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Implications following the end of negative interest rates in Japan – Shiro Hayashi

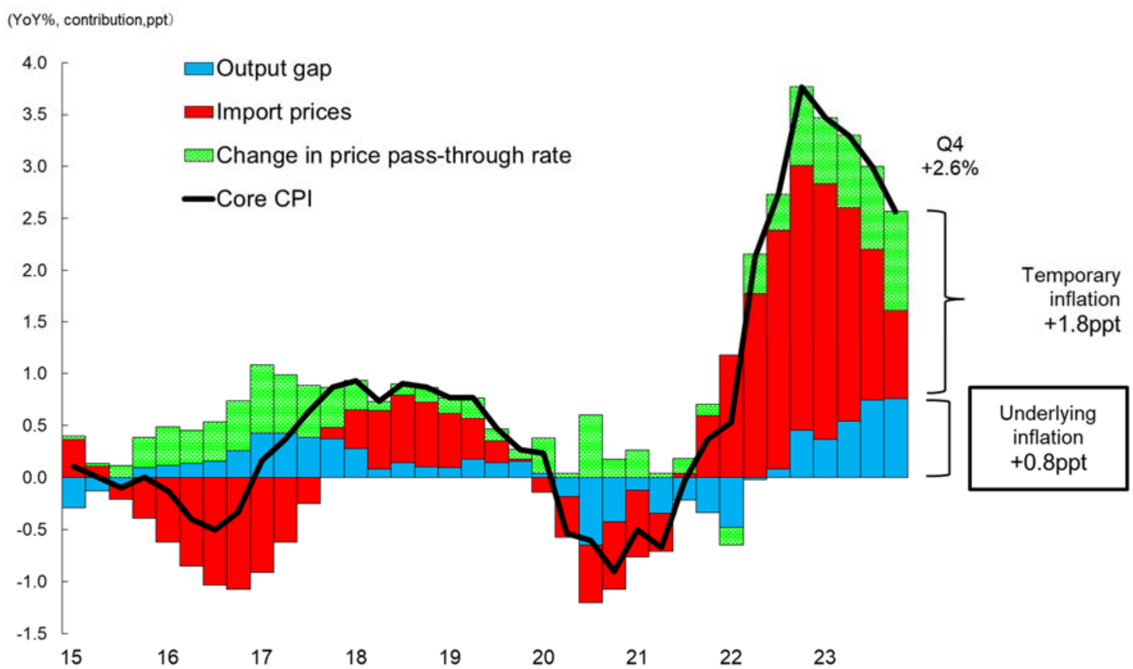
On March 19, the Bank of Japan (BOJ) made three major announcements:

1. A 0.1-0.2% increase in its policy rate (unsecured call rate) to a range of 0-0.1%. This ends Japan's unique position as the last major developed market with negative interest rates.
2. The abolition of its yield curve control policy, which aimed to suppress short- to medium-term rates (which affect corporate borrowers), without depressing long term yields too much (which would reduce returns for pension funds and life insurers)
3. The end of the BOJ's purchases of ETFs/REITs, which had formed part of its stimulus program.

The market's response to the BOJ's announcement is best illustrated by the contrasting reaction of real estate and banking stocks - real estate stocks traded higher, while banking stocks declined. The reason for this divergence is the BOJ's statement, which included the words "continued accommodative financial environment," easing fears of higher interest rates, which would have been a headwind for the real estate sector and a boon for banks.

The team at Dalton had expected the continuation of accommodative monetary policy in Japan, based on the BOJ's emphasis on "underlying inflation", which continues to be less than 1% (Figure 1). On the other hand, we were happy to observe the number of recent wage increases exceeding 5%, perhaps indicating that the negative growth in real wages that has continued for more than 20 months is coming to an end. Our central expectation remains the beginning of a positive cycle benefiting the broad Japanese economy. We believe that changes in Japan's monetary policy and economic environment will proceed slowly but steadily, contrary to market expectations for more radical shifts (which we have seen elsewhere in the world).

Figure 1 - The BOJ's assessment of "underlying inflation" in Japan



Portfolio implications

In recent years, Dalton's portfolios have been positioned with a general bias towards high quality export firms, which have seen the historically weak Yen provide a major boost to their global competitiveness. While we are not anticipating major changes in our portfolio, we believe that Japan's recent significant wage increases are a key step towards the country overcoming its long-term deflationary cycle. There now emerges the possibility of a virtuous cycle of corporate performance, wages, and domestic consumption (including a benefit from inbound tourism).

In our portfolios we have already begun adding select opportunities in real estate and domestic consumer firms and expect continued idea generation in this area. As always, there are many potential challenges which could provide medium term headwinds (for example any political instability), but we continue to believe that the Japanese market is positioned to potentially deliver strong long-term returns, given the growth dynamics described above, the accelerating corporate governance reforms and the valuation opportunities available.

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