FIRSTNEWS VOL 50, OCT 2024

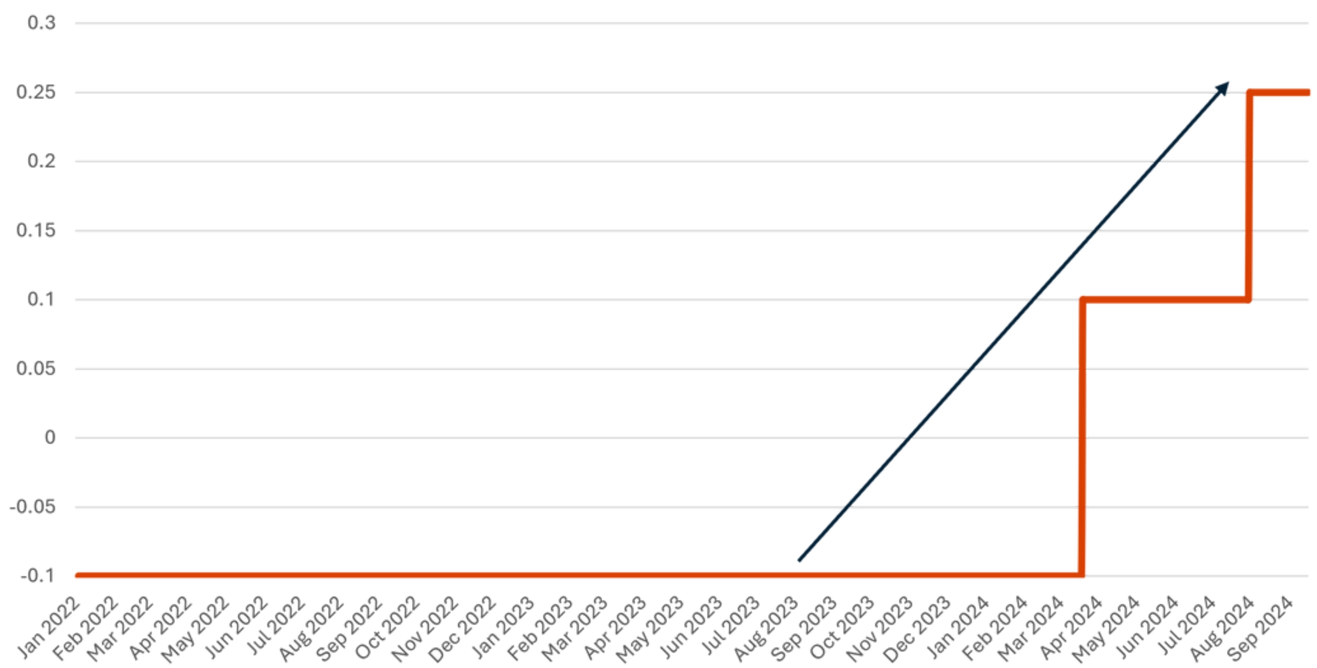
EQUITIESFIRST® Progressive Capital

RATE HIKES, YEN AND INFLATION: KEY DRIVERS OF JAPAN'S 2024 MARKET PERFORMANCE

EXECUTIVE SUMMARY

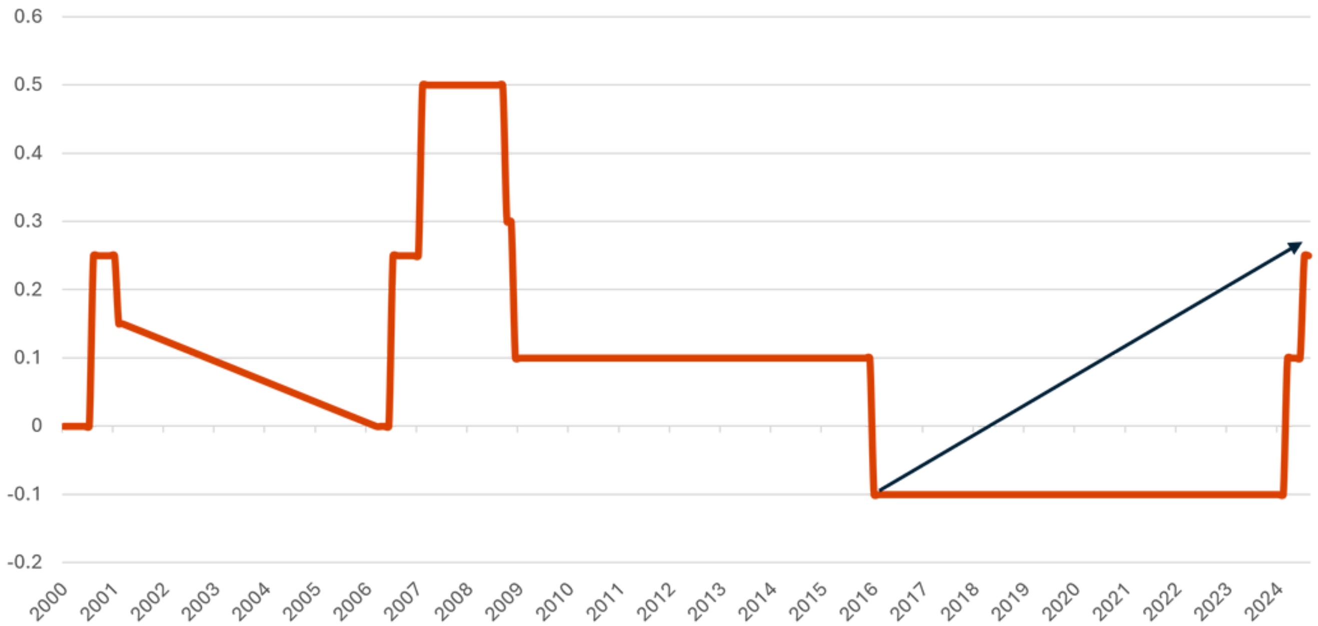
- The Bank of Japan raised interest rates, moving away from negative rates.
- The Nikkei 225 experienced significant fluctuations, reflecting market volatility.
- Yen appreciated as the US Fed is expected to cut rates, affecting the global market.
- Inflation remained above the BOJ's target, pressuring further policy adjustments.
- Bond yields increased, indicating expectations of tighter monetary conditions.
- Share buybacks surged, reaching near-record levels.
- Japan's deep liquidity makes it an ideal market for share pledging.

BANK OF JAPAN'S SHORT-TERM INTEREST RATE (%) (2022 - 2024)



Source: Bloomberg

BANK OF JAPAN'S SHORT-TERM INTEREST RATE (%) (2000 - 2024)



In 2024, the Bank of Japan (BOJ) made significant shifts in its monetary policy by raising the short-term interest rate for the first time in 17 years. In March 2024, the BOJ increased the rate from -0.1% to a range of 0 to 0.1%, effectively ending Japan's long-standing policy of negative interest rates, a move that signaled a critical turning point in the country's monetary approach, which previously required banks to pay a fee when they deposited a certain reserve funds with the Bank of Japan. This policy was designed to encourage lending and economic activity by discouraging banks from holding excess reserves.

By July 2024, the BOJ further raised the rate to around 0.25%, responding to a broader shift toward policy normalization and slight inflationary pressures. The interest rate is specifically referring to the Tokyo Overnight Average Rate (TONA). TONA is the average rate at which banks lend to each other overnight. This rate hike indicates an effort by Japan to move towards more traditional monetary policy as it aims to manage inflation and stabilize the economy.

This series of rate hikes represents the BOJ's efforts to move away from the ultra-loose monetary policy that had characterized Japan's economic strategy for decades. The shift reflects growing confidence in the Japanese economy's recovery and aims to address rising inflation, which has been sustained above the BOJ's target of 2%. The policy change underscores the BOJ's balancing act between supporting economic growth and preventing the overheating of the economy due to prolonged low interest rates.

