

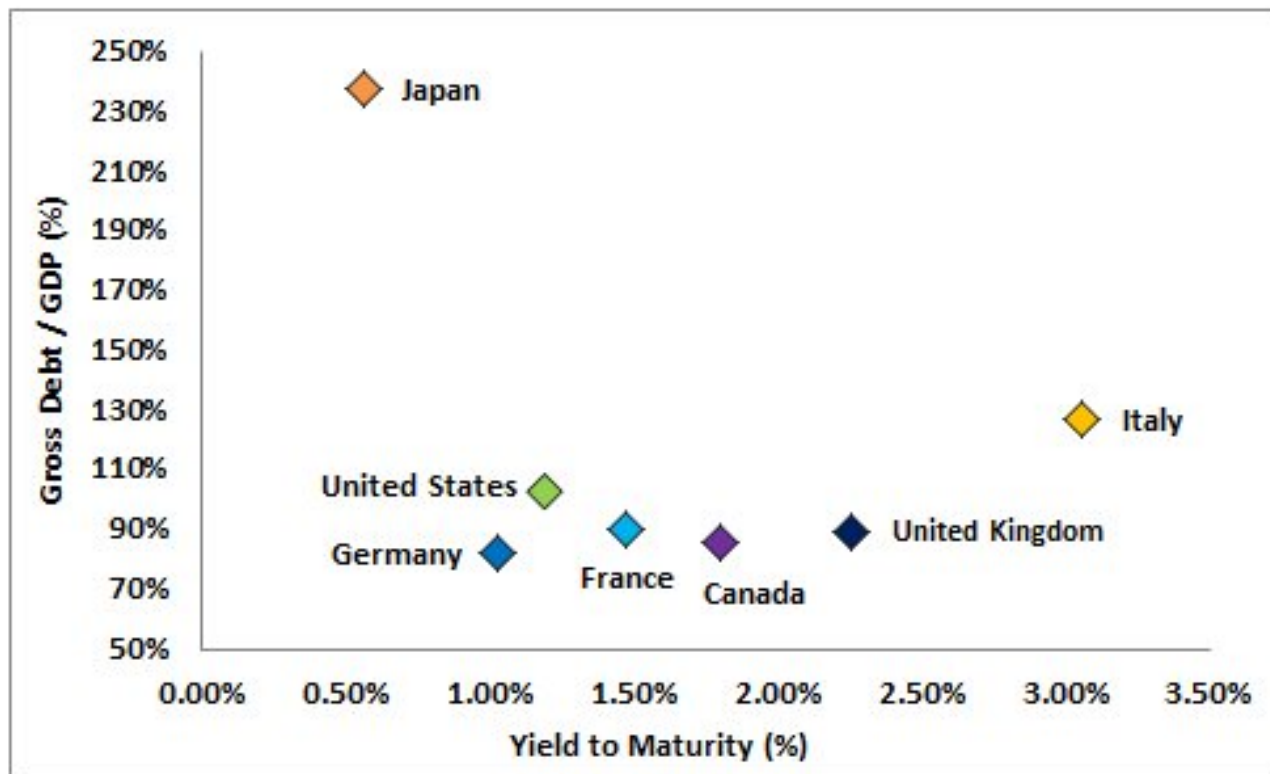
An Introduction to the Japanese Government Bond Market

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One of the most talked about investment themes of 2013 has been the dramatic turnaround in the Japanese economy as a result of Abenomics. While equities and the value of the yen have dominated headlines, one area investors might not be as familiar with is the Japanese government bond (JGB) market. When talking about bond investing, we believe it is important to maintain perspective on what debt investing really represents. When an investor purchases a bond, it is the same thing as lending money to a borrower. As we will discuss, the Japanese bond market is currently one of the most interesting markets in finance. As one of the largest developed market economies in the world, the JGB market is truly massive. In fact, according to the Japanese Ministry of Finance, the total value of the Japanese government bond market stood at ¥1.01 quadrillion (\$10.3 trillion) as of September 30, 2013—its highest level ever.¹ Given the market's size, it is also regarded as one of the most liquid bond markets in the world. According to Barclays, Japanese government debt accounts for nearly 29% of the Barclays Global Treasury Index, representing its largest individual country weight.² However, particularly large debt markets can sometimes be a double-edged sword for investors. In our view, just because a country has a large amount of debt outstanding doesn't necessarily mean it deserves a significant portion of an investor's portfolio. As bond investors, we care principally about lending money at rates that adequately compensate us for the risks we are taking. One of the most confusing elements for foreign investors looking at the Japanese bond market is that it is not only the largest government bond market in the world but also home to the lowest government borrowing costs. Generally speaking, investors have traditionally used yields as a generic barometer of creditworthiness or risk. By this metric, it appears that Japan is one of the most worthy creditors in the world, with 10-year government bond yields of 0.60%.³ Interestingly, despite its large presence in the Barclays Global Treasury Index, it contributes only 16 basis points to the overall index yield of 1.47% (11% of the index yield compared to nearly 30% of the weight). For this reason, Japanese debt has generally not been a favored allocation for international investors. While the size of the JGB market is staggering, many investors have highlighted another statistic that they find equally pertinent when assessing the country's level of debt sustainability. For many market participants, a country's debt burden relative to its output provides a commonly used metric for gaining some insight into that country's long-term debt sustainability. The International Monetary Fund (IMF) calculated Japan's gross debt at 238% of its gross domestic product (GDP) in 2012. By way of historical perspective, Japan has had a debt burden exceeding 100% of GDP since 1997. As shown in the table below, the Japanese bond market currently provides the lowest interest rates in the world with the largest gross domestic debt to GDP. **G7 Economies: Gross Debt to GDP vs. Yield to Maturity**



Source: IMF, Barclays, as of 10/31/2013. Past performance is not indicative of future results.

Traditionally, as a country's debt burden increases, investors would demand higher interest rates to compensate them for the additional risk. However, Japan has had two primary factors contributing to its comparatively low yields: a predominantly domestic investor base and deflation. At present, 90% of Japan's government debt is held by domestic investors.⁴ Compared to other major economies, this "captive" investor base provides a significant portion of government funding. In a country like the United States, a much larger percentage of the government's debt is financed by foreign creditors, who are more sensitive to large debt burdens. Also, a decade of deflation had boosted investor's real returns as the trend in prices of goods and services declined. Therefore, Japanese investors were willing to receive a lower nominal yield as long as inflation remained low (or was negative). However, as we will show in future blog posts, both of these factors currently supporting low interest rates may soon be changing in response to Abenomics. Ultimately, we believe that low borrowing costs may not persist indefinitely in Japan. In light of the variety of governmental policies seeking to boost the Japanese economy, we believe that higher interest rates may be a necessary by-product of Shinzo Abe's reflationary agenda. Read the full research [here](#). ¹Source: Japanese Ministry of Finance, 9/30/2013. ²Source: Barclays, 10/31/2013. Japan narrowly edged out the United States, which has a weight of 26.05%. ³Source: Bloomberg, as of 10/31/2013. ⁴Source: Japanese Ministry of Finance Japan Quarterly Newsletter, June 2013.

Important Risks Related to this Article

Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.