

CENTRAL BANKS' NORMALIZATION SERIES

#3. DON'T BET ON BOJ'S TAPERING!



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Since 2013, Abe's forceful first arrow has mainly managed to weaken the Yen by 40%. What next?

- Monetary easing widened the rate gap with the US, depreciating the Yen and supporting exports
- The BoJ has cornered itself to highly active accommodation stance, while it already
 - holds a balance sheet worth a full year of Japanese GDP
 - owes 40% of the Japanese sovereign bond market
 - buys 1% of the country equity market (via ETFs) per annum

Can the BoJ follow suit in the wake of Fed – and eventual ECB – tapering? Inflation says not yet

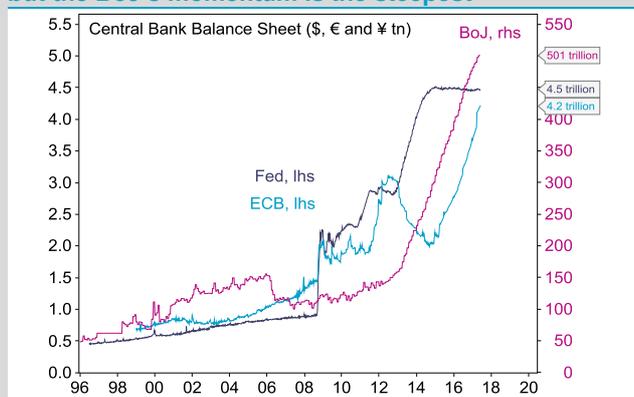
- Recent pace of purchases mellowed as markets did not challenge the “yield curve control” objective
- However, demographics have crushed unemployment figures... without wage inflation gains
- and QQE has done little to incentivize investment or borrowing
- Core inflation lingers close to negative territory

PM Abe may be tempted to declare victory on the monetary front before the Dec 2018 elections

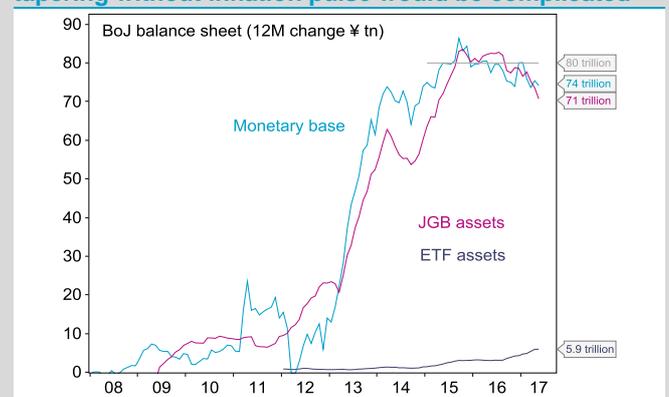
- Governor Kuroda's term ends in March and he could be thanked for his achievements
- Does it mean immediate tapering? We do not think so. First, Kuroda may stay and handle himself (like his US and EMU peers) the QE exit through 2023. Second, a replacement may not hurry either.

We do not recommend fighting the BoJ yet, and keep a neutral stance on JGBs

Similar scales in \$, € and ¥ liquidity infusions so far, but the BoJ's momentum is the steepest



Although curve control required less purchases lately, tapering without inflation pulse would be complicated



BOJ SUCCESS: SURF THE FED DIFFERENTIAL AND DEPRECIATE THE ¥

Abe's first arrow in full swing

Since his nomination on 20 March 2013, Kuroda has launched Abe's first arrow, forcefully injecting liquidity in the Japanese bond market, hoping to engineer reflation. PM Abe was at the time elected for the second time on his Abenomics platform, promising to re-awaken Japan, out of a deflationary spiral getting entrenched.

Yen depreciation delivered

Through the course of the past five years of easing, the Japanese QQE has succeeded at weakening dramatically the yen (40% against the USD), spurring exports and equity markets (both on valuation and EPS grounds).