Historically, Japan's rates had been anchored in negative territory since 2016, as part of aggressive measures to combat deflation and stimulate economic activity. The recent adjustments indicate a strategic pivot as the BOJ navigates new economic challenges, including managing inflation expectations and ensuring financial stability. This move aligns Japan more closely with global trends where central banks are increasingly prioritizing inflation control over ultra-accommodative monetary conditions.

The BOJ's actions in 2024 mark a significant departure from the past and set the stage for a potential series of gradual rate hikes, contingent on economic data and inflation trends. These adjustments will be crucial for investors as they adapt to a higher interest rate environment in Japan that could reshape financial conditions, including the stock, bond and foreign exchange markets.

Source: Bloomberg

NIKKEI 225 INDEX

Entering July 2024, the Japanese stock market, as represented by the Nikkei 225 index, underwent significant volatility. The index saw a sharp decline from its peak of 42,224 to a low of 31,458, marking a substantial drop of approximately 25%. This downturn reflected investor concerns over various economic factors, including global market uncertainties and potential shifts in domestic monetary policy. However, the market demonstrated resilience with a strong rebound, even as the Japanese yen continued to strengthen against the US dollar.

This market recovery, despite a stronger yen, suggests that investor confidence remained buoyed by underlying economic fundamentals or corporate earnings that outperformed expectations. The rebound could also be attributed to the anticipation of strategic adjustments by the BOJ. In recent comments, BOJ officials have hinted at a more balanced approach towards monetary tightening, taking into account both inflation control and economic stability. The BOJ's careful stance on policy adjustments has likely played a role in calming markets, preventing further drastic declines and facilitating the observed recovery.

The market's response illustrates the complex interplay between currency movements and stock valuations. Typically, a stronger yen can be a headwind for Japanese exporters, as it makes their goods more expensive abroad. However, the robust rebound in the Nikkei 225 suggests that domestic factors, possibly including improved corporate governance, cost-cutting measures, or sector-specific strengths (such as technology and tourism), provided enough momentum to offset currency pressures.

Source: Bloomberg

USD/JPY EXCHANGE RATE

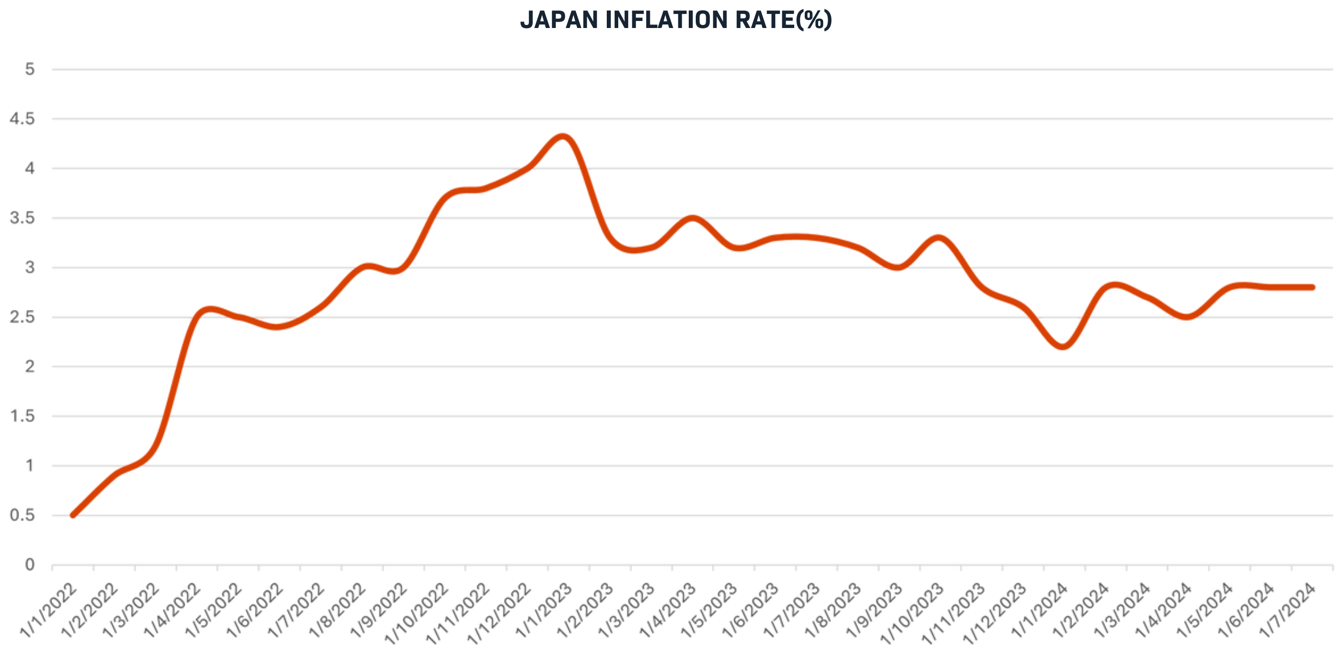
Based on the current market expectations, it is highly likely that the US Federal Reserve will start cutting interest rates in September 2024. This anticipated move comes after a prolonged period of restrictive monetary policy aimed at controlling inflation, which has started to show lagging effects, particularly in the labor market. The Federal Open Market Committee has signaled that it remains data-dependent and recent economic indicators suggest that the conditions are aligning for a rate cut.

