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BoJ hike delay a bellwether of bad weather?

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Despite being at the head of the queue for tariff deals, Japan does not seem near to securing one just yet. Wariness over economic growth uncertainties in the coming months has led the BoJ to delay the achievement of its inflation target, and we now do not see it hiking rates again this year. While all this does signify elevated risk levels in the near term, investors should nonetheless avail themselves of pockets of opportunities to bolster portfolio returns in both the equity and FX markets.

The careful rhetorical calibrations that Japan's Finance Minister Katsunobu Kato is having to do over whether Japan's holdings of US Treasuries are being used in ongoing tariff negotiations with the US highlight the tension and uncertainty that underpinned BoJ Governor Kazuo Ueda's negative tone at last week's monetary policy meeting. The BoJ kept its policy rate unchanged and pushed back the timing for achieving its inflation target to FY27 (2Q26-1Q27), from the latter half of FY26. Consequently, we maintain our forecast of no hikes this year, which we made right after the US's "Liberation day". We also expect the BoJ to only achieve its terminal rate of 1.00-1.25% in 2027 at the earliest. Is this an omen of stormy weather for the global economy in the months ahead?

To be clear, we actually see a distinct possibility of an early US-Japan trade deal as both sides are incentivized to pursue this. For Japan, the Ishiba government will be keen to reach an agreement before the Tokyo Prefectural Assembly election campaign starts on 13 June as this is likely to have implications for the subsequent Upper House elections. For the US, a US-Japan agreement would serve nicely as a model for other trading partners ahead of the 9 July deadline for the pause on "reciprocal tariffs".

Aside from the motivation, the mode for achieving such a deal also exists. Japan can offer the US increased investment and/or export access to segments like rice, autos, liquefied natural gas (LNG), defense equipment, and shipbuilding. While an extended period of elevated mutual tariff rates between the US and China will still weigh on the global and Japan's economies, there are ways that investors can cushion their portfolio returns against the ongoing uncertainty.

JGB yields range-bound but JPY likely to appreciate gradually. With the delay in future rate hikes, we expect the upward pressure on JGB yields from the BoJ's balance sheet reduction to be largely negated by the downward pull of falling UST yields. This should leave the 10-year JGB yield in the 1.2-1.3% range through 2026. Apart from a potential near-term USDJPY rebound to 146-148, we expect the pair to trend lower to 140 by end-2025 and 138 in 1Q26. This would be driven primarily by sustained diversification out of the USD thanks to concerns about US policymaking, and narrowing US-Japan interest rate and yield differentials as we expect the Federal Reserve to cut its policy rate by 100bps from 3Q25 through 1Q26. Given elevated USDJPY volatility, we favor selling USDJPY price upside for yield pickup, in light of our medium-term bearish USDJPY view.

Remain neutral and selective on Japan equities. In the wake of the recent market rally, the risk of US pressure on exchange rates and elevated volatility will likely ensure that short-term upside will be limited. Valuations appear to have bottomed at 12x price-to-earnings, near the lower end of the historical 11-16x range, but we expect stocks to remain range-bound until downward earnings revisions have run their course. We anticipate the earnings trough to become evident in the full-year or the June quarter results. We currently have a slight tilt toward domestically-oriented sectors such as some IT services and real estate names, with selective global cyclical exposure in health care, machinery, and tech.

Target potential outperforming regions, sectors, and currencies. Despite moving global equities to Neutral (from Attractive), we still favor broad exposure to US, India, and Taiwan equities. We also favor our bespoke themes of Transformative Innovation Opportunities—Artificial intelligence, Power & Resources, and Longevity—which we think offer long-term potential for outperformance. Another thematic—Six ways to invest in Europe—offers a timely avenue to gain exposure to the revival in investment spending in Europe. In the FX space, we particularly like the oversold AUDUSD as a strong domestic economy will likely allow the RBA to cut policy rates by less than the Fed.

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