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Market views and strategy

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N° 150 // **March 18, 2024**

Topic of the week: Imminent historic decision from the BoJ

- **The first results of the annual spring negotiations indicate the largest wage increase in 33 years, after the largest in 30 years in 2023;**
- **This increases the probability of a rate hike by the BoJ, for the first time since 2007, from the meeting of March 17 and 18;**
- **The Central Bank has in fact conditioned a change in its ultra-accommodative monetary policy on a sustained increase in wages in order to trigger a virtuous circle between wages and prices and exit from the deflation that raged for 25 years in Japan;**
- **The divergence in monetary policy expectations between the BoJ, on the one hand, and the Fed and the ECB, on the other hand, argues for an appreciation of the yen versus the dollar and the euro.**

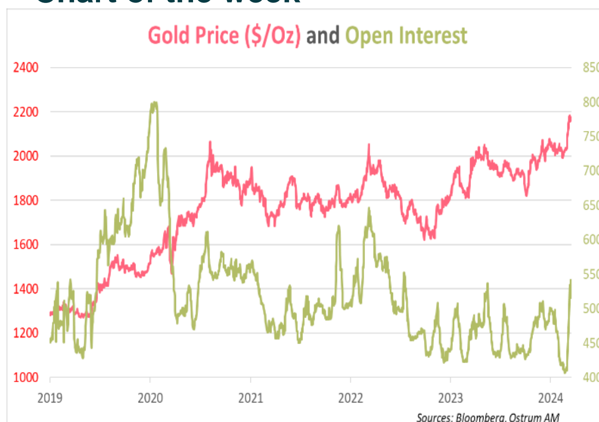
Axel Botte
Head of Market Strategy
axel.botte@ostrum.com

Market review: Will inflation spoil the party (again)?

- **The US CPI surprised with an increase of 3.2% in February;**
- **The T-note rises to 4.30%, the Bund above 2.40%;**
- **Sovereign debt and credit continue to outperform;**
- **Stocks remain well oriented, despite profit taking.**

Zouhoure Bousbih
Emerging countries strategist
Zouhoure.bousbih@ostrum.com

Chart of the week



The price of gold has increased sharply since the end of February to reach historic highs. This was accompanied by a clear increase in long positions on future contracts, indicating a renewed appetite on the part of investors.

This sharp rise in gold, however, occurred without any particular catalyst. Indeed, there have been no significant changes in traditional explanatory factors such as expected rate cuts from the Fed, making gold relatively more attractive, record purchases by central banks or fears linked to geopolitical tensions.

Aline Goupil-Raguénès
Developed countries strategist
aline.goupil-raguenes@ostrum.com

Figure of the week

5

Source : UN

According to the UN, the number of children dying before the age of 5 fell below 5 million for the first time in 2022, which represents a drop of 51% since 2000 and 62% since 1990.

• Topic of the week

Imminent historic decision from the BoJ

The Bank of Japan is set to announce the end of its negative interest rate policy implemented in 2016. The first results of the spring wage negotiations (Shunto) indicate the largest annual wage increase since 1991, after already a clear progression in 2023. The BoJ insisted on the importance of these results to become more confident in the exit from deflation, with a sustainable return of inflation towards the 2% target, and begin to normalize its monetary policy. These stronger than expected figures increase the probability of the announcement of an increase in key rates from the BoJ for the first time since 2007, during the meeting of March 18 and 19.

Strong increase in salaries

The first results of wage negotiations from Japan's main trade union organization (Rengo) were eagerly awaited. The Bank of Japan has in fact insisted on the need for a sustained increase in wages for inflation to return sustainably to the 2% target. The results turned out to be better than expected. Large companies announced an average annual salary increase of 5.28% in 2024, the largest increase in 33 years, after an increase of 3.58% in 2023, which was the largest increase in 30 years. The basic wage, which excludes salary linked to seniority, has also increased significantly: 3.7%, compared to 2.1% in 2023. This increase is stronger than the 3% necessary to achieve inflation of 2% (figure previously communicated by the BoJ).

