bloomberg data.

Under these dramatically altered circumstances, the yen has depreciated against a wide range of currencies, resulting in a broad decline against all 33 major currencies during the period from October 3 to October 8.

Further quantitative tightening?

We have discussed previously the expected ramifications of the Bank of Japan's publicised move towards shrinking their balance sheet. In a press conference held after the election, Prime Minister Takaichi expressed her unambiguous intention to set Japan on a fiscally expansionary course. She also mentioned that it is premature to be relieved that deflation is over while neglecting the risk of latent cost-push inflation. She emphasized that a sustained return to demand-pull inflation is the macroeconomic ideal she is aiming for, and indicated her intent to maintain close communication with the Bank of Japan until such a situation is achieved.

These remarks are believed to have contributed to the decline in early rate hike expectations.

Furthermore, if the view that fiscal expansion and postponed rate hikes becomes anchored in investors' minds, this will, in our view lead to a further cycle of accelerated yen depreciation. This could risk a significant spike in cost-push inflation as the weaker currency causes import prices to rise, although in this scenario we expect that the Takaichi government would moderate their policy stance. As Hiroshi Nakaso, Chairman of the Daiwa Institute of Research, recently commented when speaking at SMDAM's Japan Weeks Investment Seminar, Takaichi is known for her flexibility and willingness to be practical when making complex policy choices involving trade-offs.

Will we see central bank or government intervention in the currency market?

However, upon reviewing the chart above, it appears that the probability of a rate hike in December this year or January next year has not significantly decreased. Therefore, it is likely that the accelerated yen depreciation reflects considerable speculative activity in addition to the Takaichi trade. Indeed, for speculators, the current situation where the outlook for the new administration is somewhat unclear presents an opportunity to test how the current government perceives the ongoing yen depreciation. In Japan, the Ministry of Finance oversees foreign exchange policy, and the decision to conduct currency intervention rests with the Finance Minister.

In 2024, rapid yen depreciation led to currency interventions, with intervention levels perceived to be most likely around the 157-yen, 159-yen, and 161-yen ranges. When considering the possibility of currency intervention based on statements from key officials at the Ministry of Finance, it can be summarized as shown in the table below. It is believed that, in making intervention decisions, the Ministry will pay attention not only to specific exchange rate levels but also to the magnitude (volatility) and speed of fluctuations. Therefore, if the yen depreciation progresses further, actions by the Ministry of Finance will likely come under scrutiny.

The possibility of currency Intervention as indicated by statements from Key Officials

Low	<Stage of closely monitoring the market> ・"Rapid fluctuations are undesirable.", "Watching with heightened alertness.", etc. ・The Ministry of Finance, the Financial Services Agency, and the Bank of Japan held a trilateral meeting.
Possibility of Currency Intervention	<Stage of increased alertness> ・"Monitoring with a sense of urgency", "Responding appropriately without excluding any options", etc. ・"In the event of excessive fluctuations caused by speculation, decisive measures will be taken.", etc.
High	<Stage of considering currency intervention> ・Indicating intervention through statements, "We are always prepared", "Rapid changes are unacceptable." ・The Bank of Japan conducted a rate check.

Source: Prepared by Sumitomo Mitsui DS Asset Management.

Contact Details

Sumitomo Mitsui DS Asset Management (UK) Ltd.
100 Liverpool St., London EC2M 2AT, United Kingdom

www.smd-am.co.uk - uksales@smd-am.co.jp

Richard HAXE
Managing Director, Head of Business Development

+44 20 7507 6431

richard_haxe@smd-am.co.jp

Alex BARRY
Executive Director, Head of Sales, UK and Ireland

+44 20 7507 6419

alex_barry@smd-am.co.jp

Chloé CHOQUIN
Director, Business Development

+44 20 7507 6424

chloe_choquin@smd-am.co.jp

Thomas CARTWRIGHT
Director, Business Development

+44 20 7507 6440

thomas_cartwright@smd-am.co.jp

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