Trade Booster

16 July 2013

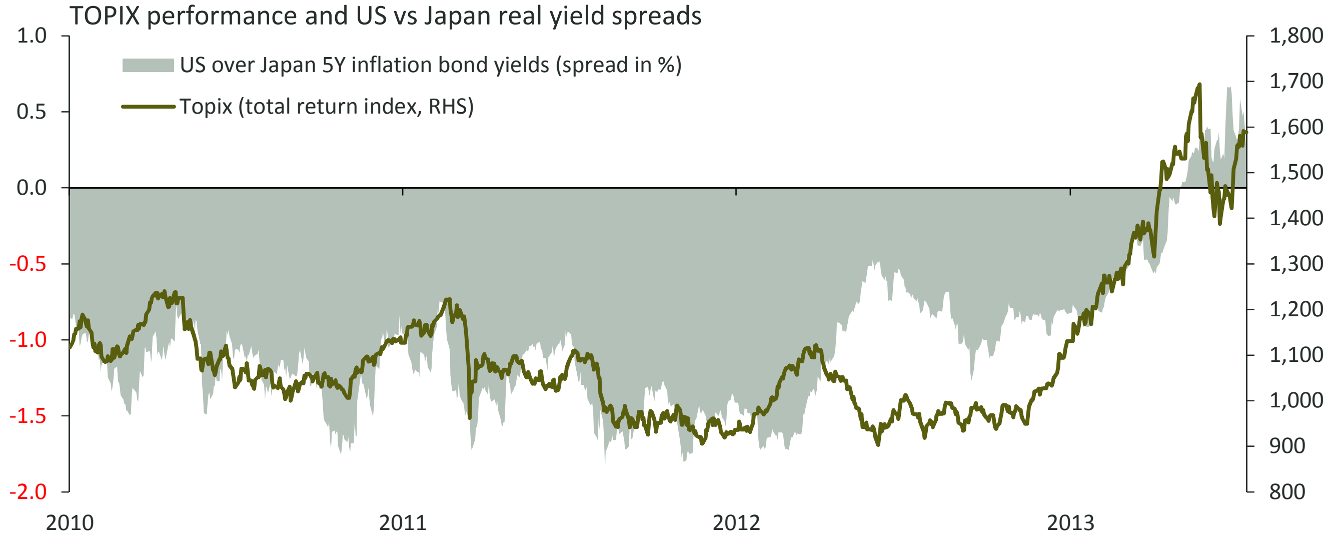
Tapering thrusts TOPIX to the top

Summary

- **Fed tapering boosts sentiment on Japanese equities as much as BoJ's explicit QE targets through its devaluation of the yen**
- **Japan is in a stronger position to end deflation with QE than when it was impaired by corporate balance sheets and extraordinary macro events which undermined previous stimulus efforts**
- **Investors may consider a long leveraged position on Japanese equities through Boost TOPIX 2x Leverage Daily ETP (2JAL)**

Fed tapering boosts sentiment on Japanese equities as much as BOJ explicit QE targets

TOPIX performance and US vs Japan real yield spreads



Source: Boost ETP Research, Bloomberg. Data as at 12 July 2013

The Bank of Japan's explicit monetary policy targets, coupled with corporate and banking sectors improved balance sheets, give Japan's QE credibility. Linking these to previous QE efforts that failed to reflate Japan is misplaced. A resilient US job market drives investors to pre-empt the Federal Reserve's tapering; which in turn widens the interest rate differential in favour of the US. The dollar strength may be stickier, helping the devaluation of the yen to sustain itself. As a result, investors may consider a long leveraged position in Japanese stocks by buying the Boost TOPIX 2x Leverage Daily ETP (2JAL).

