

Japan Bridge: Weekly Outlook

September 15, 2024

Our focus next week:

9 candidates managed to register for the LDP president elections and over the past week Japan and the market saw multiple presentations of policy platforms, press conferences and debates. Building on current economic growth in an upswing, record wage hikes over the past two years, and real wages in the process of turning positive, all candidates simply promised more growth, higher wages and political reform. Painful measures were avoided.

For the market next week therefore, there was nothing that would require an immediate reaction. The only opinion that stuck out was Sanae TAKAICHI stating that BOJ had hiked too early, implying that she would lean on the Bank to pause. She is not the front runner, but she still has a path to victory if the conservative side of the LDP bands together behind her to prevent a more liberal winner in round 2.

For the market next week, politics will remain an entertaining side-show. The FOMC decision and particularly the reasoning for the Fed cut will be the key market mover in Japan via the currency.

BOJ on Friday is a non-event in policy terms, but Ueda's comments in the press conference will be critical to form expectations for the rest of the year. Our focus will be:

Has BOJ's inflation overshooting risk assessment changed because of the Yen rally? Currency weakness was the key factor in the July rate hike, and emphasizing increased downside risks would likely put any remaining speculation about an October BOJ hike to rest.

It is critical how the Fed will justify the 25bp or 50bp cut, and how Ueda will explain the implication for Japan? BOJ is quite confident about the domestic economic cycle, and sees downside risks mainly from abroad.

The key dividing line for BOJ therefore is whether the Fed positions the cut as preventive medicine to assure a soft landing, or whether it will look like a reaction to a deteriorating labor market.

The immediate reaction to the Fed cut may be a stronger Yen, but as long as the cuts make a soft landing more likely, then BOJ can continue to focus on the domestic underlying price trend and next year's wage round.

If the Fed cut is presented as a reaction to worsened data then BOJ would likely have to adjust its risk balance down.

A 50bp cut would likely lead USDJPY lower and also give one more downward jolt to JPY rates. However as long as it is defined as preemptive, the simple fact of such a cut would not necessarily stop BOJ's path. In any case, BOJ does not need to make a decision until early next year, so they are in a comfortable spot to watch global events unfold until year end.

Unless one expects a deep US contraction, JPY 1y1y breaking below 0.5% again on a Fed cut would seem like a good opportunity to fade that move.

LDP election:

With so many candidates running and the old faction-based order suspended it is impossible to make predictions with confidence yet. We continue to see Shinjiro KOIZUMI as the front runner. He is the darling of the party base, and despite his relative inexperience he held his ground in recent debates, projecting a confident leadership image. Below our subjective views to the best of our current knowledge:

We believe that 3 candidates have the most realistic path to victory through both round 1 and round 2: Shinjiro KOIZUMI, Takayuki KOBAYASHI and Sanae TAKAICHI.

Shigeru ISHIBA may have a strong showing in round 1, but is unlikely to achieve a broad buy-in by Diet members in round 2.

Toshimitsu MOTEGI, Katsunobu KATO and Yoshimasa HAYASHI would be all viable candidates in the previous LDP framework, but now that the main topic has become political reform and rejuvenation, they are too tainted by the past and don't seem convincing .

Taro KONO and Yoko KAMIKAWA are both reform candidates, but Kono seems too unstable in his political views, while Kamikawa seems to be lacking both a plan as well as party member backing.

Possible market reactions:

A KOIZUMI win would have the biggest potential for an equity rally on hopes that deregulation and reform would become priorities, and he would not be afraid to rattle the system. How much of that can be realized will have to be seen, but he would likely assemble a strong cabinet team, helped by his mentor former PM Suga. His stance on BOJ is not very visible yet, but we would expect his senior cabinet members to broadly follow Kishida's hands-off stance while focusing on wage growth. USDJPY would likely remain driven by the Fed for the time being. Koizumi was most outspoken among the candidates about early national elections, potentially already in November.

TAKAICHI's path to victory is to come in 2nd in round 1, and then try to unite the conservative camp inside the LDP against a candidate that would seem too liberal, or too risky as a reformer. Her personal agenda is rather confrontational conservative foreign and domestic policy. In economic policy terms she does not seem to have a concrete plan besides simply reading from the previous Abenomics playbook. Her clear desire is to have BOJ stay on the monetary accelerator and at least pause normalization. The impact would likely be a weaker Yen and we doubt that her unwillingness to challenge vested interests would be seen favorably by the stock market.

KOBAYASHI's path to victory is most uncertain among the three but still viable. Despite being relatively unknown until recently, he would have to secure 2nd place in round one, nudging out Takaichi, and then try the same conservative game plan as Takaichi would in round 2, but with more of a focus on young LDP delegates and less toxicity. He would have to corral the conservative vote on the assumption that somebody like Koizumi would be too inexperienced and too risky for the LDP establishment as a reformer. Kobayashi could result in a similarly positive equity market reaction like with Koizumi, as a reform candidate, but would likely largely follow the policy vector of Kishida's administration. The hurdle really is to make himself better known over the next two weeks.

Election logistics:

Party members have to vote until 9/26th, and their ballots will be allocated to the 367 votes reserved for them on 9/27th. From 1pm on 9/27th the 367 LDP Diet member will vote, and the combined results will be announced immediately. This could still be during market hours. As no candidate is likely to receive an absolute majority in round 1, the election will immediately proceed to round 2 between the two top runners. There will be no time for negotiations between the camps of candidates who got eliminated, and plans around voting strategy in round 2 will have to be done hypothetically ahead of the round 1 results.

In round 2 the party member votes will be reduced to 47, 1 vote per prefecture based on ballot numbers from round 1. Due to the significant population differences between prefectures, this system favors candidates popular in the regions. In any case it will be the 367 Diet member votes to decide round 2, and the influence of the party base is effectively mainly in selecting the two top runners in round 1. However, compared to past LDP elections with fewer candidates and clear faction based horse trading, the party base with about 1.05 million registered members has a significant influence this time. This is the reason for the lengthy campaign spectacle that is playing out in Japanese media right now. It also means more soundbites and less substance in the discussion, as making promises is easy.

Upcoming key calendar items:

- Sep. 20: BOJ policy meeting and Ueda presser
- Sep. 27: LDP leadership election (starting at 1pm, 2 hrs before market close)
- Sep. 30: Kishida's term as LDP president ends
- Oct. 01: Likely special Diet session to formally elect new prime minister
- Oct. 01: Tankan Report
- Oct.: new Prime Minister will form cabinet
- Oct. 25: Tokyo October CPI (focus on service price hikes)
- Oct. 31: BOJ policy decision with updated Outlook Report
- Nov.: Early national elections possible in November, but not guaranteed
- Nov. 22: October CPI, as critical service price gauge



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