

Japan's corporate re-leveraging is defeating deflation. It's bullish Japanese equities, bearish yen

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Japan's corporate re-leveraging since 2012 appears to be on a sustained footing. Having accelerated to 2% of GDP, the rise in corporate borrowing is a marked reversal from companies' relentless focus on paying down debt in the years prior. The increased borrowing needs of companies is an emerging force in Japan's economy to entrench inflation, as household spending power remains limited and sensitive to fiscal tightening by the government. The re-leveraging of companies' balance sheets unlocks shareholder value on the premise that this feeds inflation expectations and disincentivises cash hoarding. Higher cash returns in the form of dividends are expected for investors. The negative real borrowing rates should also encourage more debt financing and optimise the capital structure of companies. The yen may remain fundamentally weakened if domestic demand-led inflation becomes firmly entrenched well after the BOJ unwinds its QE program and Japan's real interest rates fall. Looming Fed tightening should also sustain pressure to the yen relative to the US dollar. The willingness of corporate Japan to borrow and invest is giving Japanese equities a solid foundation of strength. It's also inflationary so that potential yen weakness may warrant foreign investors to hedge their currency exposure when investing in Japanese equities.

The effect of last year's sales tax hike on consumer spending is a stark reminder of the government's limited capacity to tighten the budget. For instance, the sharp acceleration YOY in retail sales volumes (+4.7% in Q1 2014) that came ahead of the anticipated 3% sales tax hike (from 5% to 8%) in April and has led to its subsequent marked contraction (-5.4% in Q2 2014) thereafter just shows how, having faced more than a decade of falling prices and wages, Japanese consumers' drastically cutting back spending could endanger the efforts of the BOJ to revive inflation. However, while economic growth has become largely reliant on QE and deficit spending, the corporate sector has started to pull more of its weight and in recent years has become a stronger contributor to growth. Importantly, it may be the key sector in the economy to revive inflation in the process.

Balance sheet re-leveraging

Chart 1 shows how Japan's corporate sector has been able to re-leverage its balance sheet since 2012, after the late 1980s stock market bubble burst and subsequent collapse in real estate set in motion, a decade of Japanese companies paying down debt. Attempts by corporate Japan to re-leverage in 2006 had been cut short by the seizing up of the banking system in the 2008 credit crisis and by the tsunami disaster in 2011, when much of Japan's infrastructure was destroyed. It has only been in recent years that the gradual economic recovery and improving business sentiment has encouraged Japanese companies to take on more debt. As shown in the chart, since 2012, corporate re-leveraging has accelerated, with borrowing from banks by small and mid-sized companies outweighing the redemptions of corporate bonds

by large companies. The aggregate effect has been that while corporate Japan paid down some \$68bn of corporate bonds since 2012, almost 4x as much has been taken out as bank loans in the same period. April's Bank of Japan's Senior Loan Officer Survey also shows that increases in loan demand have been attributed to not just rising working capital requirements and falling interest rates, but increasingly to rising investment needs as well.

Corporate re-leveraging unlocks shareholder value

If companies' longer term investment decisions become a bigger driver for corporate borrowing, then inflation expectations in Japan are likely to become more firmly entrenched. Its positive spill-over effect is the incentive for companies to put their excessive cash reserves to work, thereby unlocking shareholder value in the process. Significant cash hoarding of corporate Japan in recent years is evident in BOJ's Flow of Funds report. For instance, since 2012 corporate Japan accumulated an additional 30 trillion yen (\$240 billion[1]) in cash on top of existing cash and deposit balances of 223 trillion yen (\$2.7 trillion

[2] as at end of Dec 2011), which was more than the 28 trillion yen (\$225 billion

[3]) of companies' combined foreign direct and indirect investment flows over the same period. In a deflationary environment, it made business sense to hoard cash to such a degree. But the prospect of domestic demand-led growth anchoring in inflation is likely to spur management to beef up their dividend policy, offering better cash returns to shareholders in the future. The potential for this to increase shareholder value should not be underestimated, given how detrimental cash hoarding has been to shareholder returns. For instance, gauged by MSCI equity indices, Japanese

[1] Based on USS/JPY FX spot rates on 31 May 2015

[2] Based on USS/JPY FX spot rates on 31 Dec 2011

[3] Based on USS/JPY FX spot rates on 31 May 2015

large-cap stocks have an ROE of around 8%, much lower than the double digit ROEs seen in most of Europe's and US equity markets.

At around 2% of GDP, the re-leveraging of corporate Japan has reached levels that are close to the degree with which it accumulates cash. Hence, corporate re-leveraging has potential to rise by more as it has not deteriorated the credit and liquidity metrics in any way. In fact, prime lending rates of banks hover around 1.1%, which is not only historically very low in nominal terms, but in real terms is well below the rate of inflation (of which the annual growth rate has been positive and rising steadily since the summer of 2013). Hence, the macro conditions now are likely to provide the strongest incentive yet for companies to add more leverage to their balance sheets and optimise the capital structure, along securing cheap longer-term financing for expansion and investment programs.

Entrenched Inflation beyond unwinding of QE keeps a lid on the yen

After corporate borrowers have been largely absent when Japan introduced its zero interest rate policy and embarked on its first broad-based QE program absent since the beginning of the decade, corporate

re-leveraging is giving Abenomics' QE plan a major support driver that appears to have triggered a lasting rebound in inflation. As shown in chart 2, both the actual and implied inflation readings have been effectively hovering around 2% since 2014, this at a time when two large macro trends may have had an offsetting effect to consumer prices overall: the fall in crude prices oil and the depreciation of the yen. Hence, if the rise in inflation in recent years has increasingly been led by improving domestic demand in Japan and was less affected by the volatility in commodity markets and trade, it should give inflation fundamentally a much stronger footing to sustain itself.

The irony may be that with Japanese inflation expectations sustained at 2% and close to US inflation, a consequential unwinding of QE by the BOJ may not help the yen rise in value. In fact, given that the real interest rate differential between the US and Japan is likely to rise as a result of inflation forcing Japan's real interest rate lower while a tightening cycle by the Fed forcing US rates higher, the fundamentals for the yen relative to the dollar should remain weak. The pressure on the yen to devalue may continue to persist for longer well after Japan exists QE.

Foreign Investors bullish on Japan may want to consider the risk of yen devaluation in that regard, which can have a detrimental effect on the equity return of Japanese equities when converted into their home currency.

Investors sharing this sentiment may consider the following UCITS ETF:

- **WisdomTree Japan Equity UCITS ETF – USD Hedged (DXJ)**

All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.

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