



Yen movements and long-term rates: the calm before the storm?

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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.

Our view is that the post-election yen appreciation was driven by an unwinding of short-yen positions amid heightened vigilance over possible FX intervention, as well as multiple factors weighing on the U.S. dollar.

Remarks by Prime Minister Takaichi and others are gradually reinforcing the view that fiscal policy will be pragmatic, potentially easing upward pressure on long-term interest rates by reducing doubts around Japan's fiscal sustainability.

While it remains necessary to calmly and objectively assess the Takaichi administration's fiscal management, we view the risks of a sharp yen sell-off and a spike in long-term interest rates as now very limited.

The dog that didn't bark

For the House of Representatives election held on February 8, markets had largely expected that a victory for the ruling parties would lift equities, weaken the yen, and push long-term interest rates higher. In reality, however, while the Nikkei posted a sharp gain, USD/JPY moved in the opposite direction—toward dollar weakness and yen strength—and long-term rates did not rise significantly. This sudden strengthening of the yen caught many market participants by surprise. Below, we examine why USD/JPY and long-term interest rates moved contrary to expectations and provide an outlook going forward.

Starting with USD/JPY, there was an initial if only brief reaction where a stronger dollar and weaker yen were seen in the early hours of February 9 (Japan time). SMDAM's house view is that this first bout of post-election yen depreciation was limited due to very strong market vigilance over possible FX interventions by the Japanese authorities. In this regard, market speculation that emerged in late January about "rate checks" by the Japanese and U.S. authorities appears to have been a factor, contributing to a reduction in speculative short-yen positions. Additionally, as shown in the table below, the existence of multiple factors weighing on the U.S. dollar likely also played a role in a relative sense.

Key drivers of USD/JPY after the Lower House election

Key Factors	<ul style="list-style-type: none"> • Strong market vigilance over possible FX intervention by the Japanese authorities has curbed yen selling. • Possible reduction in speculative short-yen positions. • U.S. December retail sales came in below expectations (February 10). • Remarks by U.S. Commerce Secretary Lutnick that could be interpreted as tolerating a weaker dollar (February 10: "The current level of the dollar is a more natural level.")
Key Focus Going Forward	<ul style="list-style-type: none"> • The outlook for Japanese and U.S. monetary policy. • Progress in discussions at the National Council on a consumption tax cut for food. • Progress in fiscal efficiency measures led by Japan's version of DOGE (a government efficiency department). • The "Basic Policy on Economic and Fiscal Management and Reform" (the so-called Honebuto Policy), which is expected to be approved by the Cabinet in June.

Source: Prepared by Sumitomo Mitsui DS Asset Management based on various media reports.

Takaichi's balance between responsibility and radicalism

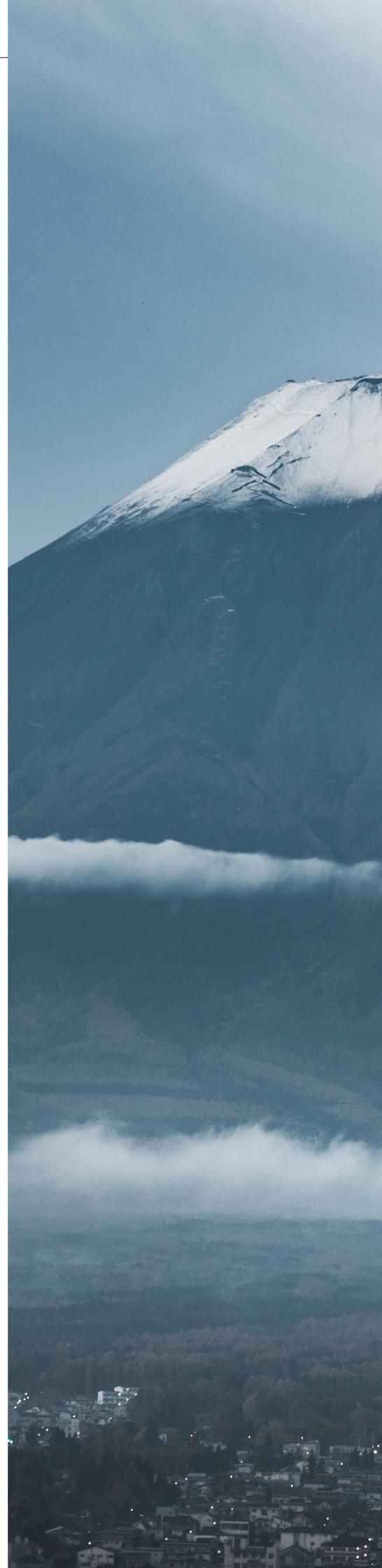
Turning to long-term interest rates, while the 10-year JGB yield rose on the 9th, it fell on the 10th, remaining relatively calm overall and maintaining the heightened level it has reached over recent months. The market had been focused on what Prime Minister Takaichi would say about fiscal management after the Lower House election. At a much anticipated press conference on February 9 she stated that the consumption tax on food would be set to zero for a limited period of two years, that the funding would not rely on special deficit-financing bonds, and that she would like to compile an interim summary at the National Council before early summer.