Most analysts expect an initial cut of 25 basis points, with some discussion of a possible 50 basis points cut although this larger reduction seems less probable unless further economic weakening is observed.

The expectation of rate cuts is largely driven by recent inflation data, which is not exceptionally low, and aligns with the Fed's broader objective of stabilizing prices and supporting employment.

If the Fed moves forward with rate cuts as expected, it will likely lead to a weakening of the US dollar. This environment could strengthen the Japanese yen, as investors adjust their positions in response to changing interest rate differentials. A stronger yen would have significant implications for Japanese exporters, potentially putting pressure on their international competitiveness but it could also boost domestic purchasing power and reduce import costs.

Source: Bloomberg

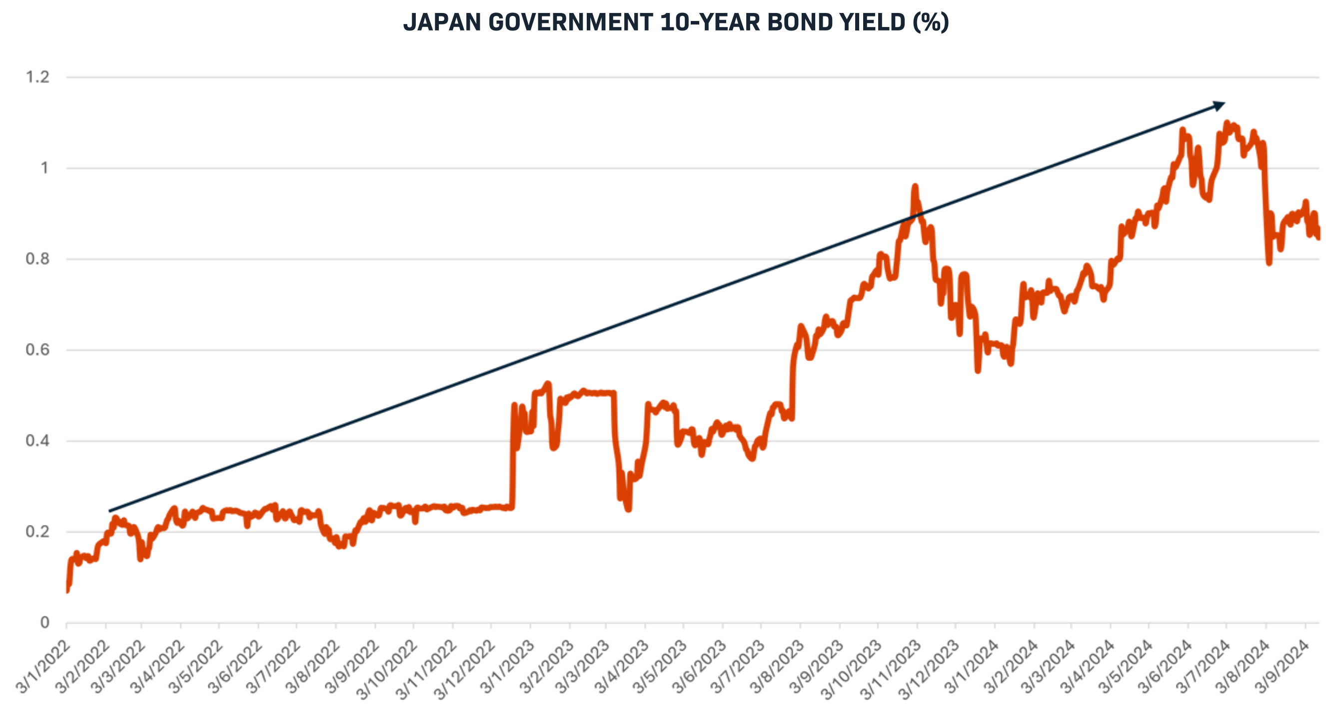


The graph shows that Japan's inflation rate has consistently remained above 2.5% for an extended period, which could increase pressure on the BOJ to consistently raise the interest rates to control inflation and stabilize the economy.

RECENT HAWKISH REMARK FROM BANK OF JAPAN

Bank of Japan Board Member, Naoki Tamura, has suggested that the central bank needs to adopt a more aggressive approach to raising its benchmark interest rate than previously anticipated by many economists. He highlighted that the neutral policy rate in Japan should be 1% or higher, indicating that a gradual increase to at least 1% by the latter half of the bank's forecast period, through fiscal 2026, is necessary to manage upward inflation risks and achieve a stable inflation target.

Tamura, known for his hawkish stance among the bank's nine-member board, emphasized the need for gradual rate hikes from the current rate of 0.25%. However, he also indicated that there is no immediate need for a policy change at the upcoming board meeting, despite the urgency to address inflation in the longer term. His comments initially boosted the yen against the dollar, reflecting market sensitivity to potential changes in Japan's monetary policy direction.

