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Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"The Market Consequences of the BOJ Regime Shift"

Dominic Wilson et al., Goldman Sachs,
April 10, 2013

The Bank of Japan (BOJ) recently announced a massive asset purchasing program in a bid to end deflation. While bond yields on Japanese government bonds plummeted and equities continued their rally on the news, markets have not fully priced in a shift to the 2% inflation target that the BOJ has vowed to achieve. In this sense, there is still further room for yen depreciation and for Japanese equities to post significant gains.

On April 4, the BOJ exceeded expectations with the announcement of a massive new asset purchasing program. Yields on long-dated Japanese government bonds (JGBs) immediately plummeted and local equity markets surged on the news. However, the ramifications of a policy shift toward a credible 2% inflation target may not yet be fully reflected in markets. There is still room for further depreciation of the yen and for stocks in general to continue their rally.

The BOJ has launched a multi-pronged attack to defeat deflation and spur faster growth. It will inject approximately ¥7 trillion per month (roughly US$70 billion) into the Japanese economy through the direct purchase of JGBs. For comparison, these purchases far exceed the scope of the Federal Reserve's actions (US$85 billion of purchases per month) relative to the size of the country's GDP and fiscal deficit. Second, the BOJ has targeted longer-dated government bonds to lower borrowing costs; since early February, 30-year JGB yields have seen an impressive 90 basis point (bp) peak-to-trough decline. Finally, the BOJ has announced that it will purchase more equities, albeit at a slower pace. Over the past six months, the Nikkei has increased by almost 50%.

Despite these significant moves, Japanese asset markets could move even further. Inflation swaps and FX forwards imply long-term inflation expectations have risen to around 0.9%, well below the BOJ's 2% target. Rising inflation expectations and real rates that look less attractive compared with global peers place further downward pressure on the yen. As U.S. Treasury rates rise, higher real rates in the United States also could put upward pressure on the U.S. dollar. Japan bears see little reason that the BOJ will succeed in achieving a 2% rate of inflation, citing decades of deflation. However, the scale of the newly announced asset purchases could give the central bank more credibility.

Investors should monitor early signs of price and wage inflation to gauge the success of this program and, in turn, consequences for the yen and Japanese equity markets. The Japanese yen will be a critical factor in determining whether the BOJ succeeds in its efforts to attain its desired rate of inflation. The yen is arguably the primary transmission mechanism for moving inflation higher, through both its direct impact on import prices and indirect influence on wages and prices via tighter capacity that export-related growth supports. Neither of these factors is immediately visible, but even the 25% yen sell-off we have already seen should lift core CPI by around 0.8% within the next two years.

The precedent set by the Bank of England and the Fed also suggest that Japanese equities and other assets still have room to run. Following these central banks' quantitative easing announcements, bond markets saw almost immediate re-pricing. However, the impact on equities, spreads, and currencies was somewhat

delayed and accumulated over the course of a few weeks as new policies took time to stimulate growth in these economies. Japanese yields have already plummeted to lows, following the average pattern of U.K. and U.S. bonds. However, investors should expect to see other asset classes affected more slowly in the coming months.

The BOJ's easing efforts will help keep policy loose at a global level through three related channels. First, as Japanese monetary easing weakens the yen, policymakers in other countries may tend toward dovishness to offset potential tightening in their currencies and to boost competitiveness. Second, the decline in Japanese bond yields affects the pricing of other sovereign yields, as the JGB rally will likely support other safe sovereign markets. For example, a 100 bp decline in ten-year JGBs is associated with a 30 bp decline in ten-year U.S. Treasuries. Finally, investors, adjustment to lowering Japanese yields may prolong the recent appetite for higher yielding credits such as high-yield bonds and perhaps some emerging markets sovereigns.

Through these shifts in the fixed income universe, BOJ policy is influencing FX and equity markets. The currencies of Japan's close trading competitors (those with similar exports such as Korea and Taiwan) have started to weaken in response to the pressures from the weakening yen. By helping to keep U.S. yields lower than they might otherwise be, the BOJ purchases are also one of several forces supporting the "defensive rally" in equities and creating a more positive equity backdrop in general. Ultimately, however, monetary policy will not be enough to support equity markets. Stable, if not accelerating, growth is necessary to sustain the rally and a move to fresh highs.

"Is Japan Here to Stay?"

Michael Hood, J.P. Morgan Asset Management, March 20, 2013

For years investors have shied away from Japanese equities due to disappointing returns. However, the regime shift and recently announced asset purchasing programs have drawn the attention of many. For equities to become attractive and for any growth to be achieved, policymakers will have to make good on their pledge to end deflation.

Investors have shied away from Japanese equities for years as returns have disappointed in the deflationary environment. However, Japan's regime shift and the aggressive quantitative easing measures announced by the Bank of Japan (BOJ) have once again made the country relevant from an investor perspective. Whether or not policymakers eventually succeed in generating positive inflation will determine whether foreign investors maintain long-term strategic interest in Japanese stocks, as well as whether the government can sustain its heavy debt burden.

