Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Bullet Points February 6, 2014

Here are some further thoughts on the Japan correction:

1) It's not a total coincidence that this correction is occurring in the wake of the recent 1.6% CPI print. The concern is that the Bank of Japan is getting close to its 2% CPI target and thus is running out of room to do further QE. If the BoJ stops the QE, the thinking goes, that would spell the end of the equity rally. So better to sell now.

2) There are a couple of obvious counter-points to make to the argument that the BoJ will stop QE when CPI hits 2%. First, the 10-year JGB yield has fallen to 0.6% even as CPI has risen to 1.6%. Normally one doesn't see 10-year bond yields plunging against a backdrop of rising CPI and strengthening nominal GDP growth. Falling JGB yields are saying that investors *don't believe the BoJ will stick with QE long enough to keep CPI elevated*.

3) BoJ Deputy Governor Kikuo Iwata gave a speech in Miyazaki yesterday re-affirming the Bank's commitment to keep printing. He said:

> Even if CPI reached 2% YoY, unless the Bank projects that inflation is likely to remain at around 2% in a stable manner, it will not simply end monetary easing.
>
> If the Bank judges that achieving the 2% target will become difficult due to some unforeseeable risk factors, then it will make adjustments in the conduct of monetary policy as appropriate.
>
> [Changes in monthly gross bond purchases] are by no means a tapering of the pace of JGB purchases nor a reduction of quantitative easing as long as the annual pace of purchases on a net basis remains about 50 trillion yen. *(Source: Bloomberg)*

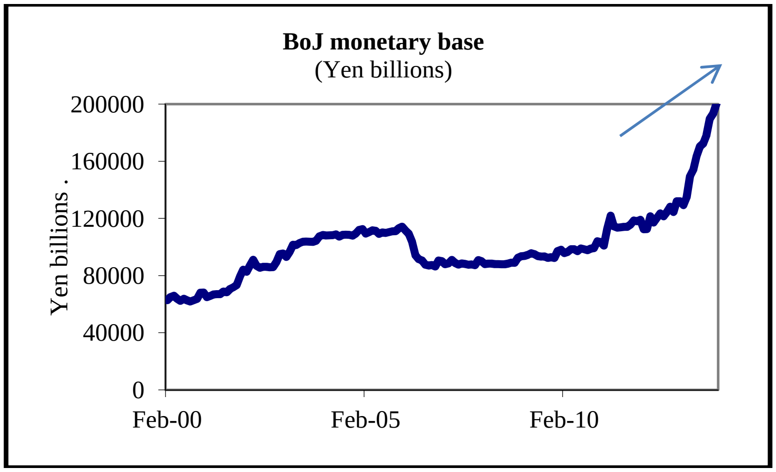
4) Iwata is saying something very interesting here: If "unforeseeable risk factors" make achieving the 2% CPI target difficult, the BoJ will adjust policy accordingly (i.e. print more money). He seems to be alluding to fear that an EM crisis could trigger huge safe-haven flows into the yen, strengthening the currency despite the BoJ's efforts to pull it down. Izawa is saying that the BoJ will accommodate safe-haven flows -- and print more besides (to get to the sustained 2% CPI target). *That's exactly the right thing to do*.

5) Forward CPI expectations are there for all to see in the 10-year JGB breakeven, now at 1.12%. Any dove can forcefully argue that as long as the 10-year breakeven is below 2%, monetary policy is not on a path to sustained CPI of 2%. The 10-year breakeven is corroborating the message of the JGB itself: Both indicators are saying the BoJ hasn't done enough QE to achieve 2% CPI -- nor *will* it do enough in the future.