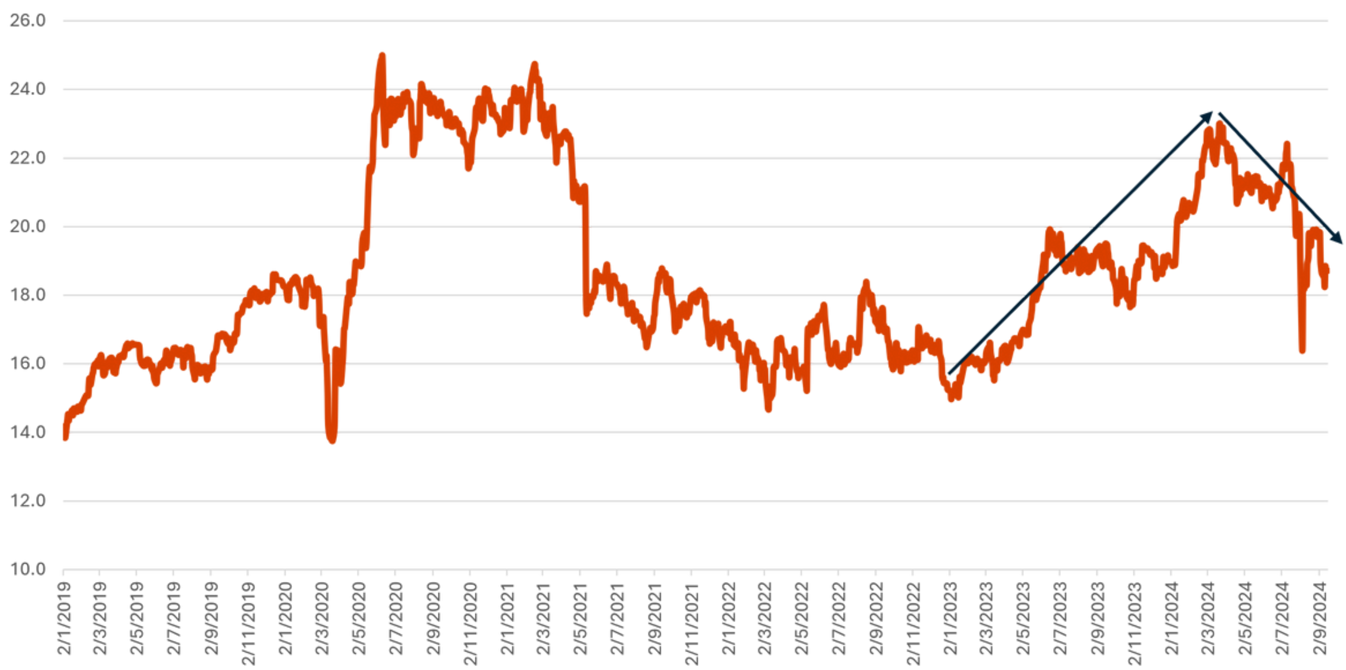


Source: Bloomberg

Since 2022, the yield on Japan's 10-year government bond has been on an upward trajectory, reflecting market expectations of a tightening monetary environment driven by rising inflation, anticipated interest rate hikes and a stronger yen. This rise in yields signals that investors are pricing in a shift from the Bank of Japan's ultra-loose monetary stance towards more restrictive policies to counter inflationary pressures.

This trend underscores the market's anticipation of persistent upward pressure on yields as Japan navigates its monetary policy path. As such, the current bond market movements suggest heightened