CIO Perspectives

How Will the Markets React to Interest-Rate Hikes by the Central Banks of Japan, the United States, and Europe?

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The central banks of Japan, the United States, and Europe all raised interest rates over the same period. The Federal Reserve (Fed) raised its policy rate by 0.25 percentage points on Thursday, September 17, followed by the Bank of Japan (BoJ) on Friday, September 18. The European Central Bank (ECB) had raised its policy rate by the same amount one week earlier, on September 10.

These rate hikes reflected persistent inflationary pressures, as well as the relatively solid performance of the economy despite ongoing geopolitical risks. Although the pace and continuity of future rate hikes, as well as the direction of monetary policy next year, are likely to differ among the central banks, current market pricing suggests that the next policy move is also more likely to be another rate hike.

Against this backdrop, our Active Global Investment Team has the following views on the outlook for the U.S. dollar/Japanese yen exchange rate, Japanese government bonds, U.S. Treasuries, and German government bonds.

Dollar Yen Exchange Rate

The yen weakened after two Policy Board members voted against the rate hike following the BoJ's September 18 policy meeting and during the Japanese holiday period from September 21 to 23. Nevertheless, we believe that the underlying environment remains favorable for yen appreciation, supported by the coordinated intervention by the Japanese and U.S. authorities in July, strong warnings from U.S. Treasury Secretary Scott Bessent about excessive yen weakness, and the BoJ's faster pace of rate hikes.

Market reports late last week also suggested that the BoJ had conducted a rate check, heightening vigilance over the risk of foreign-exchange intervention. However, the yen could weaken again if crude oil prices remain elevated, if Japan maintains its expansionary fiscal policy, or if the pace of the BoJ's rate hikes falls short of expectations.

Japanese Government Bonds

The initial reaction in the Japanese government bond market was limited, as the BoJ's latest rate hike had already been fully priced in. Financial conditions also remain accommodative, while inflation concerns persist amid heightened tensions in the Middle East. We therefore expect the BoJ to continue raising rates gradually.

Apart from periods of heightened uncertainty, such as those resulting from U.S. trade policy, the BoJ's previous rate hikes had generally occurred at six-month intervals. This time, however, the latest hike came only three months after the previous one. Although markets are pricing in further rate hikes at roughly three-month intervals, considerable uncertainty remains regarding the timing and pace of policy adjustments, given the continued uncertainty surrounding the situation in the Middle East and other factors.

Nevertheless, we expect the BoJ to remain on a rate-hiking path. Medium- and long-term bond yields are therefore likely to remain under upward pressure in the near term, albeit with some volatility. Super-long-term bonds, meanwhile, are expected to remain relatively firm over the medium to long term, supported by expectations of further rate hikes and an improving supply-demand balance resulting due to reduced government bond issuance.

U.S. Treasuries

U.S. Treasury yields rose last week as hawkish remarks by Fed Chair Kevin Warsh at the Jackson Hole symposium in late August strengthened expectations of a rate hike at the Federal Open Market Committee (FOMC) meeting. In addition, most FOMC members' projections pointed to another 0.25-percentage-point rate hike before the end of this year.

Although the next policy move could also be a rate hike, Chair Warsh's commitment to preventing a sharp acceleration of inflation is helping to contain inflation expectations. We therefore expect future rate hikes to be limited. Consequently, we do not expect the recent sharp rise in the 10-year U.S. Treasury yield to continue and anticipate that the yield will remain at around 5%.

German Government Bonds

German government bond yields have risen along with crude oil prices. The ECB began raising policy rates before the Federal Reserve in response to elevated inflation driven by surging energy prices. However, wage growth has not accelerated.

As inflation moderates from next year onward, we expect the ECB to begin cutting its policy rate, with 10-year German government bond yields also moving lower.

Our Global Active Investments teams do not expect sustained high crude oil prices to lead to a sustained acceleration in inflation. We therefore believe that the risk of further substantial rate hikes by the central banks in major countries and regions is limited.

We will continue to closely monitor evolving geopolitical risks and global monetary and fiscal policy developments as we manage portfolios with the goal of generating superior performance for our investors.

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