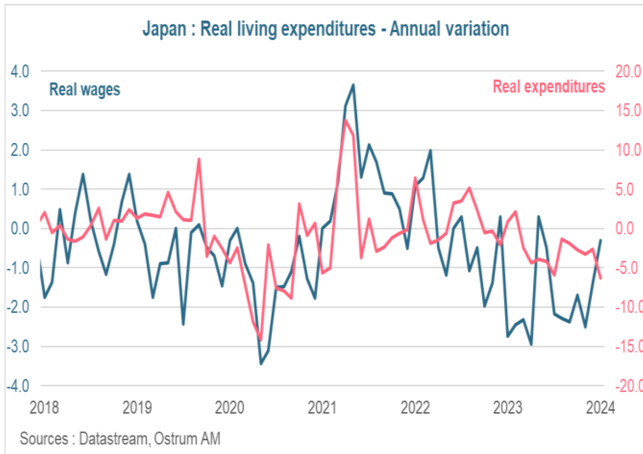
As the following graph shows, a break took place in 2023, putting an end to 25 years of low wage growth characteristic of the deflation period. The increase in salaries had been on average 1.9% per year between 1999 and 2022 (wages linked to seniority included).

After 25 years of stable prices and wages, which have become the norm for companies, they are changing their behavior. They increase their prices and wages without fearing a drop in their sales. The explanatory factors lie in particular in the sharp rise in profits to record levels, government tax incentives to encourage companies to increase wages as well as significant labor shortages.

Virtuous circle between wages and prices

The fact that wages show a clear increase in 2023 and will show a sharper one in 2024 is very reassuring for the Bank of Japan. This will be likely to encourage households to increase their spending and strengthen Japanese growth, which narrowly escaped recession in the second half of 2023. Faced with this stronger demand, companies will be more inclined to increase their prices and allow inflation to return to 2% sustainably. This is why the BoJ is very attentive to the evolution of wages to trigger, in its terms, a virtuous circle between wages and prices and put an end to deflation.

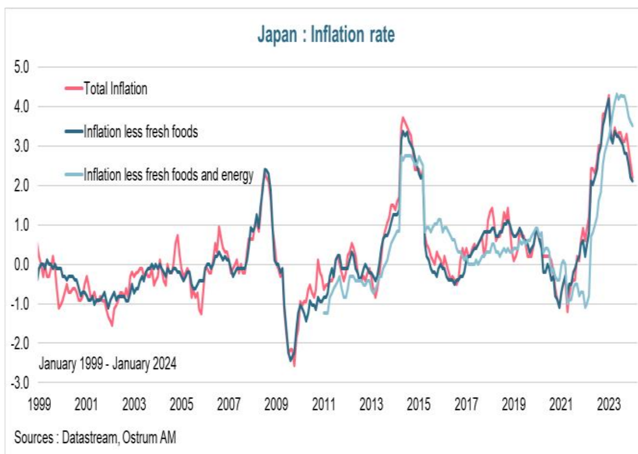
For the moment, real household spending has been contracting since March 2023 (-6.3% year-on-year in January 2024) due to losses in purchasing power linked to high inflation. The nominal increase in wages in 2023 was not sufficient to offset the impact of the price rise, which resulted in a drop in real wages (-0.3% in January 2024 after -2.9% in April 2023).



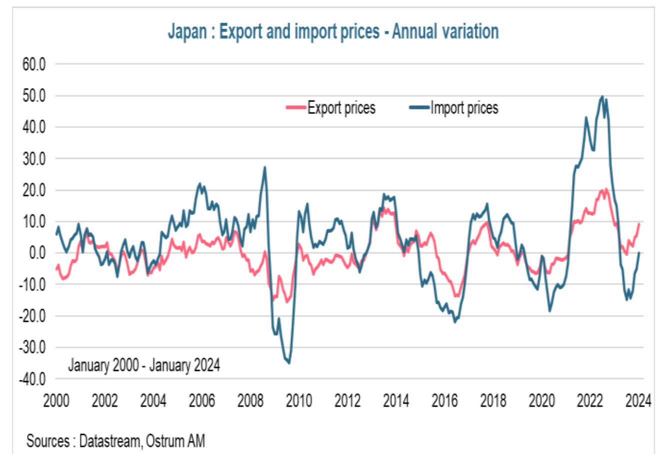
The fact that wages accelerate in 2024 in a context of a tight job market should allow households to benefit from an increase in their real income, which will support their consumption and reinforce the positive dynamic on prices and allow Japan to escape from deflation.

