BNY MELLON

TRIP NOTE
JAPAN
JUNE 2015

NEON KNIGHTS

TRIP NOTE
JAPAN
JUNE 2015

BNY MELLON

NEON KNIGHTS

As Japan strives to eliminate stubbornly persistent deflation and achieve its stated 2% inflation target[1], the country continues to post mixed signals for international investors – and its prime minister Shinzo Abe looks set to face further tests in the year ahead.

The landslide re-election of Abe last December – albeit with an unusually low election turnout – appeared to give the prime minister a renewed mandate to continue with his reforming programme of so-called *Abenomics*.

Despite spurring limited core inflation, Japanese quantitative easing (QE) – expanded last October – and fiscal spending flexibility have not proved the panacea some government officials originally hoped for.[2]

Improvements in corporate governance and agricultural reform have been significant achievements for Abe. But with further reform needed and the economy struggling to meet its inflation target amid high fiscal deficits, his government faces a potentially challenging 2015.

Against this backdrop, a recent Japanese business visit to Tokyo and Kyoto gave me a good chance to assess the current mood in the investment market and amongst the broader financial community.

It was clear from my visit that shifting demographics and strong cultural and institutional rigidities continue to present some stark challenges to the Japanese economy. Indeed, Japan's rapidly ageing population is causing a growing imbalance within the domestic labour market[3] which could ultimately place an added strain on the Japanese pension system and lead to ballooning healthcare costs.

Nevertheless, speaking to Japanese policy makers and investment and banking professionals in Japan gave me the sense that at least some green shoots of economic optimism are appearing. A weaker Japanese yen is driving stronger corporate profits in Japan[4] which, together with rising wages due to ageing population-related labour shortages, should ultimately push prices up. Against this backdrop, it seems the potential for stable yet higher inflation is very real.

The yen depreciation may also be starting to make material impact on demand for Japanese exports. At Tokyo airport I was impressed by the number of Asian shoppers from Hong Kong and China I encountered – laden with heavy bags of gifts to take home – perhaps at least one indication of an improving picture in the consumer export market. A meeting I had with a local academic confirmed this rise in Japanese consumer optimism.

Taking the bullet train from Osaka to Tokyo it was hard not to be impressed by the technological sophistication of Japanese society – while also pondering its contrast with long-running national deflationary problems.

At a global macroeconomic level Japan pioneered QE and it has become an important instrument in the *Abenomics* tool kit. How much further its application can assist domestic economy recovery, however, remains open to debate.

In the current environment, it seems unlikely the Bank of Japan (BoJ) will apply fresh QE measures again this year unless the economy worsens substantially or some unexpected major political or global development disrupts markets. Amid reasonably strong wage pressures – buoyed partly by tumbling oil prices and rising domestic demand – I understood from my meetings with policy makers the BoJ was more likely to guide market expectations down with regard to the timing of reaching its inflation target rather than adding new economic stimulus. Indeed, the BoJ did just that at its April monetary policy meeting.

On the downside, liquidity in the Japanese debts markets is in very poor shape[5] and looks set to worsen. Domestic banks are not selling as much debt as the BoJ wants to buy from them and the credibility of its QQE2 market support programme announced last October is likely to come into fresh scrutiny in the next 18 months – unless the BoJ modifies the programme or it can deliver significant market improvements.

From an investment perspective, my sense is that the Japanese Government Bond (JGB) market looks increasingly challenged and is likely to face a choppy year ahead, despite ongoing support from the BoJ. On the upside, Japanese inflation-linked bonds (linkers) look set to continue to perform well on a fundamental basis and sentiment in this sector of the market appears to have improved in recent months thanks to increased involvement from domestic banks and foreign investors.

At a macroeconomic level – and despite the impact of *Abenomics* – the Japanese economy remains extremely rigid with much deeper progress on labour market, energy and economic reforms required. While there are signs of market optimism, there is little doubt Japan faces some tough decisions ahead. It may be that far-reaching change will only come if Japan is hit by a fresh economic crisis. For now, its economists, financiers and investors hope the Abe government can spur recovery from an unenviable market position and navigate the numerous looming fiscal challenges ahead.

Rebecca Braeu

Rebecca Braeu,
Director of Sovereign Research,
Standish[6]

A weaker Japanese yen is driving stronger corporate profits in Japan.

It seems unlikely the BoJ will apply fresh QE measures again this year unless the economy worsens substantially or some unexpected major political or global development disrupts markets.

The Japanese Government Bond (JGB) market looks increasingly challenged and is likely to face a choppy year ahead.

1 Years After BOJ Shock-and-Awe, Inflation to Fall Short. Bloomberg Business. 19 January, 2015.
2 A bigger bazooka. The Economist. 31 October, 2015.
3 Is Japan's Population Aging Deflationary? IMF Working Paper. 30 August, 2014.
4 Weaker Yen set to drive corporate profits higher in 2015. Wall Street Journal. 05 December, 2014.
5 Japan bond market liquidity dries up as BOJ holding hits 200 trn yen. Reuters. 15 April 2014.
6 Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited ("BNYMIM EMEA") or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA or the BNY Mellon funds.