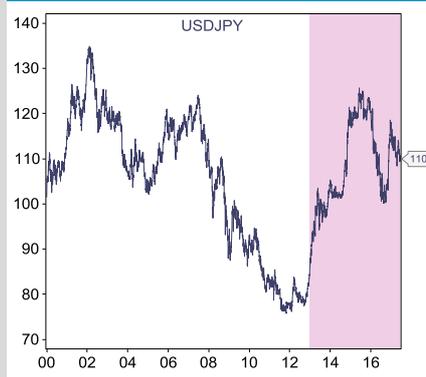
However, ultra-low yields have been met with hardly any enthusiasm by investors and borrowers. Limited return prospects on investment and a saving-minded population seem to mute the traditional monetary transmission channels.

Reaching the limits of Quantitative Easing

An attempt at coercing banks into lending (via the imposing of negative deposit rates, or NIRP) failed in 2016, as yields started free-falling in negative territory as savers kept piling more cash into bonds, which face value threatened to erode. The dynamics was stabilized via curve control (target on 10 year sovereign yields at 0%) last year, and JPY re-depreciated on the back of the widening differential with US rates.

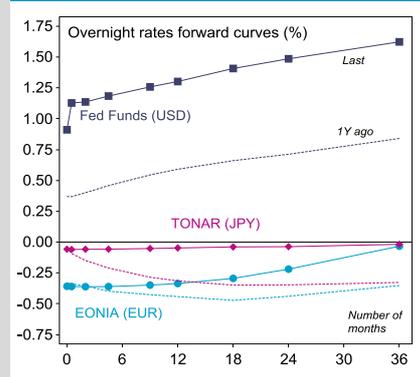
“Ultra low rates have been met with hardly any enthusiasm by investors and borrowers”

1st arrow depreciated the JPY



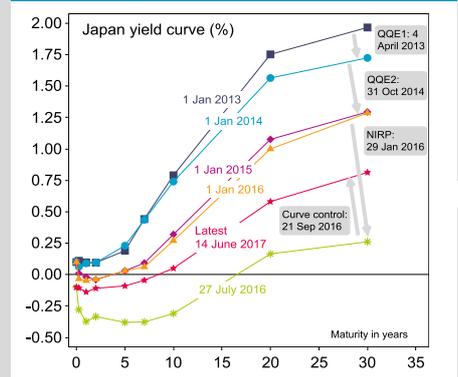
Source: Macrobond, Lyxor AM

Lately, NIRP put to the sidelines...



Source: Bloomberg Macrobond, Lyxor AM

while 10Y yields anchored near 0%



Source: Bloomberg, Macrobond, Lyxor AM

BOJ DISAPPOINTMENT: DESPITE PROGRESS, SUBDUED INFLATION

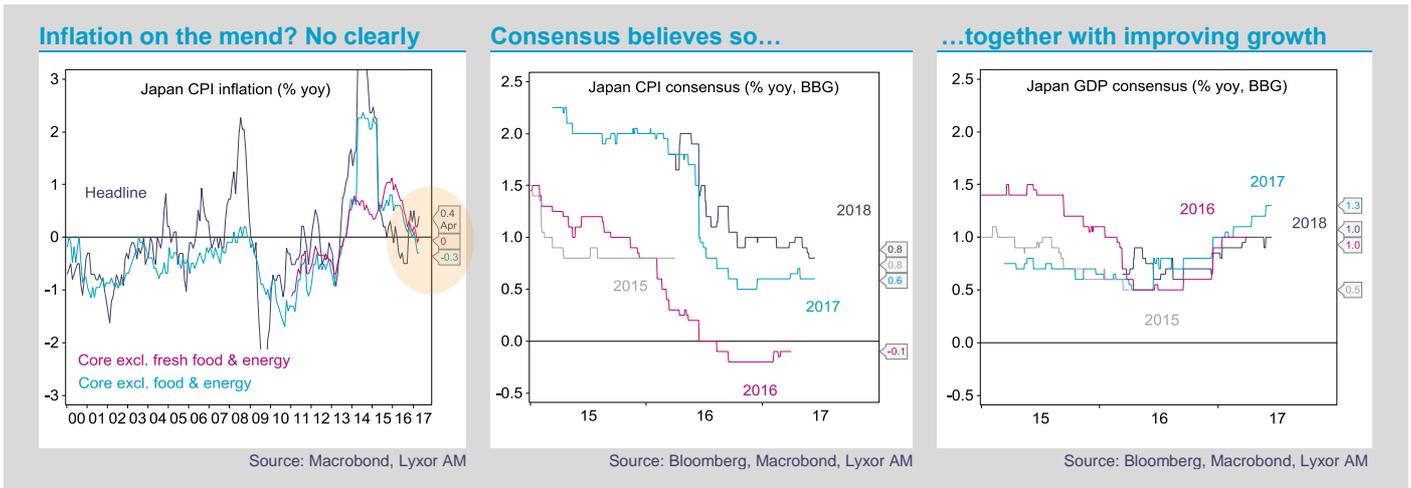
Core inflation not convincingly positive, while wage growth is not gearing up: Kuroda will not see 2% inflation target reached by the end of his term in March 2018