Return of inflation towards 2%?

Like all countries after the Covid-19 crisis, inflation accelerated sharply in 2022 in Japan to exceed 4% in April 2023 then moderate to return to 2.2% in January 2024.



This inflation was initially mainly due to the price of imported goods. This notably reflected the sharp increase in the price of energy, raw materials, food and goods following the strong post-Covid recovery and disruptions in supply chains. The price of imported goods increased by almost 50% over one year between June and September 2022, before sharply declining and falling from April 2023. They remained almost stable in January 2024 (-0.1% over one year) as shown in the following graph.



Inflation is therefore no longer dependent on changes in the prices of imported goods but on domestic factors. In this context, inflation excluding fresh products and energy (in sky blue in the 3rd graph) also exceeded 4% between April and September 2023 before moderating to remain high. It stood at 3.5% in January 2024. This reflects in particular the rise in prices in the service sector, which is more labor intensive and crystallizes the impact of wage increases. The establishment of a wage-price loop thus allows the BoJ to be more confident that inflation will return to 2% in the long term and is not just a transitory phenomenon as was the case previously.

BoJ: March or April?

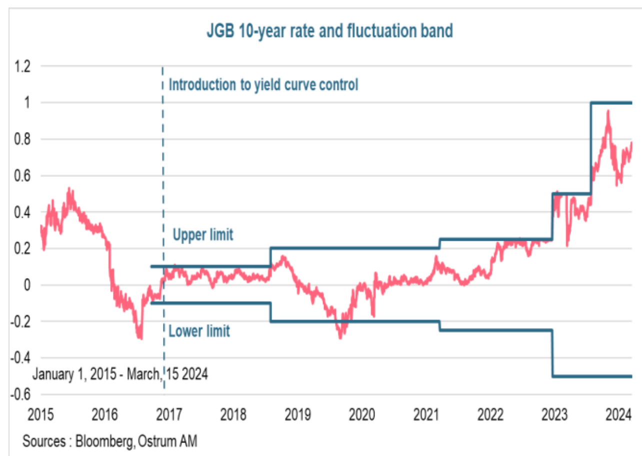
The BoJ made a change in its ultra-accommodating monetary policy conditional on the results of the spring wage negotiations. Rengo's announcement of the largest wage increase since 1991 increases the likelihood of an announcement this week, at the March 18-19 meeting.

The BoJ could, however, decide to wait until April in order to have the results of wage negotiations in small and medium-sized companies which represent the vast majority of the industrial fabric. It will also have detailed results by sector and in particular wage increases in services which had been more moderate than in other sectors in 2023. Waiting for the meeting on April 24 and 25 will also allow the BoJ to better prepare the markets to the changes it will make and to explain them in its report on the outlook for activity and prices.

In any case, a decision from the BoJ should come in March or April, before the Fed and the ECB announce a cut in their key rates to make their monetary policy less restrictive.

Increased probability of a decision on March 19

A Nikkei article on Friday indicates that the BoJ has started to take steps to exit the negative rate policy. It reports that the rate should go from -0.1% to a range between [0; 0.1%] in order to keep short-term rates close to 0. The newspaper also indicates that the BoJ could end its policy of controlling the yield curve by stopping the control of the 10-year rate in place since September 2016. This policy aims to maintain long-term rates at a low level by establishing a target around 0% for the 10-year rate and the establishment of a fluctuation band to regulate it, while maintaining the intervention rate in negative territory, at -0.10%, and this since January 2016. The fluctuation band has been raised several times to allow better functioning of the markets. In October 2023, the BoJ indicated that the upper limit of 1% was a reference and no longer a strict limit in order to give more flexibility.



