Japanese Equity Report

Tokio Marine Asset Management (London) Ltd
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Assessing the impact of the BOJ's negative interest rate policy

Summary

- Bank of Japan announced negative interest rate policy on 29 January.
- Commercial banks will be charged benchmark rate of -0.1% for some deposits held with BOJ.
- Intention is to reduce pressure on further yen strengthening.
- Impact on economy limited even though this might give the government time to implement something more tangible, such as measures to increase CAPEX.
- Impact on equity market seems to be marginally positive depending on the industry and sector. Those whose income is dependent on interest rates may feel pinch.
- Expect yen to depreciate against US dollar, reflecting monetary policy difference.

Please see below for a full analysis.

Background

The Bank of Japan was urged to introduce further incremental monetary easing, driven broadly by receding inflation expectations or more specifically by the recent trend of yen appreciation and sluggish wage growth. The ECB's additional easing measures in December with a cut in deposit rates deeper into negative territory and suggestions of further additional easing during January caused a widening of the gap in short-term interest rates between Europe and Japan. We believe that the introduction of negative interest rates for the first time in Japan will weaken the upward pressure on the yen driven by the divergence between the monetary easing stances in Japan and Europe.

Impact on banks

The introduction of negative interest rates will reduce the profits that banks gain by building up excess reserves. A rate of minus 0.1% will apply to excess reserves saved with the central bank from now on, although the previous 0.1% rate will continue to apply to existing excess reserves as before. In addition, the rise in bond prices due to the adoption of a negative interest rate policy should have some positive effects for banks' earnings. As such, this may help to diminish the concerns of some market participants who fear that the introduction of negative interest rates will significantly reduce banks' earnings.

Impact on the Japanese economy

Limiting the risk of further yen strengthening should have a positive impact on the Japanese economy; it should prevent the return to a deflationary mindset, reverse the potential negative impact on corporate earnings and ward off a contraction in household and corporate sentiment due to lower share prices which the BOJ has been concerned about. We believe that the decisive stance shown by the BOJ towards escaping deflation has given a strong impression to global investors in particular.

The tightening monetary policy stance of the Fed and uncertainties surrounding China's economy, both regarded as the main factors behind the recent instability in financial markets, still remain however and it is unlikely that the introduction of a negative interest rate policy will immediately lead to significant wage hikes and more capital spending. Instead, we believe that this policy will buy time for the government and corporations to take action, while limiting the risks associated with the yen's appreciation and the potential downside to the Japanese economy.

Impact on Japanese equities

Japanese listed companies on the whole should benefit from the yen's depreciation, boosting corporate performance due to the higher proportion of exporters and companies developing their overseas business. In addition, we should be able to expect negative interest rates to alter corporate sentiment; it should promote the use of excess cash, enhance shareholder return and lead to a recovery in investment. We therefore believe that the introduction of a negative interest rate policy will underpin corporate performance through exchange rates and boost share prices. We believe that continuing expectations for additional easing by the BOJ is also positive for share prices.

While some have pointed out the limitations of further monetary easing by the BOJ, another policy option is to cut interest rates further into negative territory moving forward. However, what differentiates negative interest rates from quantitative easing is the differing impact on industries; some will benefit from negative rates while others will suffer. Sectors such as property should benefit from lower borrowing rates but there is a concern that downward pressure will be applied to the performance of sectors such as banks which rely on earnings from interest rates. We therefore need to carefully assess industries benefiting and suffering from negative interest rates, which could be cut further into negative territory, as well as monitor its impact on performance and share prices.

Impact on the Japanese Currency

We have seen a strong yen trend since the beginning of the year, with the dollar temporarily falling below 116 yen in mid-January. Although the exchange rate stabilised briefly due to comments by government officials on the level of exchange rates, it has not become entrenched above the 120 yen level. However, we believe that the negative interest rate policy will weaken the upward pressure on the yen and our base case scenario going forward is for moderate depreciation of the yen. This will be driven by monetary policy divergence, continuing monetary easing by the BOJ, relatively higher growth of the US and anticipated rate hikes by the Fed.

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

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