Japan Market Commentary FAQ

Japanese yen trends and the impact on investments in Japan, June 2024

Recently, the Japanese yen has been falling in its value against the U.S. dollar. Below, we provide our responses to key questions we have received from clients regarding this trend and the impact it has on investments in Japanese equities.

Q: Does the falling yen represent the demise of Japan as an economic power?

A: We do not believe so. On the contrary, Japan's macro economy is strong right now, and the country is breaking free of the past three decades of a deflationary economy. Prices of goods are increasing as businesses push the cost of inflation to the consumer prices. Wages are increasing on the back of the labor shortage to support consumption. The Nikkei stock index reached its highest level in its history in February 2024, breaking the 30+ year slump. The yen had reached its highest level (80 yen per dollar or stronger) in 2011 and 2012 when the country's macro economy was at its worst state following the damage caused by the great financial crisis, the Great East Japan Earthquake, and the subsequent nuclear power plant accident. Currency exchange rate does not necessarily represent the strength of the macroeconomy.

Q: Then why is the Japanese yen falling so much?

A: The biggest factor that determines the exchange rate between yen and dollar is the differential of short-term interest rates/policy rates by the Federal Reserve Board (Fed) and the Bank of Japan (BoJ). While the Fed maintains a high policy rate to contain ongoing inflation in the U.S., the BoJ maintains a low/near-zero policy rate as Japan's macroeconomy is recovering from the COVID pandemic and is getting out of the decades-long deflation. The directional difference between the central banks is resulting in a strong dollar and weak yen.

Q: Why doesn't the BoJ raise interest rates to defend the yen?

In general, the first priority of central banks is tackling inflation/deflation, not controlling foreign exchange rates. In the BoJ's case, the regulator monitors the long-term trend of macro data, including consumer prices and wage trends, to decide its monetary policy. As Japan is getting out of a deflationary economy and real wage growth exhibits improvement this year, we believe the probability for the BoJ to raise its policy rate may increase going forward.

Q: What is the impact of a weaker yen over the performance of Japanese equity strategies?

A: If you do not hedge against currency exchange fluctuations in Japan, a weaker yen is simply a headwind to investment performance. For example, if a stock's performance is listed in local currency (i.e. yen) and the yen falls by -10% against the U.S. dollar, then the performance denominated in the U.S. dollar would be down -10%. The opposite is true when the yen rises against the U.S. dollar. Conversely, if the yen appreciates by +10% against the U.S. dollar, it would be a +10% tailwind for the performance of the local currency assets.

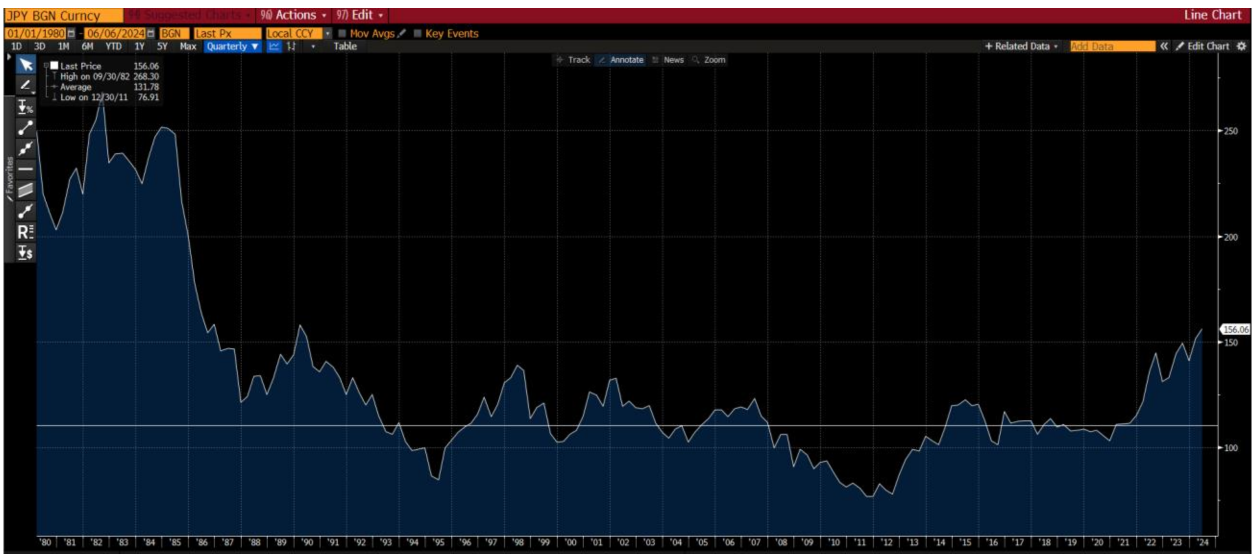
Q: Will the yen keep falling going forward? When and where will it stop?

A: We do not believe there will be a significant decline in the yen from this point. Historically, the value of the dollar vs. the yen has seen fluctuation from time to time, depending on the policy rate differential between the central banks, while the exchange rate has generally been mean-reverting. The average dollar/yen exchange rate was around 110 yen per dollar since 1985, when the dollar was de-valued to the current levels as a result of the Plaza Accord.

Bottomline: Try to take advantage of the currency fluctuations

Never say never, but we believe that the yen is not going to lose its value forever. Similar to other financial instruments in general, when the prices move to an extreme, people overreact from the long-term perspective (e.g. buying at the peak or selling at the bottom). From a historical perspective, when the yen appears to be at its cheapest level, it may be the best time to buy Japanese assets. Indeed, many current travelers visiting Japan are taking advantage of the strong dollar/cheap yen ratio and enjoying a spending spree in Japan. Why not investors?

The long-term trend of USD/JPY rate since '80s



Source: Bloomberg

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