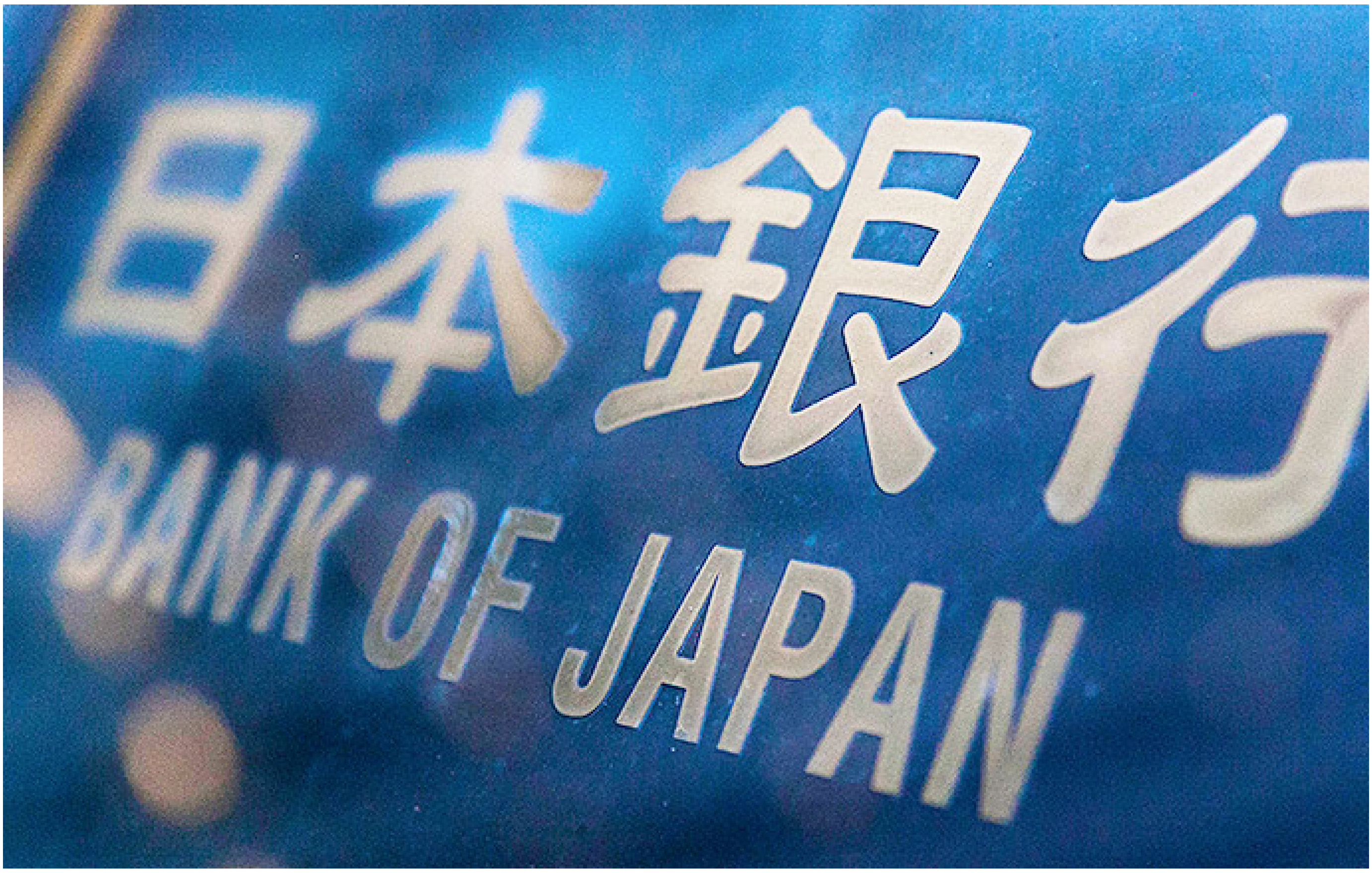


The Bank of Japan warrants closer attention

Growth expectations for Japan continue to improve and combined with record low unemployment, a surprise policy shift by the Bank of Japan should not be discounted.

