

## MARKET CALLS

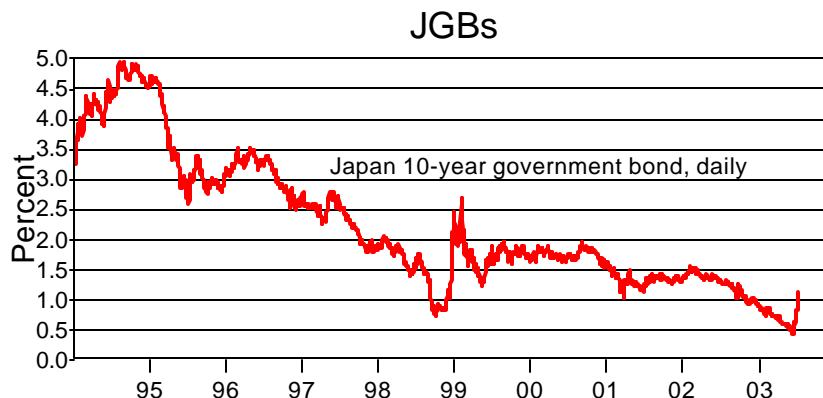
### JGB Sell-Off: The Real Deal?

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**Japanese government bonds take a tumble, but without monetary reflation, they may not have much further to go.**

We have long believed that an outstanding investment opportunity would eventually present itself when **Japanese** policymakers finally take the steps required to put an end to the country's long era of deflationary misery. Over the years, long-term Japanese government bonds have served as a market proxy for yen deflation and -- as the only asset class capable of converting the withering price-level destruction into sustained capital appreciation -- have been the lone beneficiaries of it. At their peak around the middle of last month, 10-year JGBs carried a yield below 0.45%, the apparent culmination of a rally that -- with but a few brief interruptions -- had been in progress since the bond last traded near 5% in 1994. A convincing end to Japan's monetary deflation will bring with it a powerful reversal in government bonds, with potentially exceptional returns available to portfolios positioned short Japanese government paper.



The three-week sell-off that has taken the benchmark JGB above 1% for the first time since last December, then, raises a compelling question: *is this it?* At this point, our initial assessment is probably not. Yes, it's possible that the sudden appearance of bear market conditions could continue to lift yields in the short run. Sustaining the turnaround, however, and bringing yields to around the 3% levels that would indicate expectations of rough price stability are being restored, will require a genuine reflationary policy thrust from the **Bank of Japan**, which still isn't happening.

For months Tokyo has been awash in chatter about the monetary stimulus supposedly being provided by a zero overnight rate target, increased open-market purchases of both government and privately issued securities, and recent currency market interventions. Fact is, though, if these operations were adding to the supply of yen and thereby easing the scarcity of monetary

liquidity that created and has sustained the deflation, it would be reflected in growth in assets on the BoJ's balance sheet. On net, though, the BoJ balance sheet has shown virtually no expansion over the past year and, in fact, has contracted by more than 10% just since March. In other words, whatever added liquidity the central bank has been supplying to the Japanese financial system with its right hand, it has been withdrawing with its left.

One plausible explanation for this JGB rout is that in the mood of overwhelming pessimism that has long characterized Japan's financial climate, long-term yields were pounded down to levels that overshoot for the likely magnitude of both present and expected future deflation, and are now correcting. While a real reflationary impulse is not yet visible, neither are there indicators suggesting deflationary forces are intensifying. The yen/dollar rate has traded in ranges around ¥118 to ¥119 for most of the year, and the yen price of gold, largely tracking the somewhat volatile course of the dollar gold price over the past several months, is now -- at about ¥42,000 per ounce -- right about where it began the year. Indeed, a not-insignificant impetus to this JGB sell-off appears to have been the repeated jawboning of **Finance Ministry** officials suggesting a stronger yen would be most unwelcome. But while all that would indicate that a renewed rally in JGBs at this point appears unlikely, it seems a leap to suggest that a sustained bond sell-off to reflect a decisive termination of the deflation is in the offing. **TM**