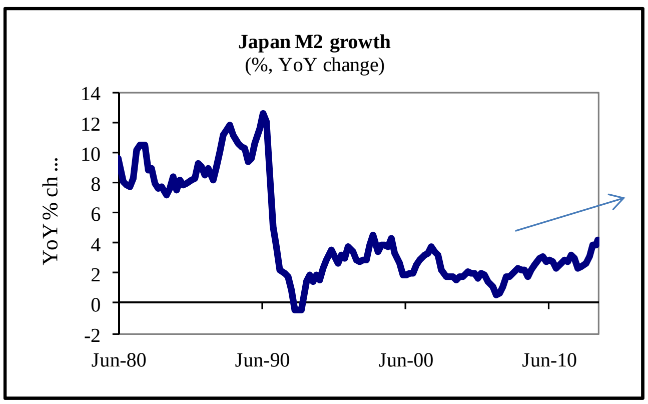
6) QE has broad and deep support in the Chamber of Deputies, the BoJ economics team, the executive branch (Shinzo Abe himself) and the populace. This isn't like Obamacare, jammed through on a razor thin margin against overt hostility from 49.9% of the country. A vast majority of Japanese at every level of society wanted to try QE, and it's clearly working. It's also helpful that Abe has been around the block a few times and won't be easily dissuaded from this path. Recall that Abe's first term as Prime Minister was ruined by premature BoJ tightening. He most definitely does not want a repeat of that mistake.

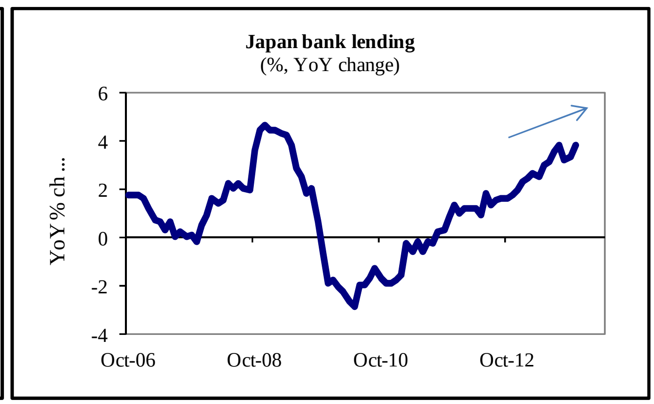
7) It seems likely, then, that the dominant strain of thought among policymakers will emerge along the following lines: "Yes, CPI is rising – but what is really important are the 10-year JGB yield and 10-year JGB breakeven. If JGB's are at 0.6% and the breakeven is 1.12%, we have plenty of room to keep going with QE. In fact, markets are practically *daring* us to stick with QE." Skeptics at the Ministry of Finance, concerned about rising JGB yields, really don't have much of a case given the aforementioned 0.6% JGB yield.

8) The January monetary base number came out two days ago week and it was up big again: It's now 200 trillion yen (up from 193.5 trillion at the end of December). That's a whopping 52% YoY increase.



QE is flowing into the broader economy: December M2 was up 4.2%, bringing the three-month moving average to its highest level since 1999. Bank lending was up 3.8% YoY as of November and that figure is probably higher now.





9) As if on cue, the first "Japan is done" stories are starting to appear. Two days ago Bloomberg's William Pesek wrote a piece entitled, "Nikkei Bubble Means Abe's Clock is Ticking Faster." Pesek argues that Abe needs to stop "coddling the dinosaurs of Japan Inc with a weaker yen," and pursue deregulation instead. Pesek gets it exactly backwards. *You can't do deregulation in a relentless deflation,* because political opposition is always too strong. The notion that anybody in Japan is being coddled by a weak yen is preposterous given that the yen has been the strongest currency in the world over the last 40 years. The yen was 350 per US$ in 1971, 150/US$ in 1991, and averaged 120 to the dollar for the decade of the 2000s. The yen is only "weak" relative to the destructive 80/US$ level attained in 2010-12.

10) Japan certainly could use some deregulation but from my perspective, having crunched about 200 companies and met with 35, I'm just not seeing any of these so-called dinosaurs. There has been a dramatic corporate culture change in Japan Inc over the last 5-7 years, driven by the one-two punch of the 2008 crash (or "Lehman Shock" as they refer to it) followed by the Fukushima earthquake/tsunami three years later. Corporate Japan has been cutting debt, slashing excess staff and boosting margins ever since. I see this in a solid majority of the companies I analyze (say 65%). The cliché of stodgy old Japanese black-suit managers who don't care about profit margins ... that's basically over.

11) The Pesek piece reminded me of the countless eulogies written for the commodity boom, beginning as far back as 2003. The commodity rally had barely even gotten started and already the naysayers were pronouncing it dead. Every spring the "commodities-are-done" stories would make the rounds again. Eventually the bears were right, of course, but the first obituaries were about eight years too early.

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