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MACROCOSM

Japan: At Long Last a Correction

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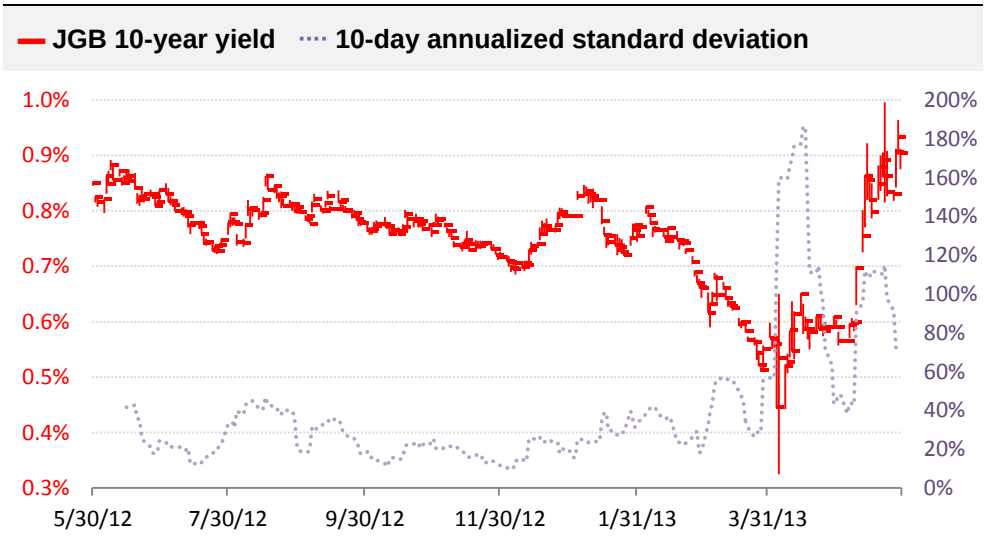
The BOJ can't have both higher inflation and lower yields -- but that's making a buyable dip.

In talking with clients this year about Japan, a persistent issue has been *timing* -- when do you get into a stock market that never gives you a pullback to buy? Well, now's the chance. Japanese stocks are in a real correction. But investment psychology can be a strange thing. Now that we finally have a pullback, that very fact raises doubts about whether we wish to buy after all.

- We reiterate our secular bull case for Japan -- Abenomics is a real and durable turnaround story (see "The Abe Restoration" May 10, 2013). This correction may continue for a while. But buy the dip.
- The current correction in Japanese stocks has an underlying narrative, which we will explore. But the fact of the correction itself does not overturn the bull case. It was inevitable, indeed long overdue, after an 88% run in less than a year.

To the extent that the correction is more than technical, its proximate trigger last week was the print below 50 for China's flash manufacturing PMI, indicating contraction in a key trading counterparty for export-driven Japan. But we think the heart of the matter is the back-up in yields of Japan government bonds (please see the chart below).



Source: Bloomberg, TrendMacro calculations

Update to strategic view

ASIA STOCKS, ASIA BONDS, BOJ, ASIA MACRO: Japanese stocks are finally correcting after nearly doubling in less than a year. We think it's a buying opportunity. Abenomics remains a real and durable turnaround story. The proximate cause is the highly volatile back-up in JGB yields. But this is only a sign that the BOJ's reflation strategy is working. It entails trade-offs, to be sure. Banks and insurers will take mark-to-market losses versus the past year's unusually low yields. And nominal government financing costs will gradually rise. But if the inflation targets are hit, real financing costs may not rise at all, and the stock of existing debt can be paid back with yen less valuable in real terms. The only substantive risk here is that complaints and fears about higher yields, and the stock market correction itself, may scare the BOJ off its reflationary path.