sensitivity to future rate adjustments and inflation dynamics, making it a crucial area for investors to watch closely.

NIKKEI 225 INDEX FORWARD 12-MONTH P/E (X)



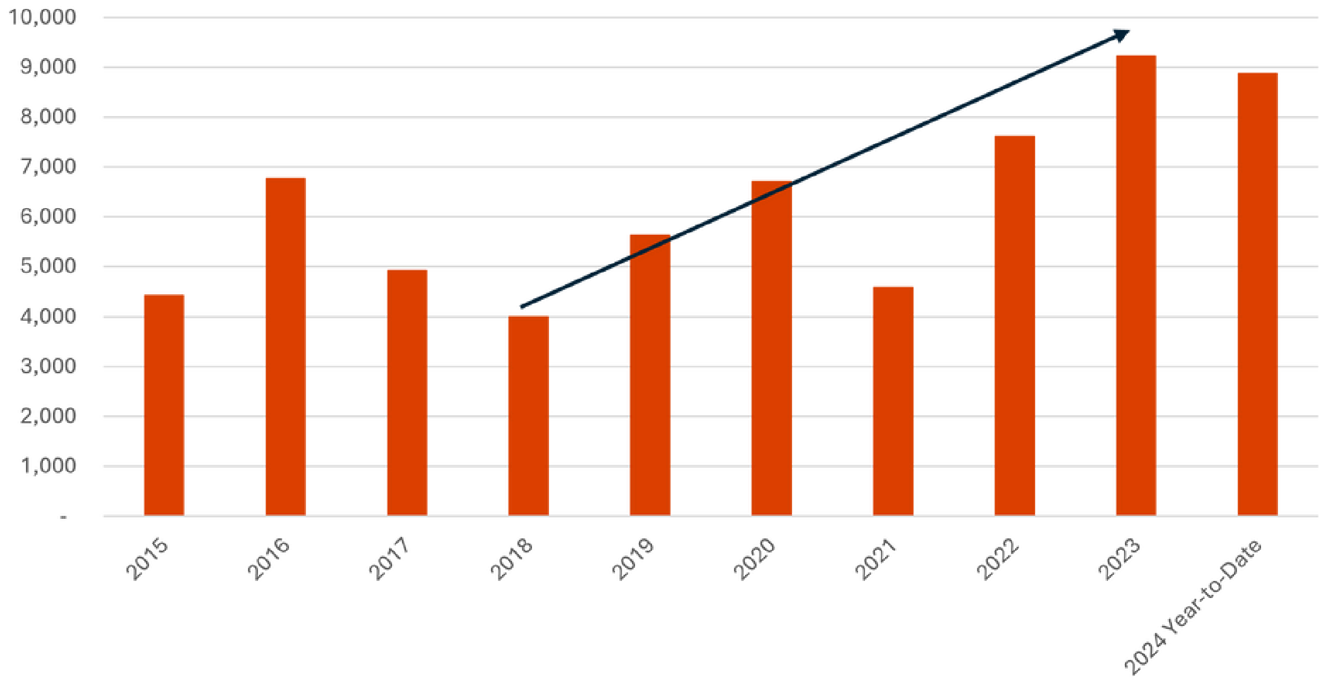
The recent volatility in the Nikkei 225 Index has been accompanied by significant changes in its forward 12-month P/E ratio. As the index fluctuated, the P/E ratio, initially increased sharply since 2022 before declining in recent months. This decline in the P/E ratio is largely due to rising market concerns over Japan's economic outlook, driven by expectations of tightening monetary policy, potential impacts from global economic slowdowns and fluctuating investor sentiment.

