Market Report:
Revisions to the BOJ’s Monetary Policy and its Effect on the Japanese Market

Tokio Marine Asset Management (London) Ltd
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Revisions to the BOJ’s Monetary Policy

The Bank of Japan changed the framework of its monetary easing policy following its Monetary Policy Meeting held on 20-21st September. There are two major changes to its policy: the first is to target interest rates rather than the quantity of purchases and the second is to control the yield curve.

The BOJ is now targeting interest rates due to the need to drag out its monetary easing program longer than initially planned. There is a limit to the amount of Japanese government bonds the BOJ can purchase and so by shifting its framework to rate targets instead, the BOJ is able to maintain its policy for longer. This measure has been implemented in acknowledgement of the difficulty in achieving its 2% Consumer Price Index target. The second major change has been made in response to discontent in the financial sector over the marked drop in long-term interest rates as a result of the BOJ’s negative interest rate policy. The measure could be interpreted as putting a cap on the lower limit of long-term interest rates. Specifically, the BOJ has promised to maintain 10-year JGBs at around the 0% mark, while keeping short-term interest rates at -10 basis points, or -0.1%. For Kuroda’s BOJ, which has attempted to raise expectations of short-term inflation by surprising the market with quantitative targets since it introduced its quantitative and qualitative monetary easing policy in April 2013, this can be seen as a major shift in policy.

The market has read the move as meaning the BOJ is reaching its limits on lowering interest rates through quantitative easing, and though the BOJ has vowed to overshoot the 2% CPI target, its deviation from a clear two-year target does not instil much confidence in this new commitment. As such, it would appear that the BOJ’s monetary policy effect has weakened, if only slightly.

However, we believe any negative impact will be minimal. The Japanese economy is supported by its high level of employment (unemployment is as low as 3%), and will have an injection of cash just shy of 30 trillion yen in the new year from the government’s economic stimulus package. Furthermore, the government is believed to be well prepared to implement additional fiscal policy measures in the event of a short-term downturn in the economy without the need to raise interest rates. The time for BOJ action, which has led Abenomics up until now, has come to an end, and it remains to be seen how the

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government and corporations can take advantage of the low interest rate environment created by the BOJ to bolster the economy, and whether this will in turn increase the economy's potential growth rate.

Effect on Japan's Bond Market and Outlook

Immediately following the BOJ's announcement, short- and long-term bond yields saw a slight rise, while rates on superlong JGBs fell marginally, but no further movement has been noted.

From the BOJ's statement that it intends to control the yield curve by setting 10-year bond yields at around 0%, a great deal of uncertainty has been created with regard to what shape the yield curve will take. It is expected that investors will reach a consensus only after the BOJ takes palpable action, such as when it announces its plan for JGB purchases in October at the end of this month. The bond market may well be volatile until this consensus is reached, but is expected to stabilise after with superlong bond yields likely to stick within a narrow range.

Effect on the Japanese Stock Market and Outlook

We expect changes to the BOJ's policy framework to affect the Japanese stock market in two key ways. However, as these changes follow previous fiscal policy, we don't expect any significant changes to the market as a whole.

1) Yield curve control
   There is a good chance that the BOJ will maintain long-term interest rates at close to 0% even if it chooses to implement further negative interest rates, which should act to reduce the negative impact to the financial sector from lower rates.
2) Restrictions concerning ETF purchases
   The BOJ has, up until now, purchased ETFs according to their market capitalisation, resulting in an obvious bias for the price-weighted Nikkei Stock Average. As such, the BOJ has become the largest shareholder of a number of companies, creating misgivings over the sustainability of the BOJ's ETF purchase program. Changes to ETF buying guidelines appear to address this problem to some extent and secure the sustainability of the program, which should prove a positive for the stock market.

Corporate earnings had continued to be downgraded on the back of a strong yen and the slowdown in emerging markets; however, this now appears to have bottomed out with earnings heading for recovery. This, together with expectations of increased government spending, continued large-scale monetary easing measures by the BOJ, and the gradual recovery of the US economy, should act as a tailwind for Japanese stocks.

For further information regarding the above or should you wish to discuss Japanese equities with us, please contact Tokio Marine Asset Management (London) Limited.
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