Market Insight

Mark Bathgate

Portfolio Manager

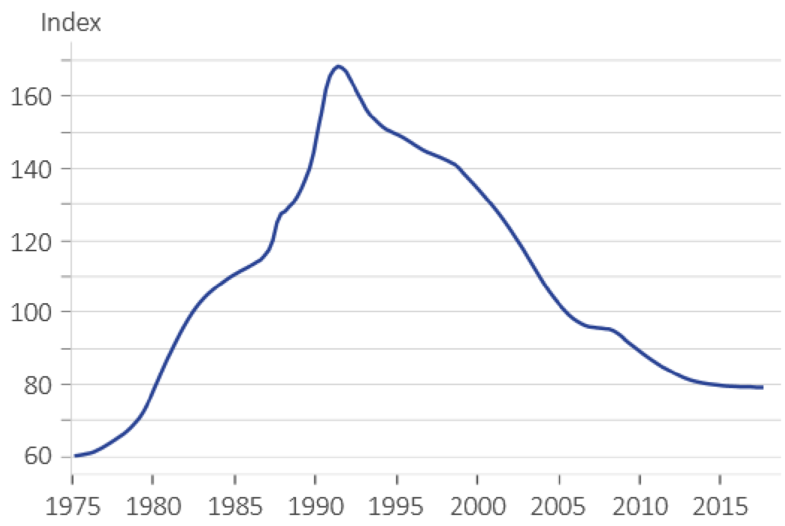
February 2018

The biggest wild card for global bond markets this year might be the Bank of Japan (BoJ). It's starting to look more likely, if not probable that the BoJ will look to exit QE later this year and move to hike rates back towards zero as capacity pressures grow in the economy. A surprise move to tighten policy might have broader repercussions in markets and while some consensus is starting to build around this theme, market participants, on the whole, seem to remain cautious with little priced into forward markets.

Policy innovators

The BoJ has traditionally been a pioneer when it comes to policy innovation. Unconventional measures such as QE and 'forward guidance' were introduced in the early 2000s to battle against years of chronic deflation – techniques that were later followed by the Federal Reserve and the European Central Bank (ECB) in the aftermath of the global financial crisis and the European sovereign debt crisis, respectively.

Japan real estate price index



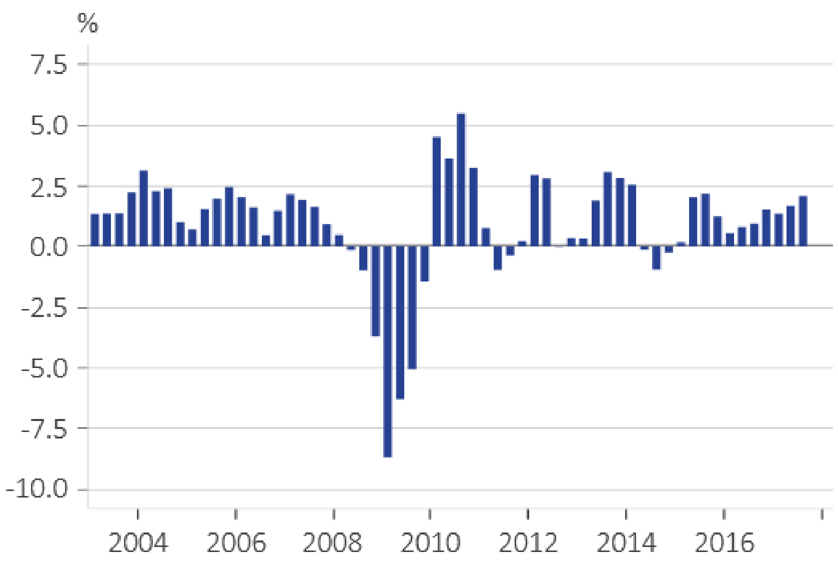
Source: Federal Reserve Bank of Dallas 2017 Q3

But it wasn't until 2013, and the introduction of 'Abenomics,' that Japan really became aggressive in the battle against deflation. With new BoJ governor Haruhiko Kuroda at the helm, 'quantitative and qualitative monetary easing' was boosted and 'yield curve control' was introduced in mid-2016 – keeping the 10-yr Japanese government bond (JGB) yield pegged to 0-0.1% to influence the long-end of the curve while minimising asset purchases. Japan's economy has improved since and continues to move along as we begin 2018.

Japan's economy is the strongest for two decades

The economy has enjoyed a decade of good growth.

