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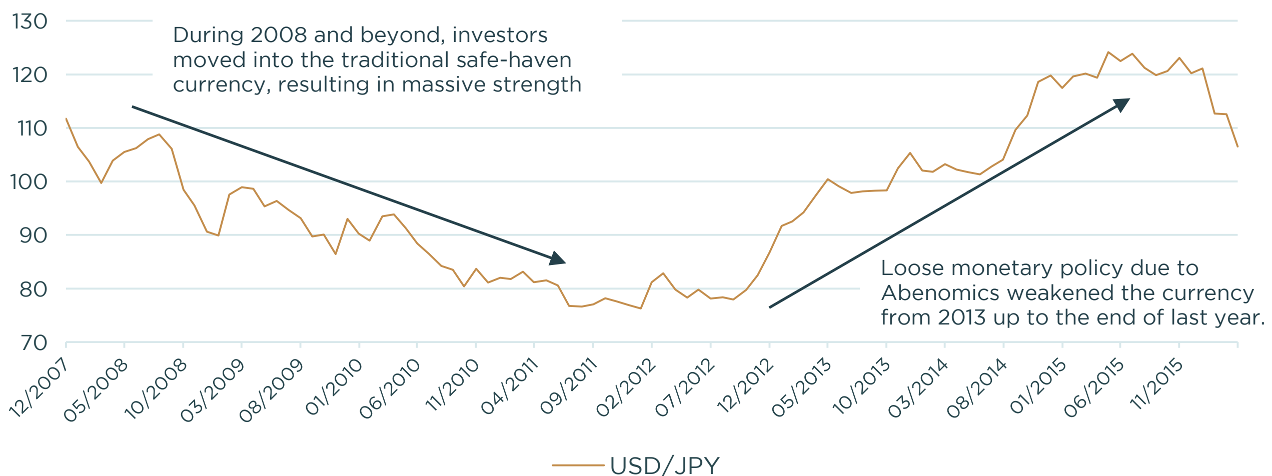
Mister ¥en

2015 marked the 25th year since the Nikkei 225 plunged nearly 20,000 points, losing over 45% of its value in a few months. This devastating blow to Japan's equity market was dealt when a major asset price bubble, an overheated economy, uncontrolled money supply and a credit boom led to an inescapable and all-encompassing bust. Over the following years, investors were consistently beaten down when looking for a recovery. There was of course a glimmer of hope between 1995 and 1998, but ultimately the responses of policy makers failed to live up to expectation. That is, at least, until the economic strategy advocated by the current President Shinzo Abe (creatively dubbed 'Abenomics') promised to provide the jolt the economy sorely needed to wrench itself from deflation's vice-like grip. A powerful combination of reflationary monetary policy, government spending, and structural reform led to a period of strong performance for the Japanese equity market between 2012 and 2015 – much to the relief of long-suffering investors in the region.

This year, the story has reversed, with Japanese equity markets suffering. The fundamental driver of the increased volatility has been the strength of the country's currency relative to its trading partners, which has dealt a considerable blow to expectations surrounding corporate profitability in Japan, an exporting nation. While central bankers around the world use loose monetary policy tactics for the seventh year in a row in continued attempts to stimulate economic growth, it appears that the Bank of Japan has lost the ability to weaken its currency using traditional monetary policy techniques. And since January, the Japanese Yen has strengthened markedly (along with the Euro), bearing the brunt of a Yuan devaluation and consequent volatility, stealthily executed by the People's Bank of China. The Yen this April renewed its highs, despite increased rhetoric from Japanese officials over the early part of the month aimed at restraining its advance.

Another fundamental driver of Yen strength which has thus far been largely overlooked is the widening of the real interest rate[1] spread since mid-February, which explains the currency's resilience in the face of improving global risk sentiment over the final weeks of the first quarter of 2016. Expectations of deflation have driven real yields in Japan up higher against both their US and European counterparts, even as nominal yields fall below zero following the implementation of negative interest rates. At these levels, the strength in the Yen in turn feeds further disinflationary pressures in Japan. Short of direct intervention, the Bank of Japan (BoJ) needs either higher inflation expectations or more hawkish rhetoric from the Federal Reserve (Fed) to weaken the currency again.

But the question is: at this point, is Japan *allowed* to devalue? One of the biggest unconfirmed secrets of recent market action was whether or not a "Shanghai Accord"[2] was made at the G20[3] meeting in February this year, where it was suggested that central bankers may have agreed to push the dollar lower to the benefit of China and the expense of Japan and Europe. Japan's cabinet secretary came as close as possible to admitting that there was some kind of tacit agreement when he argued that the G20's 'agreement to avoid competitive currency devaluation does not mean Japan cannot intervene in response to one-sided



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currency moves'. In a nutshell: intervention in foreign exchange markets in order to gain a competitive advantage in trade is now *unacceptable* in the eyes of the G20 and the IMF.

At these levels, however, we believe that direct Japanese intervention is unlikely. Despite market chatter, currency market intervention is not common from the BoJ. The Japanese, for example, did not intervene at all in 2008 despite the Yen plunging over twenty dollars from late August into year-end (¥110 to ¥87 to one US dollar). There was intervention to hold the Yen above ¥75 in 2011, but this intervention was supported by the G7[4]. In fact, the Fed, ECB and Bank of England jointly intervened with the BoJ in March 2011 as a show of unity to the Japanese market. Add to that words from former Japanese Finance Minister Eisuke Sakakibara, who was dubbed 'Mister Yen' for his ability to influence the exchange rate in the 1990s. Sakakibara correctly foresaw the Yen's advance to beyond ¥115 and then ¥110 against the dollar this year, and recently gave his view that the currency at ¥105 is 'no problem' for Japan's economy. Mister Yen sees the Yen at ¥100 by year end; while we do not see the Yen returning to levels last seen in 2008, we have taken a more cautious stance and now hold 50% of our Japanese Equities exposure in Yen.

Natasha Kingham
Junior Portfolio Manager

[1] The real interest rate is the rate of interest an investor receives minus the inflation rate.
[2] For an elaboration on the precedent for this potential agreement, see our piece Currency Wars.
[3] G20, which stands for Group of Twenty, is an assembly of governments and leaders from 20 of the world's largest economies.
[4] The Group of 7 (G7) is a group consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

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