

Double Dose of Stimulus Sending Japan Stocks Up, Yen Down

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On October 31, the Bank of Japan (BOJ) unleashed a surprise round of further stimulus to its monetary policies. As part of its efforts to reach 2% inflation, the BOJ now plans to increase its monetary base by ¥80 trillion per year (\$720 billion), and it tripled the size of its annual purchase of exchange-traded funds (ETFs) to ¥3 trillion per year (\$27 billion) as well as tripled the size of its real estate purchases to ¥90 billion per year (\$810 million). **A few details on these purchase programs:** **ETFs:** As part of the ETF purchases, the BOJ also approved the newly launched ETFs tracking the JPX-400 Index, which were designed to put pressure on Japanese companies to increase their profitability metrics, such as return on equity (ROE), which are part of the inclusion criteria. **Bonds:** Given redemptions of current bond holdings that range from ¥20 trillion to ¥30 trillion per year, the gross purchase of Japanese government bonds (JGB) must be ¥100 trillion to ¥110 trillion per year to reach the BOJ's goals for expanding the monetary base. The BOJ also decided to extend the maturity of its holdings from fewer than seven years to between seven and 10 years, so the BOJ just increased the duration of its JGB purchase plan from a holdings perspective. This additional monetary easing occurred the same week that the U.S. Federal Reserve (Fed) completed its monetary policy program, showing a transition in global central bank accommodation leadership. It was an amazing synchronization that surprised the markets. To wit, we have talked about the market being worried about the Fed taking away its "punch bowl," but global liquidity is aplenty with the BOJ serving up plenty of sake to go around. **Second Dose of Stimulus** Further boosting risk sentiment, Japan's Government Pension Investment Fund (GPIF), the largest pension fund in the world with more than \$1.1 trillion in assets, announced later on October 31 a new targeted asset allocation¹. • Japanese government bonds reduced from 60% to 35% • Japanese stocks increased from 12% to 25% • Foreign bonds increased from 11% to 15% • Foreign stocks increased from 12% to 25% These allocation shifts mean the GPIF looks set to buy approximately ¥10 trillion (\$90 billion) of Japanese equities and foreign assets of ¥16 trillion (\$145 billion). However, these numbers are just direct assets held by the GPIF. It is widely thought that there will be many follow-on pension funds that adopt this allocation shift and even double those numbers. Note, the type of flows that caused Japan to be the best-performing market in 2013 were approximately \$150 billion of foreign investor inflows into Japan. The GPIF and follow-on offerings are likely to rival this allocation—but this time purely from local Japanese buyers. Additional foreign buying could compound this increase in assets toward Japanese equities. **What Is Motivating This Allocation Shift?** One reason we are confident there will be much more flows into equities from local Japanese at the very least: Japan remains a low-priced market based on valuations compared to other developed markets. Back in June, we wrote a [paper](#) that said Japan was returning to being a traditional value play of compelling relative

valuations, even excluding the case for central bank stimulus that we have received. That story has not changed: Japanese companies continue to increase dividends and buybacks—managing their balance sheets more effectively at the margin. The reason the GPIF is switching so aggressively from JGBs to equities: Japan has transitioned from a period mired by deflation and falling prices to a period of inflation and rising price levels. The JGB yields the Bank of Japan is buying were sub-46 basis points on October 31.² Japan has a goal of reaching 2% annual inflation, meaning the GPIF would lose 1.5% per year after inflation on a 10-year JGB if the BOJ accomplishes its goals. The BOJ has shown with these latest actions that it is determined to do “whatever it takes.” The GPIF is moving from Japan bonds that offer no cushion against inflation toward assets that can have income streams that provide more inflation protection. The current dividend yield on Japanese stocks rivals that of the U.S. equity markets, but the Japanese competition from Japanese bond yields is even more extreme. The [S&P 500 Index](#) now has a dividend yield less than the U.S. 10-year government bond yield. But the Japanese equity market dividend yields are almost 150 basis points higher than JGB yields.³ This could be a very important catalyst that supports further allocations and increases to Japanese equities from both pensions and households. **Moves in the Yen** This double dose of stimulus by BOJ and GPIF sent the yen to ¥112 per U.S. dollar, and its equity markets reacted very positively. In the middle of October, during a volatile stretch for the markets, the yen was trading at ¥106 per U.S. dollar, showing how far it had come in such little time. We find it hard to make a strongly bullish case on the yen—the path appears to be continued strength for the U.S. dollar over the coming years. We believe there are a number of ways to participate in the equity markets. Most importantly, we believe when U.S. investors access Japanese equities, it is important to do so in a currency-hedged manner to mitigate the risk of yen weakness given these shifting central bank policies. In our next blog post focused on the news out of Japan, we’ll dive into more specific investment strategies focused on the Japanese market. ¹Source: “Adoption of New Policy Asset Mix,” Government Pension Investment Fund, Japan, 10/31/14. ²Source: Bloomberg, as of 10/31/14. ³Source: Bloomberg, as of 10/31/14. Japanese equities refer to MSCI Japan Index.

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