This time QE is explicit

The difference between this year's versus previous QE is that the Bank of Japan (BoJ), under newly elected Haruhiko Kudora, has never been so explicit in communicating its monetary policy to eliminate deflation. After doubling the inflation target in January this year, the BoJ believes that by increasing the monetary base and JGBs (to JPY 270tn and JPY 190tn resp.) and by more than doubling the average maturity of bond holdings to 7 years, a 2% inflation rate is achievable within 2 years. Dismissing this year's QE as short lived because previous attempts of QE have failed to revive inflation and produce a lasting recovery on the stock market is misplaced. Especially when considering that bad luck and external factors beyond the control of the BoJ were as much to blame as impaired balance sheets and bad policy were on previous occasions.

Corporate debt wind-down and public spending cuts undermined 1st QE

After the zero interest rate policy adopted by the BoJ in 1999-2000 helped revive growth, QE was introduced in March 2001 in an attempt to revive inflation. QE succeeded in suppressing bond yields. However, it was powerless to reignite inflation when at the same time the government was cutting back on public spending, the companies were paying down debt and the banks were restructuring bad loans. As a result of the fallout in private sector demand, inflation did not sustain itself in the few episodes between 2004 and 2006 where CPI readings were briefly in positive territory. The TOPIX however did well when the BoJ implemented its 1st QE. In the period of March 2001 to March 2006, the TOPIX rose by 47% on a total return basis.

Global crisis and Tsunami overwhelm 2nd QE

The brief period where Japan had seen marked inflation during QE came on the back of the speculative bubble in oil prices in 2008, but the ensuing global credit crisis and recession cut short the recovery in Japan's consumer prices and equity markets. As deflation deepened, the yen strengthened, in turn undermining the outlook of an export-led recovery for Japan's corporate sector during the following 5 years. When the BoJ reacted by introducing a new round of QE in October 2010, in tandem with the central banks in the West, its potential to reinvigorate inflation and trigger a recovery in the stock market was negated by the Tohoku earthquake and the tsunami 6 month later. Stocks of benchmark heavy weights such as Toyota were hit hard by the destruction and disruption inflicted on manufacturers' supply chains and the production cuts the disaster caused. Japan's 2nd round of QE was simply overwhelmed by both the global credit crisis and the tsunami to have any lasting impact on inflation, let alone a rebound in stock markets.

Improving US fundamentals devalues JPY/USD, boosting TOPIX

As Japan emerges on a much stronger footing, the explicit monetary policy targets may have a longer lasting effect on inflation expectations and stock prices now that the government is complementing QE with sustained fiscal stimulus. Meanwhile the corporate sector has deleveraged back to gearing ratios of below 1x equity, giving reasons to be optimistic on the outlook for renewed corporate spending and increased borrowing. Bank lending as a result has risen to 2.5%, extending its rate of expansion since late 2012 after emerging from contraction throughout 2010 and most of 2011.

Helping Japan's stock market recovery even more than the stabilising domestic economic backdrop is the strengthening US dollar. Bullishness on the dollar has been fuelled by a resilient recovery in the jobs market. As the recovery broadens and the Fed foresees a possible complete wind-down as soon as mid 2014, investors are confident that the tapering of QE will come sooner, rather than later. This is why, in spite of US monetary stimulus to the tune of 6% of GDP, US Treasury yields are progressively rising, with interest rates having risen above the rate of inflation since December 2012. As shown in the chart, when adjusting the yield spread for inflation expectations in both countries (such as that measured by the yield differential of 5 year inflation indexed bonds), the widening US yield spread over Japan suggests a relative strong link with the performance of the TOPIX. Hence, the yen, while devalued significantly on the back of BoJ's explicit QE targets, is receiving additional selling pressure from the likelihood of US exiting QE next year. As the fundamentals supporting the strength of the dollar may be longer lasting, so too may the weakness of the yen. On that basis, Japanese equities are as much supported by the momentum in the domestic economy as by the recovery of its 2nd largest export market. In tapering QE, the Fed will make BoJ's QE that much more effective in devaluing the yen and reviving Japan's stock market. As a result, the remarkable come-back of Japan's stock market, having risen by 40% so far this year, may see the rally sustain itself. Against this backdrop investors may consider buying the Boost TOPIX 2x Leverage Daily ETP (2JAL).

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