JAPANESE HOUSEHOLDS: EXPECTING INFLATION AND SHIFTING THEIR PORTFOLIOS

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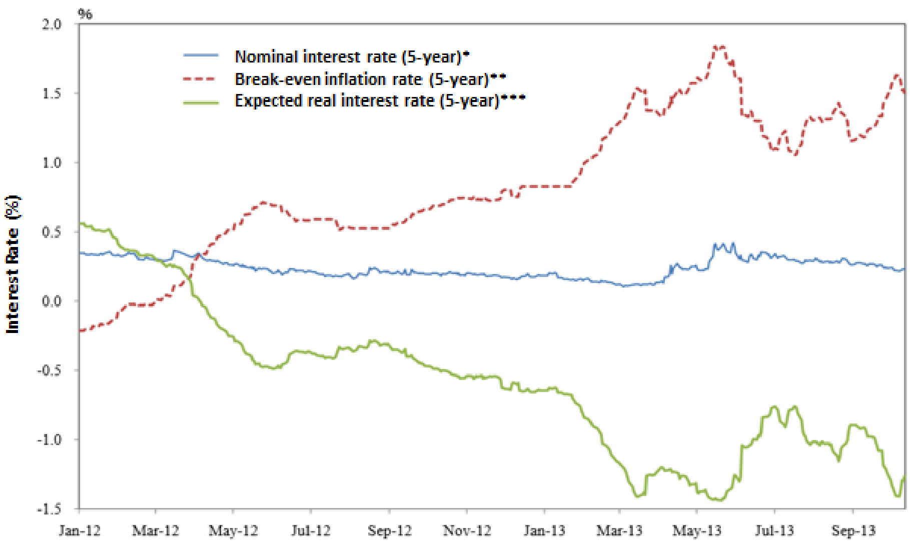
In a prior blog post, I outlined some important guidance Bank of Japan (BOJ) deputy governor Kikuo Iwata outlined in a speech on October 18. We continue that discussion here with a look at how Iwata sees the BOJ's activities manifesting in changing inflation expectations and portfolio allocations of Japanese households. Let's start with why Iwata believes the BOJ's monetary easing program known as quantitative and qualitative monetary easing (QQE) lifts inflation expectations: *The reason behind the lift in inflation expectations owes much to the market expectations that a sharp increase in the monetary base … will eventually lead to an increase in bank lending, and hence an increase in the amount of money (i.e., sum of cash and deposits) circulating in the economy. If the money in the economy increases, people will expect that it will be used partly for the purpose of purchasing goods and services, and eventually the rate of inflation will start to pick up as well.*[1] Iwata showed a graph of nominal interest rates, expected real interest rates on inflation-adjusted bonds, and then the break-even inflation rate that is implied from the difference between the two interest rate series. One can see expected real rates have been on the decline. Although to be fair to prime minister Shinzo Abe, the decline in real rates started with Abe's election in November, when the break-even inflation rate was close to 0.50%—it has since risen well above 1%. The expected real interest rate in September is really not much lower than when the BOJ began its QQE program in April. **Interest Rates and Inflation Expectations (1/1/2012–9/30/2013)**



* Nominal interest rate (5-year): The yield to maturity on a five-year Japanese government bond that does not factor in inflation expectations.
** Break-even inflation rate (5-year): The difference between the yield to maturity on a five-year Japanese government bond that does not factor in inflation expectations and a five-year Japanese government bond that does factor in inflation. This difference is the market's expectation of average annual inflation over the next five-year time horizon.
*** Expected real interest rate (5-year): The yield to maturity on a five-year Japanese government bond that does factor in inflation expectations. If inflation is expected to be greater than zero, this yield will be lower than the nominal interest rate.
Period: This period was selected to showcase a period in which one can see a change from approximately one year prior to Shinzo Abe's election as the Japanese prime minister to nearly one year after, so as to contrast any differences in more recent time frames due to his policy prescriptions thus far.
Source: Bloomberg. Past performance is not indicative of future results.

