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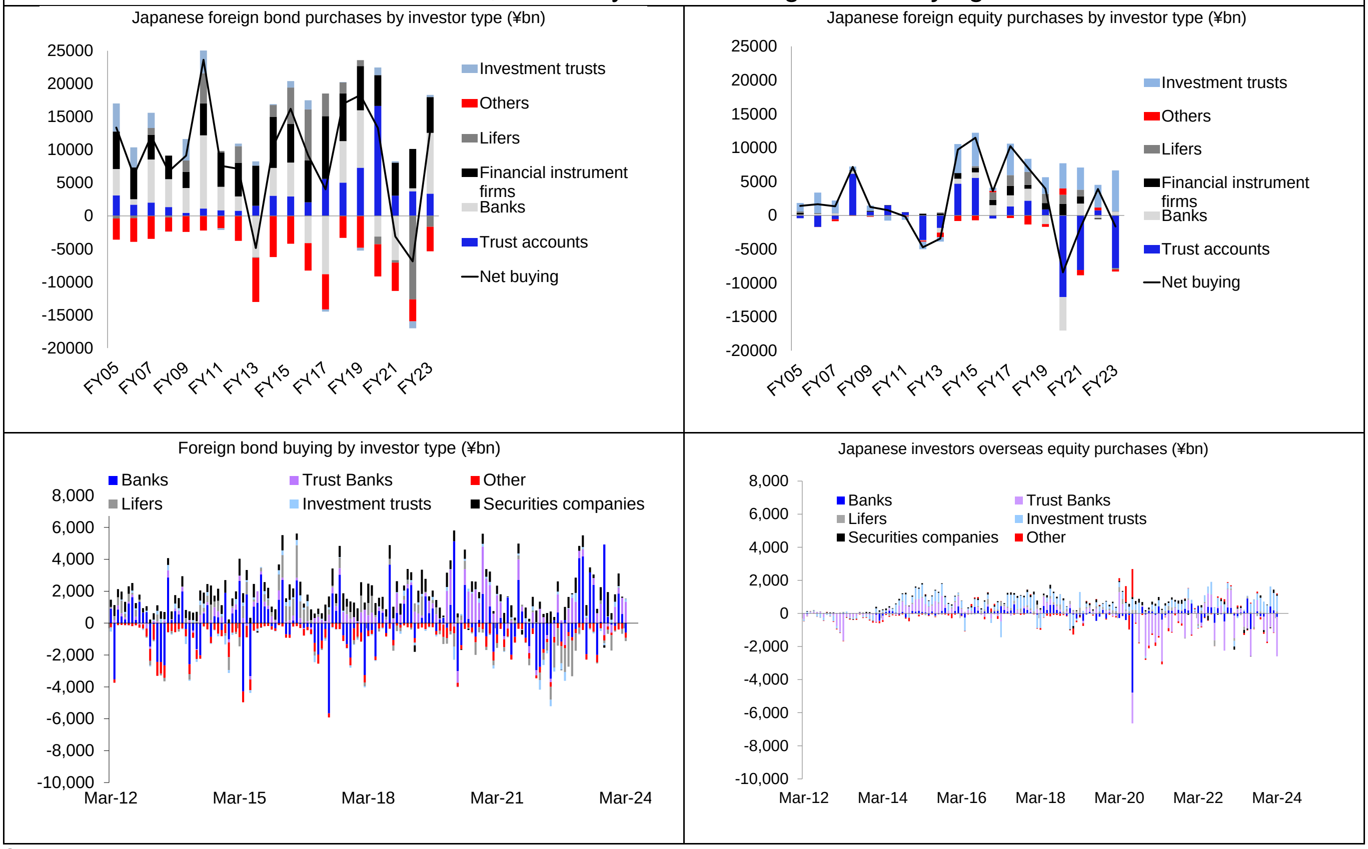
Japan Flows: Flowing into FY24

- **Our baseline forecast sees the relative policy cycle lifting JPY this fiscal year…**
- **However, portfolio outflows in H1 FY24 will likely be a mild drag on JPY…**
- **…limiting the upcoming cyclical upswing**

Banks lead the way in overseas bond markets. Equity outflows are a stalemate
With all of the portfolio flows data now in for FY23 we can look back at recent developments with a view to forming some expectations for activity in FY24. As the charts below illustrate, banks dominated investment in overseas bonds in FY23, supported by trust banks and financial instrument firms. On the equity side of the flows equation selling by trust banks more than cancelled out heavy buying by investment trusts leaving equity outflows in FY23 close to flat.

