United Japan Discovery Fund:
SMDAM's House View on the monetary policy
As at 28 December 2022

SMDAM changed the forecast on the Japanese monetary policy on 20th December 2022.
Currently Forecast: BOJ to remove negative interest rate policy in June 2023.
(Previous Forecast: BOJ to expand the tolerable band for 10-year yield in April 2024 (around ± 0.25% ➔ around ± 0.50%))

- The BoJ announced to expand the tolerable range for 10-year JGB yield (from around ±0.25% to around ±0.50%) on 20th December 2022. The decision was fairly earlier than our expectation of taking place in April 2024. According to the BoJ's statement and Governor Kuroda's press conference, the reason of the policy change was to modify the conduct of the yield curve control on the back of the deteriorated function of bond markets. The BoJ stressed that it expects the measure to facilitate the transmission of monetary easing effects and enhance the sustainability of monetary easing. Based on the recent observational media reports on the possible revision of the Joint Statement* by the government and BoJ, it seems that this policy change is not unrelated to political factors. These observations pointed out that Kishida administration would discuss the revision with the BoJ's next governor rather than Kuroda. As there is still some time before the change of governor in April 2023, expectations for policy change will likely rise due to speculation that the joint statement will be revised, making it more difficult than ever to maintain the 10-year yield at the upper end of the band at 0.25%. The BOJ appears to have been aware of this and acted preemptively this time.

- Regarding the contents of the possible joint statement revision, it is reported that, "While maintaining 2% inflation target, the phrase 'to be achieved as soon as possible' could be removed. Expression change is also likely to be considered in order to make the medium- to long-term target easier to understand.", "The government is considering revising the plan, such as setting a range for the inflation target and providing flexibility in the timeframe for achieving the target, etc.". Although a drastic revision of the 2% target is unlikely, it appears that it aims to loosen commitments. Under these circumstances, the most likely change is to end the negative interest rate policy. We expect the BoJ to lift negative interest rate, which has not been well received by the public and has a large side effect on banks, after making the 2% target more flexible and thereby eliminating the situation where the target has not been met. For the time frame, it is conceivable that the joint statement will be reviewed in April 2023, then instructions for a comprehensive assessment will be given, and the negative interest rate policy will be lifted in June 2023.

- On the other hand, the BoJ is unlikely to steer toward full-scale monetary tightening. Looking at recent articles related to the joint statement stated that "The Kishida administration intends to make sure the revision of the joint statement will not be perceived by domestic and foreign investors as a "exit from monetary easing", leading to a rapid appreciation of the yen and a sharp rise in interest rates and chilling down the Japanese economy." (Kyodo News), "One of the government officials said that an accord is important for the government and BoJ to work together to overcome deflation. Even if it is revised, it is not a story of 'financial tightening.' " (Reuters), we expect the policy change accompanying the revision of the joint statement will be only limited to the lifting of negative interest rates, while the likelihood of further interest rate hike is small.

- We expect that the impact of this change of monetary policy on the economic outlook will be limited and plan to revise our economic outlook in due course. Elimination of negative interest rates means a 0.1% increase in short-term interest rates, and the economic impact is expected to be quite small. On the other hand, the lifting of negative interest rates could swing the yen exchange rate. If the yen appreciates against the dollar by 5 yen, the impact on real GDP will be minimal. Meanwhile, in terms of nominal GDP, it is expected to have an impact of -0.2% to -0.3%, taking into account the effect of curbing inflation. (Currently, due to policies such as gasoline subsidies, the exchange rate sensitivity of prices has decreased to a half level).

*Joint Statement: <Joint Statement of the government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth> established in January 2013.

Quick Comment on Japan Mid & Small cap strategy (from Kimura PM)

The change of YCC at this early timing is of course a surprise to the market, which saw Nikkei 225 decreased by 2.5% in one day. We believe that the change was made to allow the new governor, who is scheduled to take office next spring, to conduct policy more flexibly. Therefore, the future of monetary policy will still depend on the new governor. This point remains no change from previous situation.

With the thin trading volume before Christmas and the end of the year, this news will cause more volatility than necessary in the short term. However, we believe that the market will regain its composure after the new year, when attention will be focused on the new "governor" and his/her actions.

Regarding to my strategy, although the volatility might be high in short term, I believe the impact would be limited as:

- The YCC correction has limited impact on fundamentals of domestic demand companies (Digital transformation, human resource services), which are the focus of Mr. Kimura's small- and mid-cap portfolio. Rather, the fundamentals favor the decrease in energy costs due to the strong yen.

- The healthy financial condition and low financial leverage of the investees in the portfolio also limit the impact of the 0.25% band widen. (The portfolio's equity ratio was 57% as of the end of November 2022).

- The market preferences would shift to domestic demand companies from foreign demand companies given the Yen appreciation.

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