Deflation Threatens to Push Yen Higher on Japan Real Yield Gain

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By Chikako Mogi

(Bloomberg) -- The prospect of reflation in the U.S. stands in stark contrast to deflation-prone Japan again, pushing the east Asian nation's real yield advantage to its widest in nine years and threatening to ignite a rally in the yen.

The gap between 5-year inflation-protected bond yields in the two countries hit its most negative since 2012 at the beginning of the month, as U.S. inflation expectations pushed higher and Japan's languished. The spread has shown a close relationship in the past with the dollar-yen and suggests the greenback has further to fall against its Japanese counterpart, following its 5% decline in 2020.

"Japan's real yields are high and are rising with deflation underway," said Tohru Sasaki, head of Japan markets research at JPMorgan Chase & Co. "The real yield gap widening in the negative is very significant. It may eventually drag the yen higher."

Consumer price growth in Japan excluding fresh food -- a measure closely watched by the country's central bank -- has been negative or zero since April. Expectations for future inflation -- derived from 5-year breakeven rates -- sit at minus 0.12%. Equivalent U.S. breakevens are at 2.16%, up over 60 basis points and rising since November, as investors bet further stimulus under new President Joe Biden will help reflate the American economy.

Yen at 100

The result is a higher real yield in Japan, where 5-year inflation-protected notes trade around zero versus minus 1.73% in the U.S., increasing the relative attractiveness of the country's bonds and its currency.

The yen touched a 10-month high against the dollar in early January when inflation expectations in the U.S. rose before paring gains. Strategists expect the currency to break the closely-watched barrier of 100 per dollar this year.

A stronger yen would cause a headache for the Bank of Japan which has failed to boost prices despite seven years of aggressive monetary easing. The central bank has limited options to act in a world where currency intervention is closely policed and a significant shift away from its yield-curve control policy is unlikely.

Structural Pressure

A lack of inflation isn't a uniquely Japanese issue, with structural changes, aging populations and global competition all helping weigh on prices in other advanced economies. But the problem is being exacerbated by the priorities of Prime Minister Yoshihide Suga, who is keen to cut mobile phone fees and subsidize travel costs to boost the economy.

"These government policies are putting downward pressure on prices, without which, prices would have stayed around zero," said Mari Iwashita, chief market economist at Daiwa Securities

Co. “This is not the area where the BOJ can step in.”
JPMorgan’s Sasaki agrees, suggesting there is little more the central bank can do to impact prices and therefore real yields under its current policies. That means deflation will push the yen’s equilibrium exchange rate stronger and stronger, he added.
“It’s a fundamental issue of boosting productivity or the potential growth rate,” he said.

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