As can be summed up in the table below, we see the policy measures as part of a broader picture which suggests upwards pressure on long-term rates.

Key drivers of long-term Interest rates after the Lower House election

Key Factors	<ul style="list-style-type: none"> • Prime Minister Sanae Takaichi stated that the consumption tax on food would be reduced to zero for a limited period of two years, that the funding would not rely on special deficit-financing bonds, and that an interim summary would be compiled at the National Council before early summer (February 9). • Finance Minister Satsuki Katayama indicated that the government would conduct a comprehensive review of funds and special accounts, among other items, to secure fiscal resources (February 8).
Key Focus Going Forward	<ul style="list-style-type: none"> • The outlook for the BOJ's monetary policy. • Progress in discussions at the National Council regarding a consumption tax cut on food. • Progress in fiscal efficiency measures led by Japan's version of DOGE (a government efficiency department). • The "Basic Policy on Economic and Fiscal Management and Reform" (the so-called Honebuto Policy), which is expected to be approved by the Cabinet in June.

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In addition, on the 8th, Finance Minister Katayama disclosed on national TV that the government intends to thoroughly review broad government spending to identify where savings on fiscal resources can be made, regarding a cut in the consumption tax on food. In response to these remarks, the view has gradually spread that the Takaichi administration will pursue highly pragmatic fiscal management, and as concerns about fiscal deterioration and accelerating inflation have eased to some extent, we suspect upward pressure on long-term interest rates has declined—also contributing to a check on yen depreciation.

Has the worst volatility already passed?

However, we believe it will still take time for the Takaichi administration's fiscal policy to win the market's confidence, and we continue to see an environment in which yen depreciation and rising long-term interest rates could occur relatively easily. That said, even if USD/JPY moves back above 157 and the dollar strengthens against the yen, a rapid move beyond 160 seems unlikely given strong market vigilance over potential FX intervention. In addition, when assessing the outlook for USD/JPY, monetary policy by the BOJ and the U.S. Federal Reserve will also be in focus.

For the 10-year JGB yield, the key question is whether it will break above the recent 2.35% level. Exactly how the Takaichi administration's patented 'responsible proactive fiscal policy' will be implemented remains to be seen, and attention will be on discussions at the National Council as well as progress in fiscal efficiency measures led by the Japanese version of DOGE (a government efficiency department bearing some limited resemblance to the US department briefly led by Elon Musk).

Our view is that while the broad direction of the Takaichi administration's fiscal policy may be expansionary, it is highly likely that her and her team will show some regard for fiscal discipline given the need to keep the bond market calm. This means Takaichi is unlikely to be fully unrestrained in her approach, and accordingly, we see limited risk of a sharp spike in long-term interest rates.



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