Japan GDP (quarterly data, year-on-year)



Source: Japanese Cabinet Office (CaO) 2017 Q3

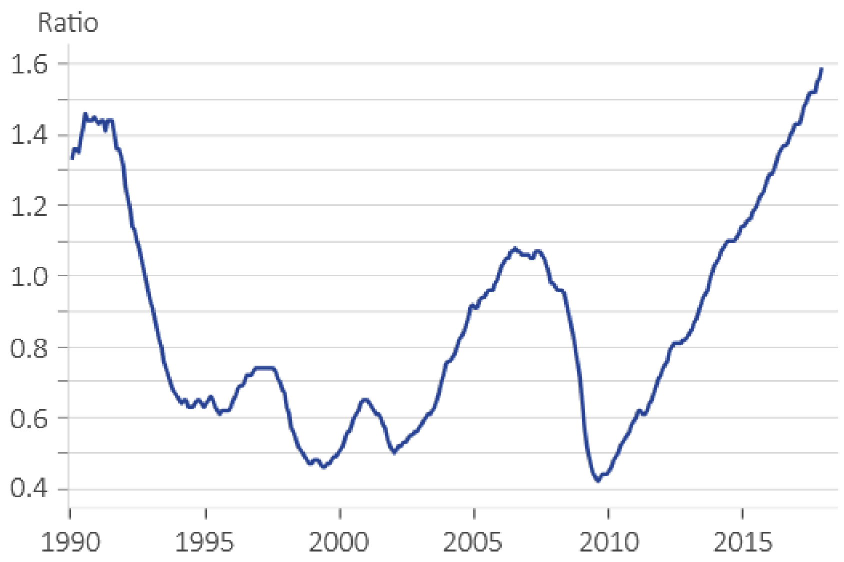
Unemployment has moved close to a 30-year low – standing at 2.8%.

Japan unemployment rate

Source: Japanese Statistics Bureau 12/2017

Labour shortage is becoming a key issue in the jobs market.

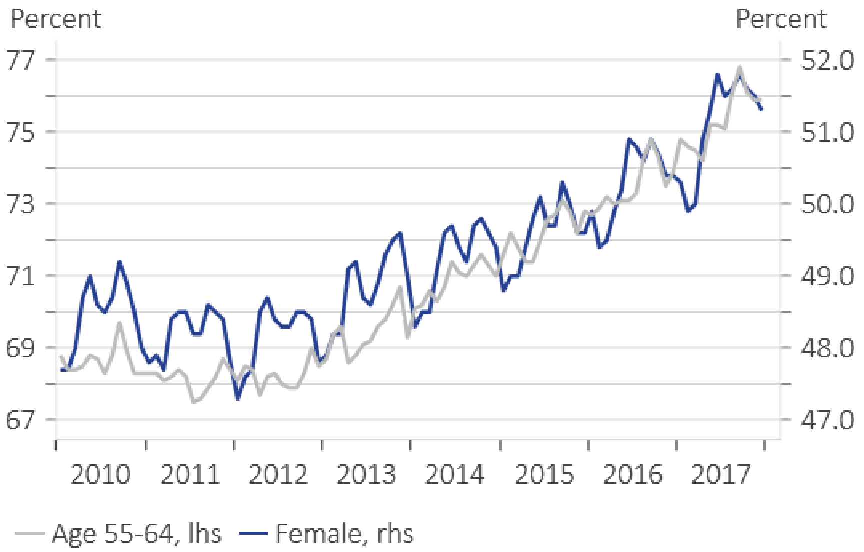
Active job openings-to-applicants ratio



Source: Japanese Ministry of Health, Labour & Welfare 12/2017

There has also been a huge shift in female and elderly participation rates which has allowed wages to hold steady, straining the ability to move further for now. Wage growth has been stable but in positive territory, consistent with other growing developed economies.

Labour force participation



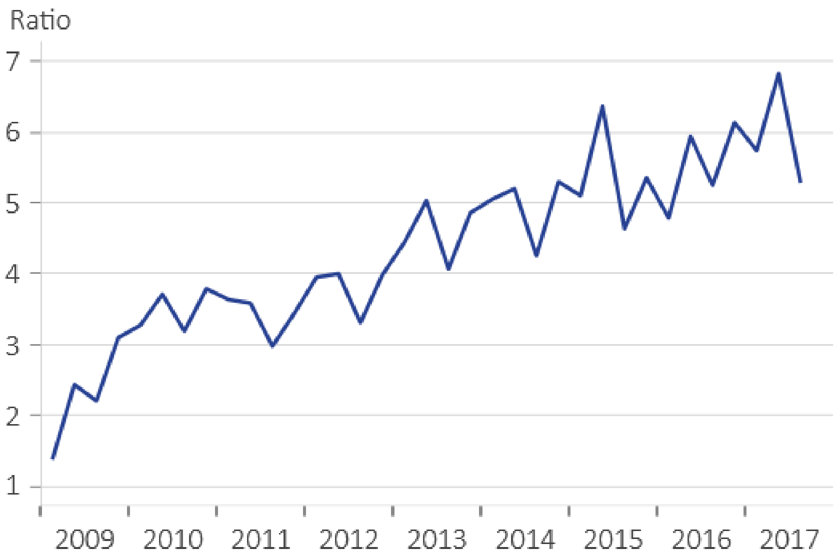
Source: Japanese Statistics Bureau 12/2017, 12/2017

