RATHBONES

LAND OF THE RISING PRICES

REVIEW OF THE WEEK
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IN A WAVE OF CENTRAL BANK MEETINGS THIS WEEK, ONE OF THEM IS TRULY DIFFERENT. WHILE ALL OTHER DEVELOPED WORLD POLICYMAKERS ARE PONDERING RATE CUTS, ONLY JAPAN IS CONSIDERING RATE HIKES.

This week is what we in the business call a central bank fest. Three of these important monetary policy institutions will meet to discuss whether or not to change interest rates.

The Bank of Japan (BoJ) is first up on Tuesday; it's in a much different place to central banks in Europe and the US. While rates in the West are between 4.5% and 5.5%, Japan's benchmark interest rate has remained at -0.10% since early 2016. Before that, it was 0% right back to October 2010. The last time that rate was above 1% was 1995. Japan has battled deflation – **where prices generally fall each year, rather than rise (the opposite of inflation)** – since 2001. Yet after years of ultra-loose monetary policy, and more recently economic reform, there are signs that victory may be in sight.

Japanese inflation has been above its 2% target since April 2022. And while it has dropped back from roughly 3.3% in the third quarter of last year to 2.2% in early 2024, it's still at a highly unusual level for the nation, going back decades. Meanwhile, wages are rising. In important company salary negotiations this spring, employee pay jumped 5.3% – the largest increase since 1991. BoJ Governor Kazuo Ueda has said that wage growth is one of the necessary pillars for starting to raise interest rates.

This titanic effort to kickstart inflation in Japan has meant persevering with huge differences between the risk-free returns you get on Japanese yen and those of other developed currencies. Assuming inflation of 2% across all nations, the real return on yen is: -0.1% – 2% = -2.1% each year. Meanwhile, for the pound it's: 5.25% – 2% = 3.25%. Because of this huge gulf in attractiveness, the value of the yen has plummeted as investors have sold it and bought higher-yielding dollars, euros and sterling. Since the start of 2022, the yen has dropped about 20% against the pound. Against the dollar, it's fallen even faster. The devalued yen has helped boost the Japanese stock market, but it has also eroded the returns of overseas investors because gains are made in yen, which are now worth less in pounds, dollars and euros.

Pressure has been growing on the Bank of Japan to raise interest rates to start the long journey toward bringing its monetary policy back into a more normal (and sustainable) place. As well as keeping interest rates negative, the central bank has on occasion bought huge amounts of 10-year Japanese government bonds to keep the benchmark bond's yield from rising. Currently, there's a loose "reference point" of 1%. Before October, it was a hard cap at 1% and before July last year the yield was capped at 0.50%. Some market watchers expect the BoJ to ditch this 1% defence line altogether.

For sure, the yen-dollar exchange rate often has a strong correlation with the relative performance of Japanese equities. We also acknowledge that a strengthening yen could be a headwind to Japanese equity performance: Japanese companies' overseas profits, denominated in dollars and euros, will translate to less in yen terms. But its trade-weighted real effective exchange rate is at a 53-year low, so the yen's appreciation would have to be very pronounced to erode the global competitiveness of Japan's manufacturers. What's more, that yen-equity correlation isn't invariant – it has broken down from time to time. It's possible that a mild currency appreciation at a time of ongoing structural improvements in company profitability and renewed foreign interest in investing in Japan may mean we are about to go through one of those moments again.

Divergent paths astride the Atlantic

The other two central banks pondering monetary policy this week are the US Federal Reserve (Fed) on Tuesday and Wednesday, and the Bank of England (BoE) on Thursday. While we – yet again – expect no change from the transatlantic banks, we think we're approaching the time when rates in Europe and the US will begin to fall. Central bankers' comments should help to thicken the sketch lines of the path ahead.

US headline inflation rose unexpectedly in February to 3.2% from 3.1%. This was quite broad based, particularly across all types of services. It has further dampened expectations of the number and timing of rate cuts. A few months back we had thought markets were getting overexcited – some were assuming five or six cuts. Now they seem to expect two to three. With the US economy roaring ahead unabated, the last mile of disinflation may indeed be the hardest for the Fed.

Here in the UK, rates are forecast to stay flat as well. BoE policymakers are still particularly focused on services-driven inflation (which is highly susceptible to the price of labour) and the state of the jobs market generally. The UK unemployment rate increased by 0.1 of a percentage point in December and wage growth continued to decelerate. And **while UK state labour surveys should be taken with a pinch of salt**, this cooling is corroborated by private market data and surveys.

Because the economy is so much stronger in the US than in the UK, we believe there's a greater chance of rates falling further and faster in Britain than in America. That's why we prefer UK government bonds to US ones – government bond prices tend to rise when rates in their home country fall. After America's hotter-than-expected inflation print, the global bond market appears to be coming around to the same view, with short-term US bond yields rising slightly and their UK counterparts' falling considerably. We believe there's still a way to go before that disconnect between the two paths of interest rates are fully accounted for in prices.

Finally, **our client survey of financial well-being** has been published. It reveals interesting differences in concerns between northern and southern clients, from global warming and geopolitics to property crashes, the cost of retirement and setting children up for their adult lives. We hope you find it interesting.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.