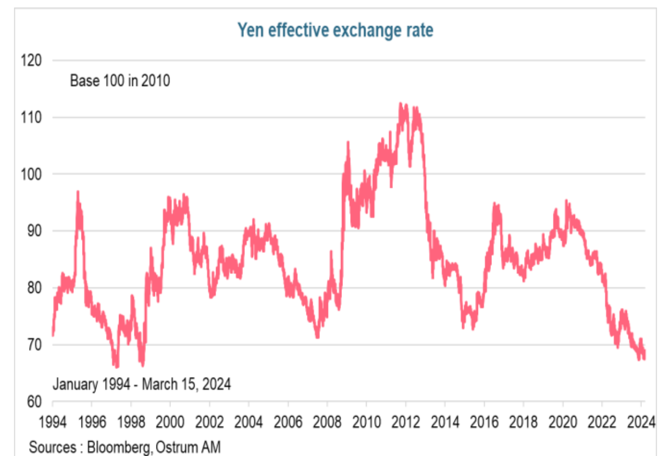
Sources : Bloomberg, Ostrum AM

To avoid excessive tensions, the BoJ should continue to buy government bonds to keep long-term rates low. Currently, its monthly purchases of Japanese government bonds are of the order of 6 trillion yen per month, with some flexibility, or $40 billion. Maintaining this pace would help avoid volatility on long rates. On the other hand, it could stop its purchases of ETFs and real estate investment funds.

Thereafter, the normalization of monetary policy will be very gradual. The BoJ aims to maintain a monetary policy that is still very accommodative in order to allow internal demand to strengthen and reinforce the virtuous circle between wages and prices which has just begun. The rise in rates from the Central Bank and the presence of the BoJ on the bond market, to limit tensions on long rates, argue for a flattening of the yield curve, particularly the 2-10 year segment.

The yen will be the big winner

The effective exchange rate of the yen is currently at its lowest levels since 1998 due to the fact that the BoJ is the only central bank to have maintained negative rates while the other central banks have raised them sharply to combat a too high inflation. This is about to change. The BoJ should carry out its first rate increase in March while the Fed and the ECB are preparing to lower their key rates probably in May for the first and June for the second. This divergence in monetary policy expectations argues for an appreciation of the yen against the euro and the dollar over the coming months.



Sources : Bloomberg, Ostrum AM

Conclusion

The first results of the spring wage negotiations portend a stronger wage increase in 2024, which should reassure the BoJ on the prospect of a sustainable return of inflation towards the 2% target. These results increase the probability of abandoning the negative interest rate policy and controlling the yield curve from the March 18-19 meeting. The normalization of monetary policy will subsequently be very gradual to allow the virtuous circle between wages and prices to

strengthen via a strengthening of internal demand. The divergence in monetary policy expectations between the BoJ, on the one hand, and the Fed and the ECB, on the other hand, argues for an appreciation of the yen in relation to the dollar and the euro.

Aline Goupil-Raguénès

Market review

Will inflation spoil the party (again)?

The publication of the CPI revives the debate on inflation a few days before the FOMC.

The issue of high inflation resurfaces as US data releases of consumer and producer prices on the eve of the FOMC came in on the high side of expectations. During his recent speech before Congress, Jerome Powell invoked “confidence” in the disinflation process to justify the monetary easing planned since last autumn. It is fair to say that market expectations of Fed rate cuts have been the key to the broad-based rally in the financial markets since last fall. The tightening in spreads even accelerated last week on both the sovereign debt and credit markets amid higher government bond yields. The US dollar is regaining ground, to the detriment of the Japanese yen, which is still sensitive to uncertainty over the date of the rate increase mentioned by the BoJ. This rebound in the greenback does not prevent a significant rush for gold ($2,160 per ounce) and even more so for cryptocurrencies whose speculative bubble dynamics seem obvious. The improvement in equity markets continues in Europe and to a lesser extent in the United States, where the Russell 2000 fell by 2.5% in contrast to the rise in the S&P.

In the United States, growth should be around 2% in the 1st quarter or even 2.3% according to the GDP Nowcasting by the Atlanta Fed. However, household consumption of goods has turned a touch softer. Retail sales in February (+0.6%) failed to correct the 1.1% drop in spending recorded a month ago. Inflation once again came in above expectations at 3.2% in February. Shelter cost inflation, and to be fair, that of services excluding energy (5.2%), remains much higher than goods’ inflation, which hovers around zero. This poses a dilemma for the Federal Reserve, whose confidence in the continuation of the disinflation process underpins the promise of rate cuts. These data could delay the start of the monetary cycle, or even raise the floor on rates for years to come. The Fed has communicated little on the normative long-run equilibrium policy rate, which has been unchanged at 2.5% for years despite a troubled international environment since 2020. The prospect of sustainably higher rates would not be without consequences for the refinancing of the US Treasury according to Janet Yellen. The March FOMC may be an opportunity to adjust guidance on the balance sheet reduction policy and confirm the outlook for lower rates. In the euro area, the ECB published its new monetary framework. The system of abundant reserves will remain the norm. The refi rate from September 18 will be lowered to 15 bp above the deposit rate. The institution also announced the launch of a structural securities portfolio, independent from current monetary policy, aimed at injecting the liquidity necessary for activity.