The market's adjustment in the P/E ratio suggests that investors are recalibrating their expectations for corporate earnings amid a backdrop of higher interest rates and ongoing global economic slowdown pressure. As a result, the valuation of Japanese equities has moderated from earlier highs, reflecting a more cautious outlook. This re-rating underscores the sensitivity of equity valuations to broader economic conditions and monetary policy expectations.

Source: Bloomberg

INCREASING SHARE BUYBACK IN 2024

JAPAN COMPANY SHARE BUYBACK (JPY BN)



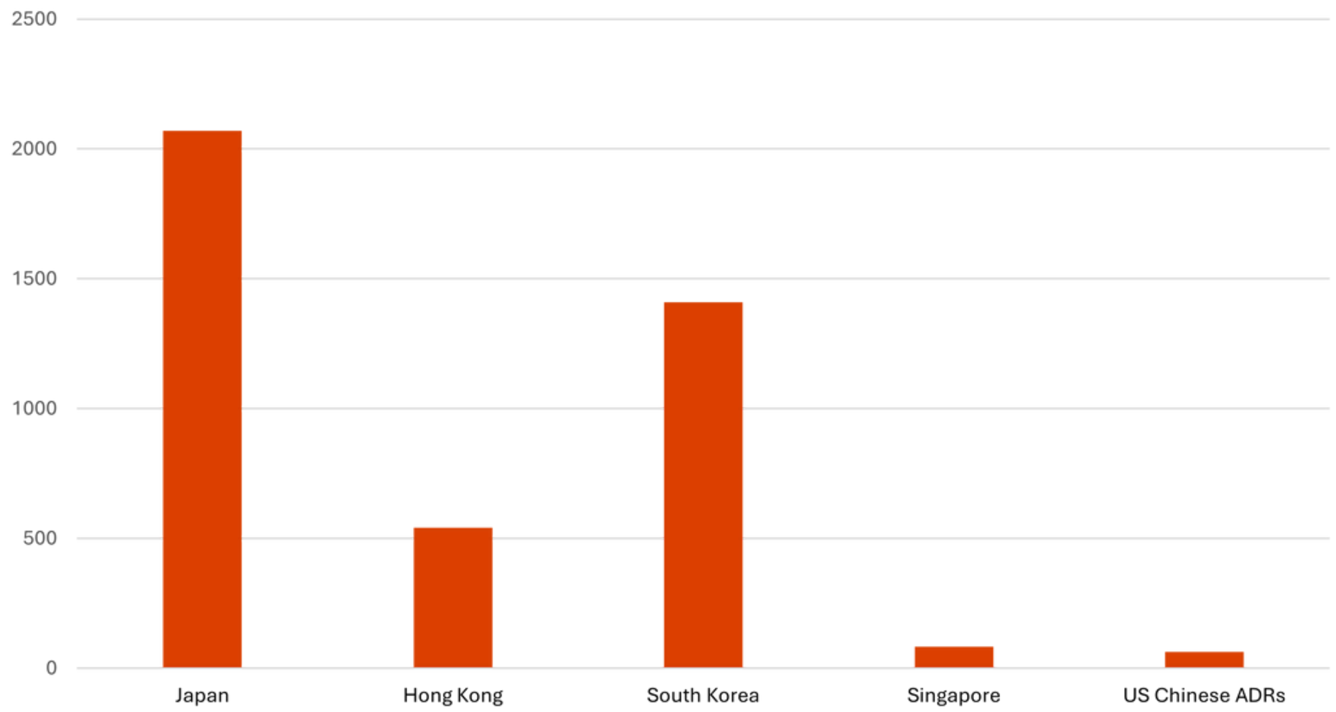
As of September 13, 2024, Japanese companies have engaged in share buybacks over JPY 8,880 billion year-to-date, reaching 96% of the total buyback volume seen in 2023. Given this rapid accumulation, it is highly likely that 2024 will surpass the previous year's record, setting a new peak for share repurchases in Japan.