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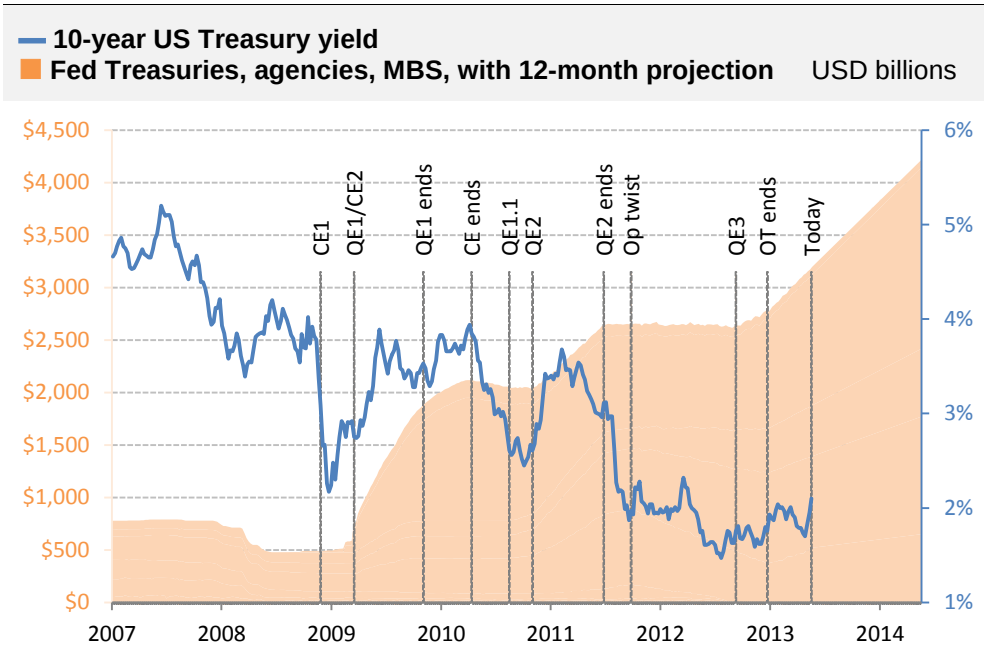
- The sheer *volatility* of yields since the Bank of Japan began large-scale asset purchases (see "On the April BOJ Policy Meeting" April 4, 2013) -- the 10-year JGB yield has traded as low as 32 bp and as high as 100 bp within mere weeks -- has given the destabilizing impression that the central bank is doing more harm than good, and is not in control of events.
- There have been reports that alarmed mainstream investors such as domestic insurance companies have pulled back from trading, making the volatility even worse. So the BOJ has engaged in dialogs with market participants, and has announced new procedures for spreading its purchases across more numerous but smaller -- and presumably less disruptive -- trades.
- But we see the complaints as mostly just carping. The volatility of the benchmark government bond hasn't prevented corporate issuance from rising to a three year high.
- The real issue is the *level* of government yields.
- Central banks undertaking quantitative easing all make the same rhetorical mistake. They all tell markets that the purpose of their bond-buying is to lower long-term yields.
- But when they say that their aim is to raise inflation and output growth, they are in fact confessing that they want long-term yields to *rise*. After all, if inflation and growth expectations rise, long-term yields have to *rise* at the same time.
- Over the last four-plus years of QE in the US, yields have always *risen* when the Fed has undertaken new purchase programs (please see the chart below).
- Indeed, yields *fell* while Prime Minister Shinzō Abe was struggling to appoint reformers to the BOJ (see "On Kuroda and Iwata at the BOJ" February 25, 2013), and then again when the new BOJ announced its asset purchase program (again, see "On the April



Source: Federal Reserve, TrendMacro calculations

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Recommended Reading

Letter to Paul Krugman
Carmen M. Reinhart
May 25, 2013

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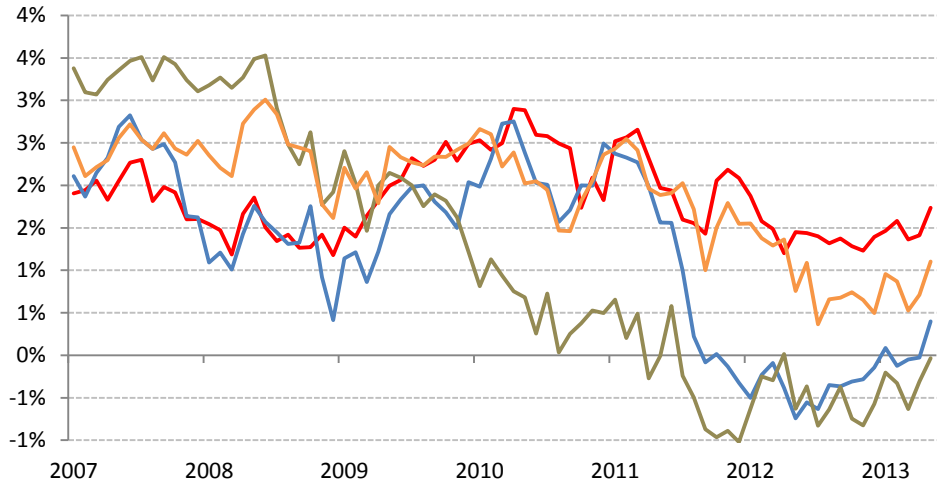
BOJ Policy Meeting"). We were worried then that it was the market's verdict that the BOJ would fail to aggressively pursue its inflation and growth objectives.