After decades of deflation in Japan, the Abe administration believes that deflation is a monetary phenomenon, augmented by a persistent output gap, as opposed to the previous belief that deflation reflects structural forces such as the shrinking population. To boost inflation toward the new 2% target set by authorities, the BOJ will begin an aggressive asset purchasing program similar to that of the Federal Reserve. Quantitative easing will help boost inflation through two channels, the first of which is the devaluation of the yen. Currency devaluation can affect inflation directly by boosting import prices and indirectly by supporting growth and narrowing the output gap. The recent sell-off in the yen represents a "downpayment" on the inflation promotion

efforts; further depreciation will help signify that the BOJ's policies are having an effect. The rest of the anti-deflation effort will come through the effect of monetary easing on the domestic economy and inflation expectations.

Abe has also signaled that he is determined to implement a "growth strategy" to boost real GDP growth, but this goal may face significant challenges. Although certain regulatory policies and labor market practices could be improved, generally the country is open to trade and investment flows, which keep it at the technological frontier and exposed to international best practices. In fact, using the measure of GDP per worker, Japan has grown only slightly more slowly than other developed countries, and total factor productivity growth has run only slightly below U.S. levels. However, Japanese growth has been stagnant for decades given the country's demographics; Japan has found it incredibly difficult to promote growth in the context of an aging population and declining workforce. The eventual success of any "growth strategy" that does not involve expanding the workforce (through immigration, more female participation, etc.) seems doubtful.

Even if the real growth that Abe desires is not achieved, nominal growth would still be beneficial for Japan. For one, it would put Japanese stocks back on the radar of foreign investors. Since nominal GDP growth peaked in 1997, the size of the Japanese economy has been contracting. For equity investors, this meant that the core of the earnings base for Japanese companies was reduced over time. Although Japanese companies have mitigated some of this contraction through investments in developing Asia, corporate earnings have steadily declined. A return to positive inflation and positive nominal GDP growth would also help the Japanese government to sustain its heavy debt burden. The country is mired in debt, yet a financing crisis has not yet occurred thanks to the country's high private sector savings rate and current account surplus, which create a large and stable domestic market for Japanese government bonds. If Japanese prices continue to fall, eventually the shrinking nominal economy will become unable to sustain the existing stock of government debt. The return of inflation will help reverse this and alleviate some of the doubt.

Recent optimism surrounding the policy shift has created a significant tactical opportunity in Japanese stocks. However, from a long-run perspective, Japan's role in the international equity and debt markets depends on the creation of sustained inflation. Given population constraints and the likelihood that real GDP growth remains fairly soft, the nominal economy and thus the strategic opportunity for investors will not expand without a significant increase in inflation.

"The Politicization of Monetary Policy: Should We Care?"

Martin Barnes, BCA Research, April 15, 2013

The line between monetary and fiscal policy is becoming increasingly blurred in major developed countries. Current monetary policy carries various embedded risks, but the real challenge may come when it is time to normalize policy as central bankers and politicians could come into conflict.

The line between monetary and fiscal policy is becoming increasingly blurred in major developed countries. Historically, most central banks have never been truly free from political pressures. However, for most developed economies today, economic weakness, not

political pressure, is driving the unprecedented monetary experiments in the Eurozone, Japan, and the United States, among others. Current monetary policies carry many risks, but the real challenge may come when it is time to normalize policy as politicians and central bankers could come into conflict.

One rationale for central bank independence is that monetary policy should be "one size fits all"; the goal of price stability should not have distributional effects. In contrast, politicians determine fiscal policy, which is explicitly about creating distributional effects by raising tax revenue from those who can pay and distributing the proceeds across the poor, the elderly, the infirm, etc.

However, as shown in the United States during the financial crisis, the line between fiscal and monetary policy can blur, and central bank policies can create winners and losers. The Federal Reserve bailed out some firms, but not others (e.g., Lehman). Zero interest rate policy has been a boon for banks in the United States, as a steep yield curve helps to generate profits and rebuild capital. Meanwhile, savers and individuals on fixed incomes have lost out. Further, employing loose monetary policy to create a wealth effect by boosting asset prices has also created winners and losers, as most financial assets, particularly equities, are held by the wealthy.

Many central banks may feel they have little choice but to continue with current loose policies, given large fiscal deficits help stave off the deflationary impacts of private sector deleveraging. However, by buying large amounts of government debt and thus keeping government borrowing costs down, central banks directly enable governments to execute largesse fiscal policy and again blur the line between their monetary and fiscal mandates.

At the moment, despite this unprecedented monetary and fiscal support from major developed markets central banks, most of the major economic forces in the global economy are deflationary. There is slack and weakness in the labor and goods markets, and the traditional monetary mechanism remains impaired. Money growth has also been mild by historical standards, given deleveraging. However, at some point the plumbing will become unblocked and inflation will become a realistic concern. When this occurs, the current alignment of central bank and political interest may start to fracture, and central banks will need to resist the pressure to maintain loose conditions for longer than economic conditions warrant.

Central banks' apparent astute handling of past inflationary spikes in the 1980s and 1990s may have led to a false sense of confidence in their ability to shape economic outcomes. The lessons from the 1930s (where tight monetary policy contributed to the depression) or 1960s and 1970s (where low rates led to high inflation) are less kind. And there are indeed many reasons to worry about today's monetary policy, which creates risks of inflation, currency wars, and potential asset bubbles. Nonetheless, today's central bank actions are not the result of political pressure, and things should remain that way. Central bankers are by no means perfect and have made numerous mistakes in the past, but few would argue that letting politicians play an increased role in monetary policy would improve outcomes. ■