But there is increasing evidence that inflation expectations are becoming more firmly established. Beyond the break-even inflation rates, survey data confirms households are expecting inflation. Iwata stated that 83% of respondents to a Bank of Japan survey expected prices to go up one year from now.[2] Iwata further stated that the rise in inflation expectations should manifest in shifting portfolio allocations from cash, which earns 0% interest rate and potentially suffers from declines in purchasing power, toward foreign assets and equities. And the portfolio flow data is starting to bear out this shift in allocations. Iwata illustrated the occurring shifts: *According to recent statistics, the financial assets of households at end-June 2013 increased by 5% on a year-on-year basis. Looking at this in detail, while bonds decreased by 9%, shares and equities increased by 31% and investment trusts rose by 29%. The portfolio rebalancing … is actually taking place.*[3] **Japanese Household Assets (as of 6/30/2013)**

As of Date		2011		2012				2013		Amounts Outstanding as of 6/30/2013 in Trillions of Yen (% of Total in Parentheses)
		9/30/2011	12/31/2011	3/31/2012	6/30/2012	9/30/2012	12/31/2012	3/31/2013	6/30/2013	
Amounts Outstanding (End of Period, Trillion Yen)		1,486	1,500	1,517	1,514	1,509	1,544	1,568	1,590	
Percentage Changes	Total Assets	0.6%	-0.1%	1.1%	0.2%	1.5%	2.9%	3.4%	5.0%	1,590 (100%)
	Currency & Deposits[1]	1.9%	2.0%	2.2%	1.8%	1.9%	2.0%	1.7%	2.0%	860 (54.1%)
	Bonds[2]	-12.6%	-12.0%	-8.4%	-7.9%	-8.7%	-9.3%	-8.0%	-9.0%	31 (2.0%)
	Investment Trust Beneficiary Certificates[3]	-7.0%	-10.7%	-4.9%	-11.3%	2.0%	13.3%	20.1%	29.0%	72 (4.5%)
	Shares and Other Equities[4]	6.8%	-6.3%	0.9%	-5.4%	-1.4%	11.3%	15.1%	31.4%	129 (8.1%)
	Insurance and Pension Reserves[5]	-0.1%	0.2%	0.9%	1.1%	1.8%	2.5%	2.4%	2.6%	434 (27.3%)
	Others[6]	-4.3%	-2.1%	-0.4%	-1.0%	3.6%	4.0%	3.6%	6.3%	65 (4.1%)

[1] Currency & deposits: Consists of currency, deposits with the Bank of Japan, government deposits, both time and savings deposits, certificates of deposit and foreign currency deposits.
[2] Bonds: Holdings of fixed income securities, largely Japanese government bonds.
[3] Investment trust beneficiary certificates: Investment management companies that raise funds by issuing beneficiary certificates and invest them in various types of financial instruments, such as stocks or bonds.
[4] Shares and other equities: Holdings in various kinds of corporations established in Japan. "Other" refers to equities in special status corporations.
[5] Insurance and pension reserves: Equal to the policyholders' claims on insurance and pension fund reserves.
[6] Others: Includes claims of the central bank against the central government, claims and debts existing between the treasury that arise from the posting of government deposits as holdings of the central government, and retirement benefit trusts prepared for the retirement benefits for employees.
Source: Bank of Japan, Flow of Funds as of 6/30/2013

The increase in both equities (at approximately 30%) and investment trusts (such as mutual funds) is impressive but still needs to be put in the context of the low bases they were starting from. Only 8.1% of Japan's household assets were in shares and other equities, and only 4.5% of total assets were in investment trusts. A full 54.1% was still in "currency and deposits"—or being left in the bank and under the proverbial mattress. These assets are earning essentially a 0% rate of return and suffering losses in purchasing power. The types of increases in equities and investment trusts we saw in the first and second quarters of 2013 are an important start, but they are just that—a start of what could be a critical adjustment in portfolio allocations. As we discussed in our last blog post, the BOJ's QQE program is meant to reduce the risk premium (i.e., support higher prices) for the equity markets through their purchases of equities. This recent evidence of households shifting portfolios is thus an encouraging ramification of the QQE program, but I believe we are only in the very early innings of a large shift in portfolio allocations. This shift, if it continues, will be a big driver of Japan's equity markets over the years and is one of the reasons why I am optimistic for the prospects on Japan's markets. [1]Kikuo Iwata, "Purpose and Mechanism of Quantitative and Qualitative Monetary Easing," Bank of Japan, October 18, 2013. [2]Iwata, 2013. [3]Iwata, 2013.

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DEFINITIONS

Quantitative and qualitative monetary easing (QQE) : A central bank monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Monetary Base : For a particular economy, the sum total of all cash and bank deposits in circulation. Increasing this number is one way to stimulate economic growth.

Nominal interest rate : Interest rate that does not account for the impact of inflation.

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.

Inflation-adjusted bonds : Bonds with interest rates that adjust in order to compensate the holder for the impact of inflation.

Break-even inflation rate : For a given bond maturity, for example five years, the interest rate on the five-year nominal bond minus the interest rate on the five-year inflation adjusted bond; meant to approximate expected inflation over that time frame, in this case five years.

Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.

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.