The current momentum also points to a broader shift in corporate behavior in Japan, where companies are increasingly adopting practices that align with global standards of shareholder engagement. With 2023 already marking a historic high for buybacks, the continued upward trajectory in 2024 not only reflects optimism about future earnings but also a strategic response to market conditions that may include currency volatility and macroeconomic uncertainties.

As we move further into 2024, the Japanese market is poised to see its share buybacks reach unprecedented levels, reflecting both a strong corporate response to market dynamics and a steadfast commitment to rewarding investors.

Source: Bloomberg

NUMBER OF QUALIFIED STOCKS THAT EQUITIESFIRST CAN PROVIDE LOANS



Japan represents a significant market for share pledging, largely due to its substantial market size and liquidity. The chart illustrates that Japan has over 2,000 qualified stocks eligible for loans from EquitiesFirst, making it the leading market among the listed regions. This dominance highlights the robust potential for share pledging in Japan, driven by the extensive number of publicly traded companies and active market participation.

Hong Kong, known for its strong financial markets, has over 500 qualified stocks, also indicating a considerable share of Asia's share pledging market. Singapore and US Chinese ADRs also appear in the chart with some eligible stocks, also reflecting notable opportunities in these markets. Overall, the data underscores Japan's unique position as a prime market for share pledging, thanks to its extensive market depth and liquidity.

In conclusion, Japan's financial landscape in 2024 is characterized by a series of significant shifts, including interest rate hikes, stock market volatility and rising inflation. The Bank of Japan's departure from negative interest rates and its cautious approach to tightening monetary policy reflect a broader alignment with global trends, emphasizing inflation control and economic stability. Despite these challenges, Japan's market continues to offer robust opportunities, particularly in share pledging and corporate share buybacks, supported by deep liquidity and strong market fundamentals.

ADVANTAGES OF EQUITIESFIRST'S LENDING APPROACH IN JAPAN

EquitiesFirst utilizes the high liquidity of Japan's stock market to offer loans secured against a wide range of over 2,000 qualified stocks. These loans feature competitive interest rates (2.5-4% in USD or JPY) and attractive loan-to-value ratios, typically ranging between 60-70%, along with reasonable margin call thresholds. A distinctive aspect of EquitiesFirst's lending approach includes non-recourse loans, no need for personal guarantees and flexible use of loan proceeds. In cases of default, EquitiesFirst opts not to pursue repayment, which underscores the firm's commitment to providing adaptable financial solutions to its clients.

Source: Bloomberg

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