Japan's corporations are buoyant, with the Nikkei at its highest level since the 1990s. Corporate balance sheets and profits are also in exceptionally good shape, with the corporate profit/GDP ratio on par with the US and net interest payments by companies continuing to fall.

Nikkei 225 index

Source: Nikkei Inc. 31/01/2018

Japan’s corporations – Ordinary profits to sales



Source: Japanese Ministry of Finance 2017 Q3

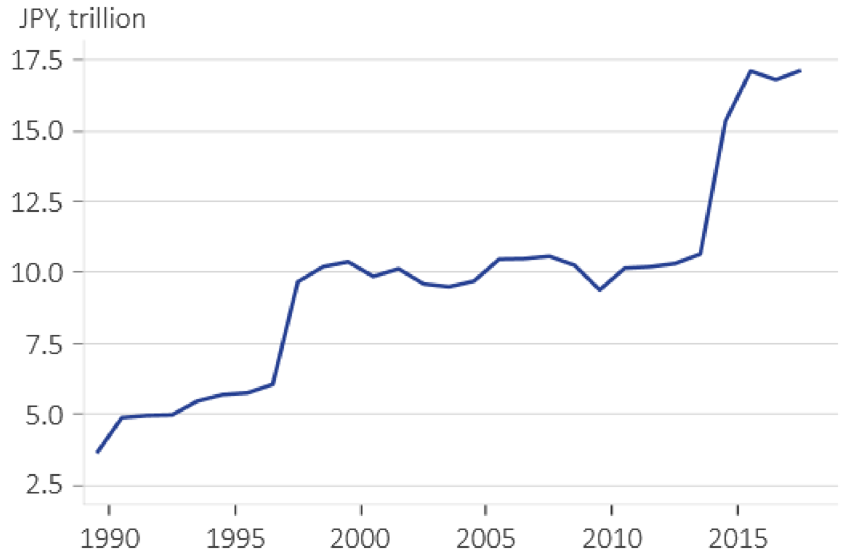
The return to health of the banking system is clear in the strength of credit growth over recent years.

Deposits and loans, financial institutions year-on-year growth

Source: Bank of Japan 12/2017

A successful move to a more 'European' taxation model with consumption taking much larger share is a good corroboration of economic strength.

Japan, revenues, consumption tax



Source: Japanese Ministry of Finance 2017

Property markets have also shown much more commonality with other developed countries with house prices continuing to move higher.

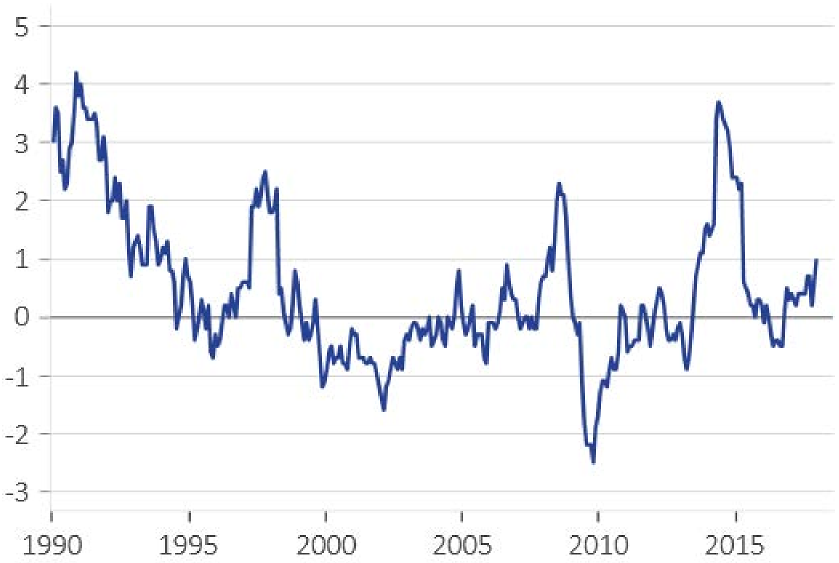
Average price, new condos, Tokyo

Source: Land Institute of Japan 12/2017

The missing piece of the jigsaw

Inflation remains below the BoJ's 2% target. However, there is little evidence of the deflationary pressures of the 90s and 2000s.