Portfolio outflows recovered in FY23, driven by banks' foreign bond buying



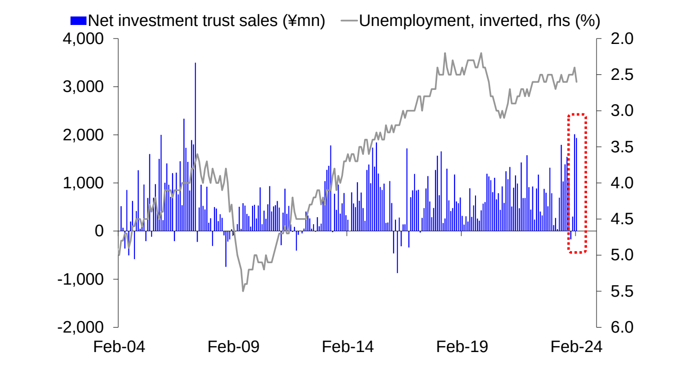
Source: MoF

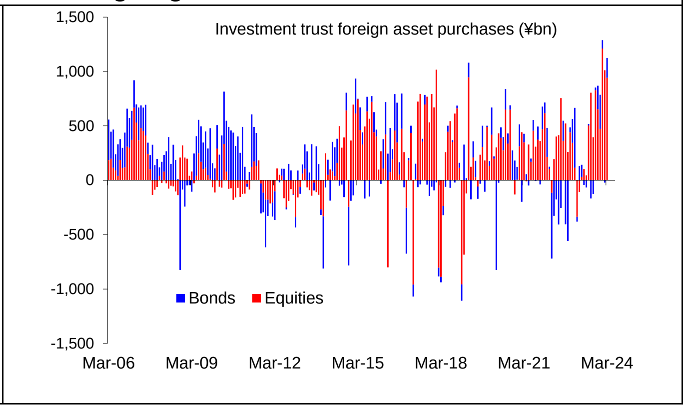
Although the BoJ only exited NIRP late in the fiscal year, it was widely telegraphed by a series of tweaks over the past 15 months. The BoJ is moving incrementally in an effort not to provoke financial volatility and in this aim it has broadly succeeded. We see no signs in the data that the exit from NIRP is set to kick off a major repatriation of funds by Japanese investors. Indeed, given that we see the global economy holding up over the remainder of the H1 FY24 and limited changes in policy rates globally, we broadly expect the trends that prevailed in late FY23 to carry over into the early months of FY24. We do not see the BoJ hike as driving a sea change in Japanese flows. Banks will likely continue to show decent demand for overseas bonds, as overseas central banks gently lower policy rates.

Investment trusts

Investment trust activity is the hot topic in the portfolio flow data in the wake of NISA reforms introduced in Japan at the start of the calendar year. These reforms significantly loosened the rules and increased the volume of funds that individuals can save tax free under the programme. The original NISA, introduced in 2014, allowed individuals to save ¥1.2mn/year tax free for a 5-year period. Since the start of this year, individuals can invest a maximum of ¥3.6mn/year tax free. Early data suggest that not only have inflows into NISA accounts been elevated since the change, but that overseas assets have taken up a higher than usual share of these inflows. This is evident in both the Investment Trust Association data, which show net sales of investment trusts near record highs in both January and February, and MoF's monthly International Transactions in Securities (ITS) report, which show net purchases of overseas equities by investment trusts hitting a monthly record in January (¥1210bn) and remaining elevated in February (¥1011bn) and March (¥942bn). Undoubtedly, these heavy outflows by retail investors, who are the main buyers of investment trusts, are weighing on JPY. However, it is important to note 1) that there are other major investor groups and it is the sum of the parts that is of most interest and 2) there is a decent chance that these flows diminish somewhat as the year progresses and some people fill up their allowance.