In spite of the various measures taken to prime the economic pump, inflation dynamics remain totally subdued in Japan. Core inflation measures are near or below zero. In particular the wage pulse is slow to upturn despite full employment (unemployment rate at 2.8%).

The central bank's mandate is to ensure that inflation heads to 2% in a sustainable manner. Kuroda, whose term ends on 20 March 2018, will not see it achieved.

Hopes are high on the inflation front as growth normalizes

Why are the analysts surveyed by Bloomberg more enthusiastic than us? Three keys reasons. #1: Surveys are based on headline CPI which benefits from oil base effect in 2017. #2: Japan has exited the 2009-2012 deflationary spiral; that we can agree with. #3: The looming growth normalization uptick should spur prices; here we are more reserved in the short term.



PM ABE TEMPTED TO DECLARE VICTORY ON HIS 1ST ARROW?

Abe is up for re-election in December 2018, while Kuroda ends his term in March

PM Abe would run through general elections in December 2018 and could be tempted beforehand to cry victory on his 1st arrow by replacing governor Kuroda, the symbol of monetary Abenomics, at the head to the BoJ. In such a case, Kuroda on his end, turning 74 next year, could with no embarrassment argue that he has reached retirement age.

Analysts are skeptical however and see Kuroda remain at the helm of the central bank

If the Fed is any reference, Ben Bernanke and most likely Janet Yellen have made it a point to initiate their share of normalization (QE tapering and looming balance sheet reduction) before stepping down. We believe that Mario Draghi may do the same before October 2019. Haruhiko Kuroda could follow these steps and handle himself the pace down of QQE. A second 5-year mandate would grant him time to maneuver the exit as slowly as warranted. And in any case, we believe that a replacing governor would not hurry to tapering either.

“Kuroda could handle himself the pace down of QQE”

DO NOT FIGHT THE BOJ’S ANCHORING JUST YET

Fundamentals in Japan are far from buoyant. Recently, the country has benefitted from the global manufacturing rebound. Yet, the domestic demand pulse remains structurally uneven. Demographics and supportive stimulus measures have slashed unemployment, but neither investment nor borrowing has bloomed on the ultra-low rates ground. Core inflation is weak and could remain such for a while longer.

We acknowledge the fact that a changeover on the 1st arrow front could occur next year. A campaigning Abe may want to congratulate himself on monetary achievements, which could lead to a transition at the BoJ’s helm. However, we believe on the other hand that governor Kuroda may prefer (like his US & EMU peers) to deal with the eventual tapering himself.

We consider in any case that the BoJ will aim at remaining one step behind the Fed on the hawkish scale in order to keep the Yen depreciated. In this environment we do not see the Japanese central bank in any hurry to give-in on its curve control policy, all the more that implementing it today demands less purchases.

We do not suggest fighting the BoJ and expect JGBs 10Y yields to linger at 0%: we hold our neutral recommendation on Japanese sovereign bonds.

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