Inflation - Consumer prices



Source: Bloomberg 12/2017

We believe that that this move away from deflation will allow the BoJ to step back from the extreme policy measures of recent years, particularly given the 'cost/benefits' of negative rates and QE:

- **The experience of early 2016 was not pleasant for the BoJ**– the 'cost' side of easing relative to benefits became ever more apparent with QE at negative rates. This was set out in one of the most important monetary policy speeches of recent years by Governor Kuroda in September 2016[1]:

"What we should bear in mind when conducting monetary policy is not its "limit" but a comparison between its "benefits" and "costs," as is the case with any public policy. ***There is no free lunch for any policy.*** *Given that we have been implementing such large-scale monetary easing, any additional monetary easing entails "costs," which negatively affects some sectors. That said, we should not hesitate to go ahead with it as long as it is necessary for Japan's economy as a whole; namely, if its "benefits" outweigh its "costs." Furthermore, what is important is that a balance between "benefits" and "costs" can change depending on the situation. Monetary policy should be conducted in a flexible manner. There may be a situation where drastic measures are warranted even though they could entail "costs," depending on the situations for economic activity, prices, and financial conditions. The central bank should always prepare policy options to address such situations."*

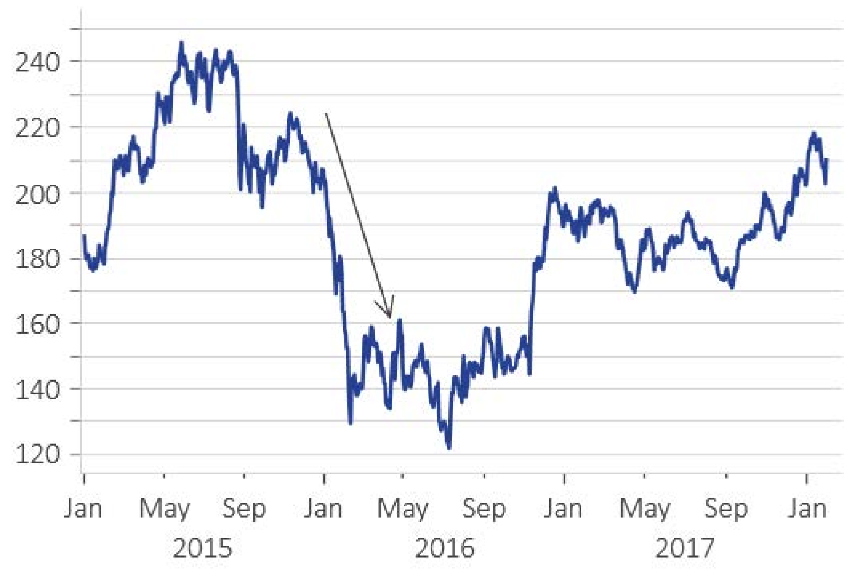
- That means the psychology around having room to ease in the face of problems (i.e. build ammo) has flipped from where it had been the previous couple of decades. If growth is strong and inflation is acceptable –

[1] https://www.boj.or.jp/en/announcements/press/koen_2016/ko160905a.htm/

particularly with soaring equity markets – one would expect the BoJ (and the ECB) to use that window to make adjustments.

- **Impact of removing negative rates** – this time two years ago, both European and Japanese bank stocks fell over 30% in Q1 2016 as the impact of negative rates and an inverted yield curve hit net interest margins. Moving back to positive rates/positive yield curve, in our view, is likely to be very positive initially for financials, and hence has a much less negative impact on the economy as a whole.

Tokyo Stock Exchange TOPIX Banks Index



Source: Bloomberg 01/02/2018

Conclusions

Given most 1990s bust problems are now resolved – almost all economic variables are now 'normalised' aside from monetary policy. We think that the BoJ may start to move the 10-year JGB yield curve target higher later this year, with the potential for a move back to zero for cash rates to follow.

Early 2016 demonstrated how influential JGB moves were for global rates – particularly for the eurozone. With the Federal Reserve Board well into a hiking cycle – and the ECB coming to the end of QE later this year central bank moves are of growing importance for global markets.

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