Express Insights

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بنك أبوظبي التجاري
ADCB
ASSET MANAGEMENT LIMITED

Bottom line: given the recent sharp rally in Nikkei 225 and rising risks of a pullback, we closed our off-benchmark position, but remain neutral Japanese equities in our Tactical Asset Allocation.

- **Japan's GDP growth is anemic, and inflation is closer to the central bank's target.**
- **The BoJ faces several challenging decisions at its upcoming policy meeting next week; we think a hawkish pivot is more likely.**
- **Recently Nikkei 225 scaled its new all-time high by moving above the high reached 34 years ago.**
- **Stay neutral Japan in our TAA but remove our off-benchmark position in FX-hedged Nikkei 225.**

- **Why we closed our off-benchmark position in FX-hedged Japanese equities:** In our recent note "Tactical Asset Allocation: Waiting for a pullback, March 7 2024", we closed our off-benchmark position in Nikkei 225 index which we held for the best part of the past year. Nikkei 225 performed strongly YTD by rising c19% in local currency terms till March 6, 2024. After this sharp run higher, Japanese equities now look technically overbought. Prospective USD weakness and possibility of hawkish BoJ pivot leading to stronger JPY could begin to weigh on the corporate profitability. However, over the 12-18-month horizon, we still see value in Japanese equities. Corporate governance reforms could pave the way for improved profitability. In the following sections, we take stock of the top-down investment case for Japanese equities.
- **Growth and inflation:** Japanese economy registered weak growth during Q3 and Q4 of 2024. The initial reading of Q4'24 GDP growth was negative which along with the negative Q3'24 growth meant that the Japanese economy slipped into a technical recession. However, the second release of Q4'23 GDP surprisingly turned positive. Nevertheless, Japanese growth remains weak. Inflation has not been a major problem for Japan though the recent months saw inflation print above central bank target of 2%. After all, it was a welcome development for Bank of Japan which struggled with deflation for years. Core inflation slowed in January for the third straight month, holding steady at the BoJ's target. As a result, the real wage growth has remained negative for almost two years now, making the spring wage negotiations in Japan even more important in framing the central bank policy. On Shunto wage negotiations, labour unions are asking for a 4.5% base pay hike – biggest pay revision requested since 1994.
- **Bank of Japan policy:** BoJ now faces several challenging decisions at its upcoming policy meeting on March 18-19. Most important of those would be relating to the practicalities of raising interest rates for the first time since the summer of 2006. Negative interest rate policy (NIRP), Quantitative easing (QE), and Yield curve control (YCC) have all helped Japanese economy in the past. More specifically, negative interest rates and yield curve control have pushed Japan's real borrowing costs to lowest in decades. Therefore, as the BoJ debates ending or tweaking its monetary policy, financial markets – especially FX – are likely to remain volatile. We think a hawkish pivot by BoJ is more likely given the strong wage negotiations, and stronger than expected second release of Q4'23 GDP print.
- **Fixed income and FX:**