Heavy inflows into investment trusts, with much of the cash going overseas



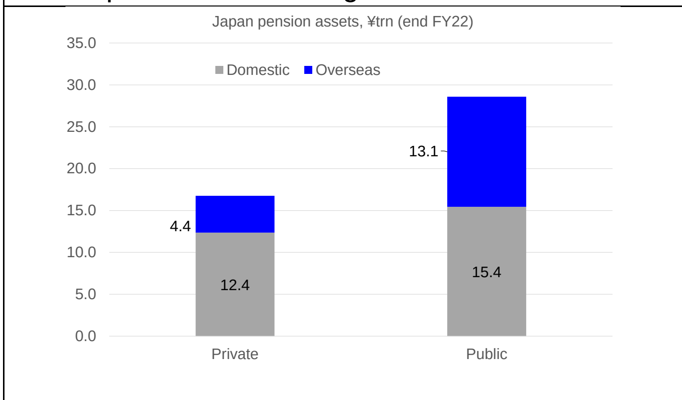


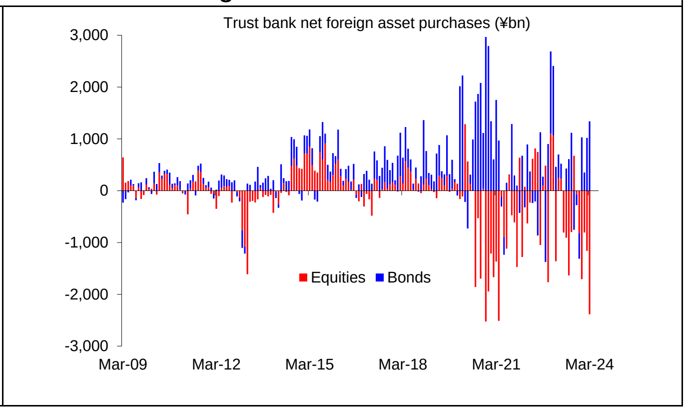
Source: ITA, MoF

Trust banks

The BoJ flows of funds data show that public pensions are larger than private pensions and have a higher exposure to overseas assets. The activity of many public pension funds is largely driven by portfolio weighs. Whilst there is a significant degree of flexibility around these weights, (EG – the GPIF has target weights of 25% for overseas bonds, stocks and domestic bonds and stocks, with deviations of 6~8 percentage points allowed). In practice, they tend to stick quite close to their target weights. Thus Japan's pension funds tend to sell strength and rotate the funds into underperforming assets. Equities have been outperforming, especially in the US. As such Japan's pension funds (which show up as trust banks MoF's ITS report) were large sellers of overseas equities (¥10179bn) in FY23 with a lot of the funds rotated into overseas bonds (¥4715bn). With the yen weakening, we assume that pensions have repatriated some funds back to Japan to maintain domestic asset weights. Many pension funds are happy to take FX risk and do not hedge much. Thus this repatriation flow will have supported JPY countering some of the NISA outflows. Will this continue? It depends on asset markets. We would be surprised if US equities perform so well again this year. We also expect that the yen will perform better this year. We suspect that trust bank flows in H1 FY24 will be more neutral for the yen than they were in H2 FY23.

Public pensions hold a higher share of overseas assets. Rebalancing drives trust bank flows



