
FIRST ARROW OF ABENOMICS REMAINS ON TARGET

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I was in Tokyo the week of February 24 and was lucky to have an opportunity to spend time with two individuals from the Bank of Japan (BOJ)—Jouji Ide and Ayana Satou. Our dialogue included a sharing of insights that we hear from clients investing in Japanese equities, what they heard during recent travels to New York and Boston, visiting [hedge funds](#) and asset managers who invest in Japan, as well as a discussion of key considerations for the BOJ's monetary policy programs. Important topics of discussion included the [yields](#) on Japanese government bonds (the primary asset the BOJ is purchasing as part of its monetary policy), the importance of equities regaining positive stock price momentum, and the exchange rate. Note that the views shared herein represent the personal opinions of the participants and do not reflect the opinions of the BOJ.

[Japan Government Bond \(JGB\) Yields Surprisingly Low](#) I found this part of the discussion interesting and perhaps surprising: at least one of these individuals feels that the yields of the 10-year JGB were low, given the higher inflation levels Japan has experienced recently. The 10-year JGB yield, at the time of our trip, was less than 60 [basis points](#), which doesn't compensate holders of these JGBs for even half the inflation levels last year. Either the market does not believe the BOJ will be successful in maintaining its 2% inflation target over the longer run, these holders are going to suffer a negative after-inflation return going forward, or perhaps the portfolio reallocation from JGBs toward equities and foreign assets has yet to really begin in earnest and is set to expand soon. A portfolio reallocation process is a key part of the intended BOJ monetary policies—the BOJ wants large life insurance companies and other government pension funds to take the large balances they hold in JGBs and invest those assets in [risk-assets](#) such as equities and foreign bonds.¹ It is interesting to hear that some market watchers at the BOJ think yields are “surprisingly” low—which is in part caused by the fact that the BOJ is buying the vast majority of all the issuance of JGBs as part of its monetary policy program. We heard one reason Japanese institutions have yet to really move away from JGBs and into assets such as U.S. 10-year government bonds (which as of February 28, 2014, had over 2% higher income) is that there was a lot of [volatility](#) in U.S. interest rates last year. Now that monetary policy in the U.S. is on a potentially more predictable course and bond volatility has come down, we may see more portfolio flows out of JGBs. These institutions should take advantage of the fact the BOJ could be a large buyer. The portfolio reallocation desires of the BOJ are one reason I am still optimistic about Japanese equities—the [dividend yield](#) on equities offers an income stream that can potentially grow with inflation and a relatively attractive [yield spread](#) over the traditional JGBs.

Important to Keep Stock Price Momentum Going An important variable for gauging the success of the BOJ is the level of the stock market. In explanations of its monetary program, the BOJ has said it is buying exchange-traded funds (ETFs) to help reduce the [risk premium](#) to owning equities—stated more simply, the BOJ wants higher stock prices. The decline in the Japanese equity market in 2014 has coincided with a strengthening of the yen and is thus high on the BOJ radar. I have no doubt that if the market weakened considerably or the yen strengthened considerably (which would likely occur simultaneously), the BOJ would be more aggressive in counteracting these moves. I see no indications the BOJ would back

down from its commitment to support risk premiums if the situation deteriorates. I believe the BOJ is doing a masterful job of telegraphing its intentions to all market participants, and its statement, as I interpret it, is, “The BOJ is here to support the market; we want you to capitalize on these equity and risk asset opportunities.” There is speculation (and this was not discussed in our meeting with the BOJ) that one of the expansions of the monetary policy program could be to remove the caps from ETF purchases later this year. This could be a very important signal for equity markets if the BOJ expands the ETF program in various steps—whether it comes in terms of removing caps or just expanding the ETF purchase program.

Levels of the Yen The BOJ’s monetary programs have contributed to the yen weakening against the U.S. dollar from the 80s to over 100. The pace of the decline was dramatic last year, and not many expect it to continue at this level. Corporate Japan, which benefited from the yen weakness, feels much more comfortable in the current situation and is not complaining to the BOJ about receiving more currency support. Yet currency weakness for the yen still seems likely as a baseline scenario. A level of 108 yen to the U.S. dollar is the analyst consensus—based on the differentials in monetary policies between the U.S. and Japan, differentials in interest rate and the trade dynamics. From our conversation, it seems the level of 110 may be a bit ambitious for this year. Looking further ahead, if the yen were to weaken beyond 120–125, this is where market participants may become more concerned about the potential negatives of yen depreciation—driving up import prices and prices for consumers—overtaking the benefits—the higher inflation levels, stimulated corporate profits and improved sentiment with equity market gains.

Summary Mr. Ide asked what key indicators I am watching this year. My comment: the [first arrow of Abenomics](#), what the BOJ is doing, has been to me a bull’s-eye. I have complete faith that the BOJ will continue to be supportive of the markets and the economy, adapting as necessary to expand its programs if the economic data comes in weak. Everyone is watching for progress on Abe’s third-arrow growth strategy, the consumption tax set for April 1, how wages move this year, and how tax policy is set to change. We will continue our takeaways from my latest Japan trip with further discussion on these issues.

¹See, e.g., a discussion in: Kikuo Iwata, “Purpose and Mechanism of Quantitative and Qualitative Monetary Easing,” Bank of Japan, 10/18/13.

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Japanese Government Bond (JGB): A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Basis point: 1/100th of 1 percent.

Riskier assets: Assets not backed by the full faith and credit of a government entity.

Volatility: A measure of the dispersion of actual returns around a particular average level.

Dividend yield: A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Yield spread: the amount of incremental income a bondholder receives for assuming credit risk.

Risk premium: Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

First arrow policies: This refers to the component of Abenomics policy that is focused upon what the Bank of Japan can do from a monetary policy standpoint to attempt to stimulate growth.