

# Investing Opportunities in Japan

October 2011

- **Short-term interest rates will remain very low for some time**
- **Bond yields will rise by less than global yields**
- **The yen is not under any clear pressure to rise or fall**

Economic growth was brisk through 2010 but the economy has fallen into recession in 2011. This was exacerbated by the earthquakes which began in March and have led to major disruptions in production processes. Firms are well placed to expand their expenditure but the government sector faces a very large debt burden and the household sector may need to build up their savings. The recovery from the earthquakes will temporarily support economic activity but unless firms are willing to expand their investment spending rapidly, economic growth is likely to be slow in the coming few years. Even though inflation has been boosted by rising commodity prices, consumer price inflation should remain very low (see table of key forecasts).

Financial market expectations of future monetary policy have been stable during recent months. This apparent stability masks continuing turbulence in financial markets and is related to the fact that official interest rates are already zero. Market expectations are for official rates to stay near zero in the coming two years (see top chart) which seems a plausible outcome. The stubborn nature of deflation during recent years makes forecasts of sustained inflation highly uncertain so the Bank of Japan may be more wary of reducing monetary stimulus than most other central banks. Nevertheless, once inflation returns on a sustained basis, the current policy settings will be inappropriate and a process of “normalisation” will begin.

Accompanying the low and stable short-term interest rates of the past decade have been low and stable bond yields. 10 year bond yields have been 1%-2% for most of the past decade (see middle chart). Eventually, when short-term interest rates begin to rise, bond yields are also likely to rise. More immediately, because global yields have fallen so sharply recently, Japanese bond yields are less “low” relative to other countries than they usually are (indeed, Japanese bond yields are no longer the lowest in the G10 countries). Japan’s bond yields are more likely to rise than fall, particularly when global yields rise from their current low levels, but the rise in Japan should be less than in most other countries.

The yen experienced a sizeable depreciation in 2005-2007 and an abrupt rebound in 2008. Since then, the yen has been little changed in trade-weighted terms (see bottom chart). Despite this, policy makers have been expressing concerns about the high level of the yen against the USD this year. Until the current financial market turbulence reduces and/or the USD rises, there is a possibility that official action will be taken to stop the yen appreciating. Once the turbulence subsides, if the yen is still near current levels, there will not be any strong reasons for the currency to rise or fall.

Equity prices have declined recently and have lost more than -5% in the past year. There is little reason to believe that a period of rapid equity price rises will soon begin. Rather, with the corporate sector in solid shape but facing continued uncertainty about the outlook, a period of moderate returns appears probable once the current market turbulence subsides.

Key Forecasts			
	Dec-12	Dec-13	Dec-14
GDP	3	2	2
CPI	1	1	1
Overnight	0.10	1.00	1.75
JGBs	1.75	2.50	3.00
USD/YEN	100	110	110
EUR/YEN	125	132	127

