

New Bank of Japan Leader Initiates Aggressive Plan to End Deflation

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It has been hardly four months since Japan elected Shinzo Abe as prime minister, yet market participants have clearly placed their bets behind Mr. Abe's plans to resuscitate Japan's economy from the grip of deflation and slow growth (referred to as "Abenomics"), as the Nikkei 225 Index rallied from below 9,000 in early November 2012 to over 13,000 in early April 2013. Central to Abenomics was appointing a new head of the Bank of Japan (BOJ), Haruhiko Kuroda, who is charged with enacting bold monetary policy. To be fair, Japan experimented with quantitative easing, or the expansion of the bank's balance sheet into non-traditional assets, in the 1990s, prior to its being more fashionable among today's global central bankers. Yet the BOJ's previous actions failed to end deflation, get Japan's economy into gear, or convince the market its policy makers had the conviction to continue trying "whatever it takes" to end deflation.

In a way, the market can do a lot of the heavy lifting for the Bank of Japan by sending the yen's value lower and easing pressure on Japan's exporters. But the market must believe the BOJ will not back down.

Beating high expectations Expectations for Mr. Kuroda were quite high for his first meeting, held on April 3 and 4. The yen had already weakened from below 80 on November 13, 2012, to 93.44, as of the close of April 2, 2013—a 15% depreciation against the U.S. dollar. If bold, decisive action contributes to inspiring credibility, then Kuroda and the BOJ's announcement on April 4 certainly did their part. Policies included plans to:

- **Double the Monetary Base:** Increasing the levels of cash and bank deposits from ¥138 trillion to ¥270 trillion by the end of 2014. Putting these numbers in context, this amounted to an additional ¥7 trillion a month of additional purchases, which is nearly equal to the amount of purchases the U.S.

Federal Reserve is doing in its monetary policy of \$85 billion a month (despite Japan being one-third the size of the U.S.). Given the relative sizes of their economies, one might say Japan's purchases are three times more impactful than those of the U.S. Federal Reserve.

- **Purchase Longer-Maturity Government Bonds:** Extending the weighted average duration of Japanese government bonds from less than three years to approximately seven years, and even allowing the purchase of the 40-year bond to do so. Some interpret this as the Bank of Japan funding the government by printing yen.

- **Double Equity Purchases:** Increase the purchases of [exchange-traded funds](#) from ¥1 trillion a year to ¥2 trillion.

- **Double Real Estate Investment Trust Purchases:** Increase the purchase of real estate investment trusts from ¥30 billion a year to ¥60 billion.

Nikkei reaches 13,000, Yen 100 per USD—where does it go from here? During 2012, the yen reached its strongest point on February 1—76.20. With current levels near 100, the yen has weakened significantly. Over the same period, the Nikkei 225 Index rallied nearly 50%. Is there still room for more? To provide context, I believe that it is important to consider:

- The Dow Jones Industrial Average and [S&P 500](#) both surpassed their all-time highs (set prior to the financial in October 2007) during the

first quarter of 2013. • Japan's all-time highs were set in 1989 during one of the largest bubbles in history, where Japan's overall market was trading at valuations similar to technology stocks within the S&P 500 Index during the technology bubble in 2000 in the U.S. • Prior to the financial crisis in 2007, when the U.S. equities were at their prior record-high level, the Nikkei was trading at over 18,000. Based on a level of 13,000, that means there would be a little less than 5,000 points, or 40% gains, just to regain the levels before the financial crisis. • The yen's level during that time was close to 120, implying even another 20% depreciation just to hit pre-crisis levels. **A further catalyst? Underinvestment in Japan** Despite Japan being the story of the year in 2013, I believe a catalyst for even further gains in Japan's equities would be if investors removed their under-allocations to Japanese equities. There are two types of investors who appear to be under-allocated: 1) **Institutions Late to Game:** According to Goldman Sachs, global money managers appear to be underweight Japan versus their benchmarks.¹ Japan's remarkable performance run could cause many of these managers to underperform, and some are likely to respond by closing their underweight positions (buying Japanese stocks) so performance doesn't diverge as much if Japan's rally continues. 2) **Japan's Savers:** Retail investors are becoming a growing presence in the market. For years, Japanese savers have seen equity values lose value from the peak of the Nikkei at approximately 39,000 to its current 13,000. According to a *Wall Street Journal* study of Japanese household balance-sheet data:² **a.** A typical Japanese household has 55% of its assets in currency and bank deposits and less than 11% in equities and mutual funds. **b.** The comparable data for the typical U.S. households: 15% in currencies and bank deposits and four times more equities and mutual funds—about 45% of their financial assets. **c.** This study also showed that retail trading volumes have increased from about 20% of trading volumes in October 2012 to 31% of trading volumes this March. Greater participation from retail investors could cause even further gains. **d.** To put this in perspective, Japanese households have \$8.9 trillion in cash and bank deposits, while U.S. households only have \$7.7 trillion. **e.** Again, putting these cash figures in context, the market capitalization of Japan's equity markets are less than \$5 trillion, so Japanese households have enough cash to buy the entire Japan stock market and still have large cash balances in the bank. By contrast, the cash in the United States households would roughly cover purchases of only half the value of the U.S. equity markets. **Conclusion** The latest actions for the BOJ have the same goal: stimulate Japan's economic growth. Deflation has been a major structural impediment, as Japan's citizens curtail their consumption and keep large cash balances in savings accounts. Overtly, the fiscal and monetary policies announced are geared toward this end, but we believe that a positive side effect for Japan's exporters is that many of these policies also encourage yen weakening. We believe that if Japan's citizens begin to convert savings to consumption and investment in the equity markets, at the same time that Japan's exporters are faced with the tailwind of yen weakness, the result could be very positive for equity investors. **Data source is Bloomberg unless otherwise noted. Time to invest in Japan? (Video)**

¹Dominic Lau, "Japan's Nikkei Bounces 1.9%, Cyprus Still an Issue." Reuters, March 18, 2013. ²Kana Inagaki, "Investors Take Plunge," Wall Street Journal, April 6, 2013.

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