- So we've been delighted to see the 10-year JGB yield turn around and rise to new highs for the year. *That means the BOJ is succeeding*.
- And that is a good thing. It is good to be out of deflation after 15 years. It is good to return to robust output growth.
- Yet surely one of the factors behind the present correction in equities is that the market has suddenly become concerned that, along with all the good things associated with higher government bonds yields, there will also be costs.
- Such a duality should have been obvious. To suppose otherwise is to expect the impossible, to wish for a dog without fleas. But serious commentators have nevertheless taken exactly this view.
- Who are the losers, and do their losses outweigh the gains of the winners?
- Banks and insurance companies could see their capital ratios eroded by mark-to-market losses in bond positions. But did they really base all their future capital plans on the expectation that JGB yields would stay as uniquely low as they've been over the last 12 months -- well below 1% on the 10-year? Is *that* the benchmark against which losses will be determined? More rationally, the average 10-year yield over ten years has been about 1.4%. Surely mark-to-market changes to that point -- from which we are still 50 bp away -- should not make anyone regard himself as a loser from Abenomics.
- The Japanese government itself is a potential loser. With net indebtedness of 147% of GDP, higher yields will raise public financing costs significantly.
- But at the same time, if the BOJ's program succeeds in elevating output growth, the government's ability to service those costs rises commensurably. In the meantime, the average maturity of

Real 10-year government yield — **Japan** — **US** — **UK** — **Euro area**



Source: Bloomberg, national statistical agencies, TrendMacro calculations

outstanding government debt is about 6.5 years, so it will be quite a while before higher financing costs would really materialize.

- Indeed, if the BOJ succeeds in raising the rate of inflation, then 6.5 years in the future the government's *real* financing costs need be no higher than they are today. And until then, for 6.5 years, the government will be repaying the existing stock of debt with yen of decreasing real value.
- For years, while investors have automatically thought of Japan's yields as the lowest in the world, when adjusted for Japan's deflation they are actually the highest among the developed economies (please see the chart on the previous page). It is not too much to think that, without deflation, Japan would be more credit-worthy. If the BOJ's gambit succeeds, we could well see real yields decline to world norms.
- Incidentally, real yields have been rising over the last six months throughout the developed world, especially in the US -- due, outside of Japan, to the combination of rising nominal yields *and* falling inflation (again, please see the chart on the previous page). If nominal yields are rising everywhere, it will be to Japan's advantage if its rise due to *rising* inflation, not *falling* inflation -- which means that Japan's *real* yields will have fallen.
- So we are not afraid of rising nominal yields in Japan. It's to be expected, indeed to be hoped for. In the context of Japan's reflation objectives, it's a good thing.
- But when stocks had become priced for perfection under the spell of the cult of Abenomics, the sudden awareness of the inability of the BOJ to do the impossible, to deliver winners without losers -- even if the trade-off between the two is net positive -- is cause for a correction.
- For us, the only substantive risk here is that all the carping about higher rates -- and the stock market correction itself -- might scare the BOJ and cause it to back off from its avowed plans to reflate. We don't see that happening, but of all the issues we have raised here, *that* is the one to be on the lookout for.

Bottom line

Japanese stocks are finally correcting after nearly doubling in less than a year. We think it's a buying opportunity. Abenomics remains a real and durable turnaround story. The proximate cause is the highly volatile back-up in JGB yields. But this is only a sign that the BOJ's reflation strategy is working. It entails trade-offs, to be sure. Banks and insurers will take mark-to-market losses versus the past year's unusually low yields. And nominal government financing costs will gradually rise. But if the inflation targets are hit, real financing costs may not rise at all, and the stock of existing debt can be paid back with yen less valuable in real terms. The only substantive risk here is that complaints and fears about higher yields, and the stock market correction itself, may scare the BOJ off its reflationary path.