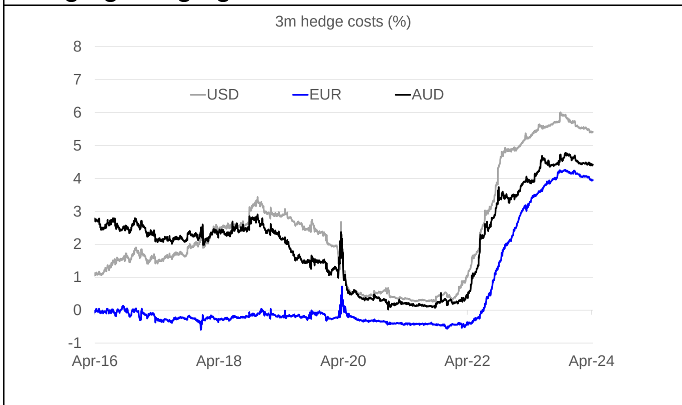


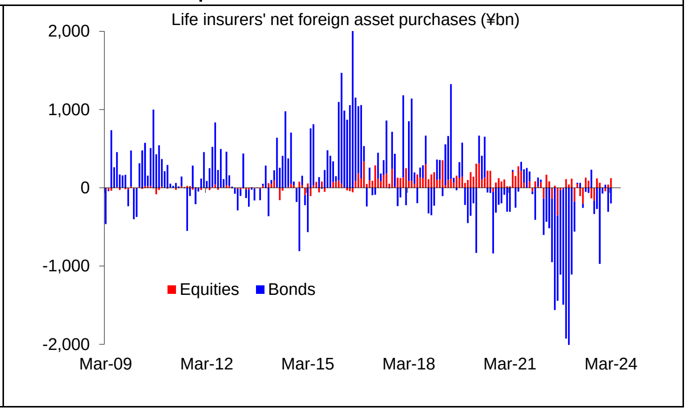
Source: BoJ, MoF

Lifers selling of overseas bonds to peter out in H1 FY24, turn more neutral

Lifers drove the heavy selling of overseas bond in FY22 (¥12629bn) as overseas yields surged and hedging become uneconomic. Since the start of FY23 lifers activity in overseas markets was much more subdued, with net sales of just ¥1834bn. Lifers were heavy sellers as hedging costs rose and almost neutral as they remained high through FY23. Our macro forecasts imply hedging costs will continue to edge lower in FY24 but not by enough to ignite heavy hedging demand by Japan's life insurers. At the same time, the prospect lower policy rates and a stable currency in the near term might see some lifers willing to look at overseas bonds on an unhedged basis. We suspect that the press interviews that the major lifers release in late April will continue to show an interest in JGBs, as they did in October. Nonetheless, we see conditions overseas as more benign and believe that, despite a professed interest in JGBs, some lifers will look overseas in H1 FY24, albeit in modest size.

Surging hedging costs… | …saw lifers dump overseas bonds in FY22



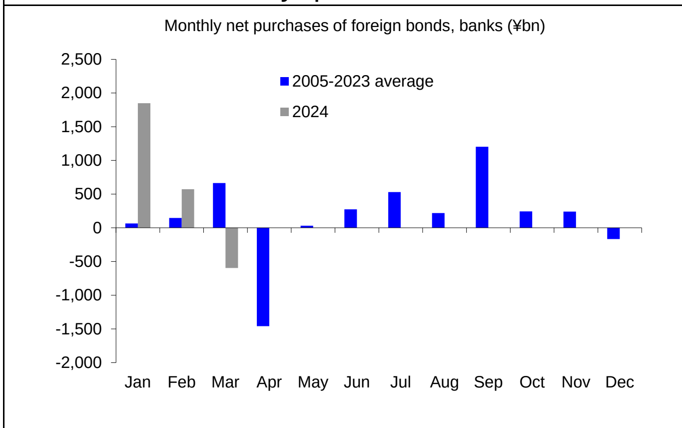


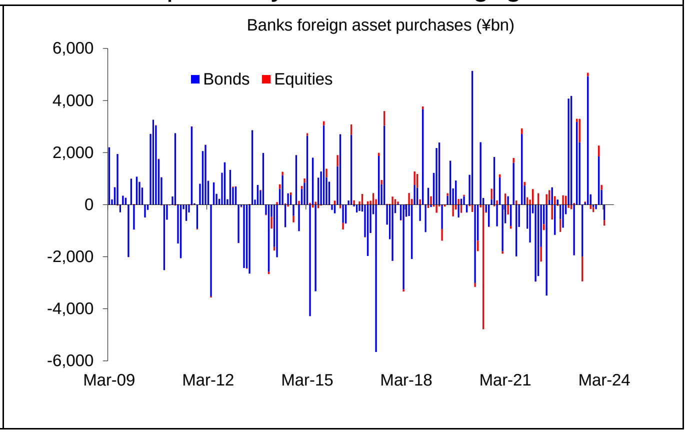
Source: Bloomberg, MoF

Banks likely to remain engaged in overseas fixed income markets

Banks are the most nimble of Japan's major investor groups. Last year they were the largest buyers of overseas bonds among Japan's major investor groups, as the fixed income backdrop turned more supportive. That said, since UST yields peaked in October last year their net purchases have only been modest. It is possible that hitting profit targets early in the year saw banks take a conservative stance in the final months of the fiscal year. This would suggest scope to buy in early in FY24. This is also some evidence that banks are waiting for higher JGB yields before turning their focus to domestic markets, which implies on-going engagement in overseas bonds in the near term. Recall that a lot of bank activity is funded in repo markets, which is why they will be attracted by steeper curves and falling front end yields, that we expect as policy rates outside Japan are lowered across the G10.

Banks were relatively quiet in Feb/Mar… | …but we expect they will remain engaged





Source: MoF

Portfolio flows to limit the cyclical upside for JPY in coming quarters

It remains our base case that the yen will firm as the BoJ hikes and other G10 central banks cut. The bulk of the portfolio outflows that we expect will be driven by banks, which have limited FX impact. However, at the margin, the mild turnaround in lifer flows and the higher investment trust buying of overseas equities, implies a little less upside for JPY. Our 12m target for USD/JPY remains 135, but for now the risks to our view seem to lie on the upside.