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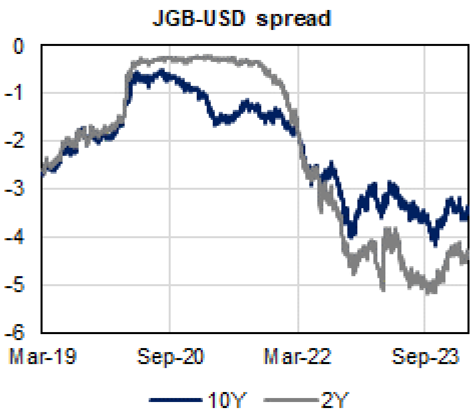
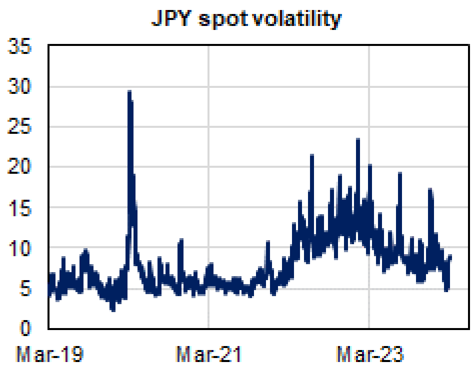
- Thanks to QE and YCC policies, BoJ's ownership of government bonds has ballooned to reach JPY576trn at end of Q3'24. Despite the number of technical tweaks to the YCC framework, yields on Japanese Government Bonds (JGBs) remained range-bound and reasonably well-behaved. Nevertheless, the vast scope for the JGB-USD yield differential to narrow is noteworthy.
- For FX too, implications of BoJ policy can be profound. Whatever BoJ decides, we can be confident that the path to policy normalization will mean different direction to those taken by the US Federal Reserve and the European Central Bank. While the latter two are likely to cut rates this year, BoJ is likely to be the hawk. This would mean that Japanese Yen (JPY) is likely to be supported over the medium-term. Accordingly, in our note Tactical Asset Allocation: Waiting for a pullback, March 7 2024, we introduced the trade of "USDJPY lower" with a target of 135 and stop at 160.

JGB-USD spread normalization will have a large room to run



Source: LSEG Workspace, and ADCB Asset Management

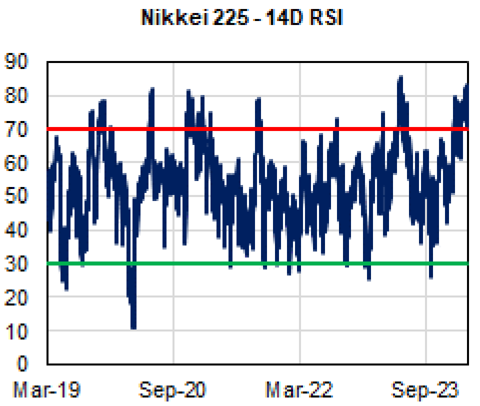
JPY volatility is low and has scope to rise



Source: Refinitiv, LSEG Workspace, and AD Management

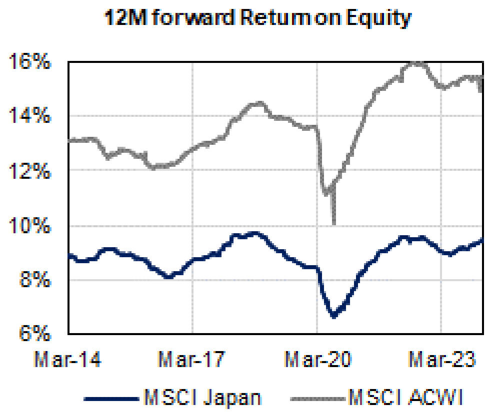
- **Equities:**
  - Recently Nikkei 225 scaled its new all-time high after moving above the high reached about 34 years ago. While the launch of Abenomics in 2012/13 marked a revival in fortunes for the Japanese equities market, more recent efforts by Tokyo Stock Exchange to raise corporate valuations have catapulted the equity indices to new highs.
  - We remain constructive on Japanese equities for the medium term (12-18 months). Corporate reforms and improving outlook for corporate profitability alongside light positioning for several decades makes Japanese equities attractive. We therefore stay neutral on Japanese equities in our TAA framework.
  - However, just like most other equity market indices, Nikkei 225 too looks overbought on technical parameters after a 19% (in JPY terms) rise since start of this year. Further, any hawkish commentary/actions from BoJ could cause a rise in JGB yields and contribute to JPY strength against the USD. A stronger Yen has historically not worked well for Japanese equities in local currency terms. To reflect this, we closed our off-benchmark position in FX-hedged Nikkei 225 – a position we held for the best part of last year.

Japanese equities look technically overbought



Source: Nikkei, LSEG Workspace, and ADCB Asset Management

Over the medium to long-term Japanese equities could be supported by improving RoE



Source: MSCI, I/B/E/S, LSEG Workspace, and ADCB Asset Management

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