The resilience of US stock markets remains fueled by flows captured by major technology stocks, i.e. $ 7.6 billion of the $56 billion inflows into US equity funds last week. At the same time, inflation fears are once again causing a rise in gold and, to a degree, cryptocurrencies. A stagflation scenario would favor sectors associated with raw materials and revive the curve steepening trend and an increase in breakeven inflation rates. The term structure of inflation expectations already includes a remote risk of an inflation overshoot beyond the next five years. Oil ($85 per barrel of Brent) and copper ($8,880 per ton) also resumed their upward trends. These signals are accompanied by a rise in the yield on the 10-year T-note towards 4.30%. In the euro area, the Bund yield is nearing 2.50%, an attractive level for institutional investors. Sovereign bond spreads also hit new lows. The 10-year OAT traded at 43 bp while the Italian BTP spread almost shrank to 120 bp.

Risk aversion also remains very low on credit. The IG credit spread in the euro area has tightened below the threshold of 80 bp against swap. IG funds have recorded inflows worth €10 billion since the start of the year compared to €15 billion in total last year. The primary market is active with a total of €200 billion issued in 2024 with another €17 billion including 12 from non-financial issuers last week. Excess demand translates into low allocations at auction, negative issue premiums and pressure to tighten secondary markets. Technical factors on high yield are even more favorable than on investment grade with inflows into the asset class and in the absence of a primary market. The Crossover, however, returns to around 300 bp under the effect of a specific stress.

Axel Botte

Main market indicators

G4 Government Bonds	18-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.95%	+15	+13	+55
EUR Bunds 10y	2.46%	+15	+6	+43
EUR Bunds 2s10s	-49.6bp	+1	-8	-11
USD Treasuries 2y	4.73%	+20	+9	+48
USD Treasuries 10y	4.33%	+23	+5	+45
USD Treasuries 2s10s	-40.8bp	+3	-4	-4
GBP Gilt 10y	4.09%	+12	-2	+55
JPY JGB 10y	0.77%	+1	-11	-23
€ Sovereign Spreads (10y)	18-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
France	44bp	-2	-4	-10
Italy	123bp	-10	-20	-44
Spain	79bp	-4	-9	-17
Inflation Break-evens (10y)	18-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	2.23%	+6	+4	+10
USD 10y Inflation Swap	2.52%	+5	-1	+11
GBP 10y Inflation Swap	3.65%	+8	+7	+12
EUR Credit Indices	18-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	112bp	-8	-14	-26
EUR Agencies OAS	58bp	-3	-6	-12
EUR Securitized - Covered OAS	65bp	-2	-7	-14
EUR Pan-European High Yield OAS	336bp	-21	-24	-63
EUR/USD CDS Indices 5y	18-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	53bp	0	-3	-6
iTraxx Crossover	300bp	+5	-9	-13
CDX IG	49bp	0	-4	-7
CDX High Yield	330bp	+1	-17	-26
Emerging Markets	18-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	356bp	-10	-28	-28
Currencies	18-Mar-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	$1.089	-0.348	1.011	-1.4
GBP/USD	$1.273	-0.656	1.080	0.0
USD/JPY	JPY 149	-1.515	0.617	-5.5
Commodity Futures	18-Mar-24	-1wk ($)	-1m ($)	2024 (%)
Crude Brent	$86.0	$3.8	$3.3	12.0
Gold	$2 161.1	-$21.7	$143.9	4.8
Equity Market Indices	18-Mar-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	5 167	0.96	3.23	8.3
EuroStoxx 50	4 979	0.98	4.47	10.1
CAC 40	8 143	1.54	4.83	8.0
Nikkei 225	39 740	2.37	3.30	18.8
Shanghai Composite	3 085	0.54	5.99	3.7
VIX - Implied Volatility Index	14.33	-5.85	0.63	15.1

Source: Bloomberg, Ostrum AM

Additional notes

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