

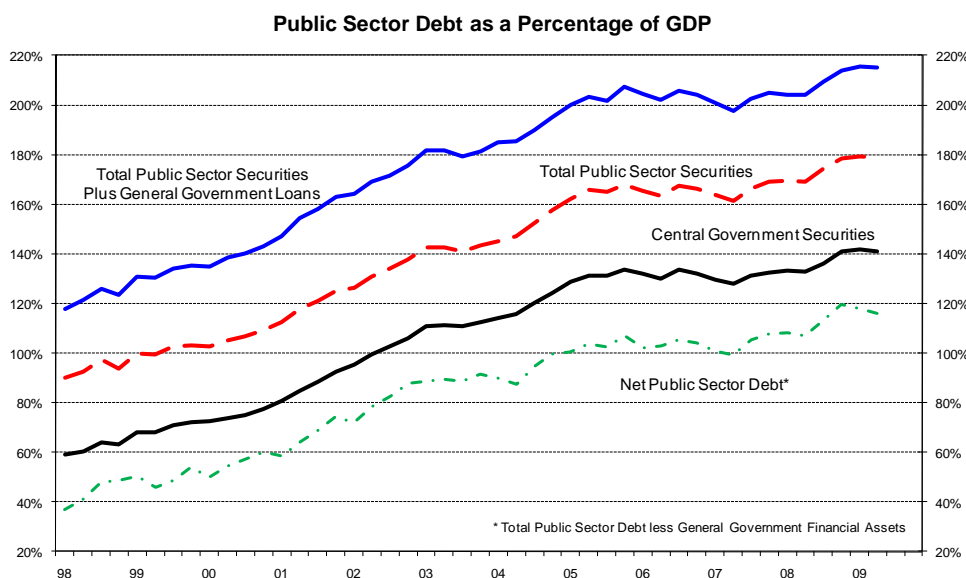
The last thing the world needs is for JGBs to collapse

Every few years, yet another cohort of barely off-the-potty analysts and money managers gets a bee in its bonnet about a great new Asian investment theme it has discovered. Regular favourites include superior growth equals superior stock market performance, the Hong Kong dollar is about to be de-pegged, Korean banks are cheap, and the subject of today's missive, shorting JGBs cannot fail.

Shorting JGBs cannot fail.... apparently

For the past two decades we have always been sceptical about the structural JGB collapse trade and have viewed periodic sell-offs as a buy opportunity. The truth is that if we had a penny (or in this case perhaps a yenny) for every time we have heard this tune, we would have three pounds forty two, so we would therefore ask you to forgive the rather weary tone of this article. To our clearly jaundiced eyes, the recent excitement does not seem to portend anything very much different albeit it has to be admitted that the absolute size of the debt stock (see the chart below) combined with the DPJ's fumbling start to life in office has provided a heightened risk profile. Nevertheless, we suspect a combination of growth fade, entrenched deflation and the unique structure of Japanese government debt ownership will all place a ceiling on JGB yields. Investors should also note that if Japanese bonds collapse then the likely response will be huge, likely-cajoled overseas repatriations which will hardly be good news for sovereign borrowings elsewhere. Shove 2% on 10-year JGBs and you can likely add 3% to USTs and 5% to Aussie bonds. Japanese bonds may well crash though not any time soon in our opinion; but be careful what you wish for.

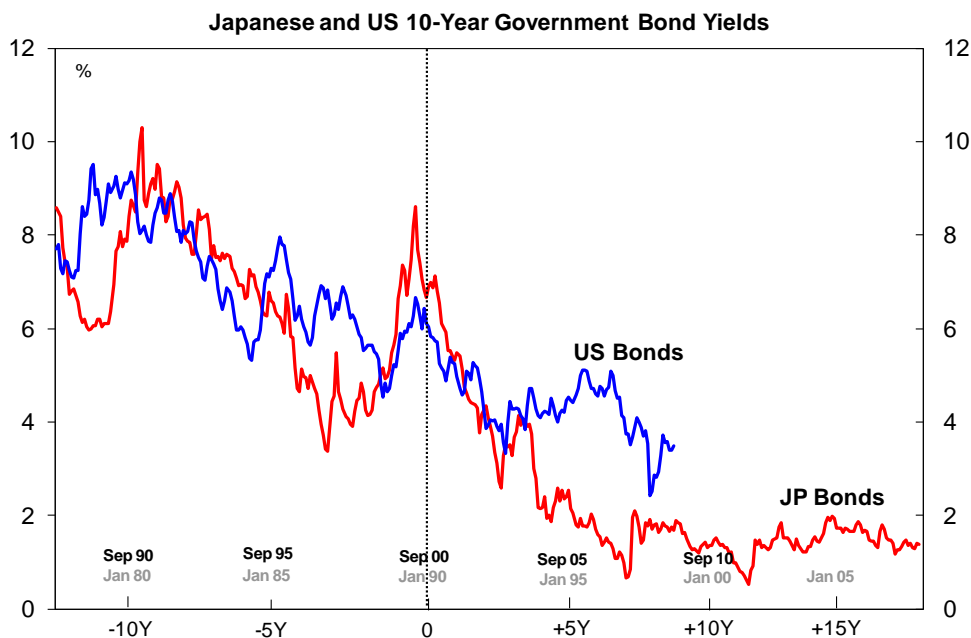
Japanese bonds may well crash though not any time soon in our opinion; but be careful what you wish for



The last thing the world needs is for JGBs to collapse

There is no doubt that the Japanese public sector debt numbers look horrific. Two decades of policy failure – albeit there are still a few brave souls who dispute this – have allowed deflationary expectations to become entrenched, have seen potential growth rates grind down to almost a crawl, and have produced a massive public sector debt pile of 220% of GDP on a gross basis, and 120% of GDP net of public sector financial assets. To put this latter number into context, OECD comparative studies peg Japan's net debt position at 105% of GDP followed closely by Italy. At 85%, Belgium and Greece fill the next two slots in the rankings with the US coming in fifth at around 65% of GDP.

There is no doubt that the Japanese public sector debt numbers look horrific



America's (and Europe's) tragicomic embrace of a Japanese approach to dealing (or not) with toxic financial assets, would appear to risk somewhat of a re-run of the Japanese experience across the developed world in the coming few years. However, as the chart above shows, inexorably expanding public sector deficits have not, in the case of Japan, resulted in a collapse in bond yields. Quite the reverse in fact! And as we discussed a week or so back in *Liquidity Update*¹ the monetary evidence we can muster all points for now to deflation rather than rising prices.

Inexorably expanding public sector deficits have not, in the case of Japan, resulted in a collapse in bond yields

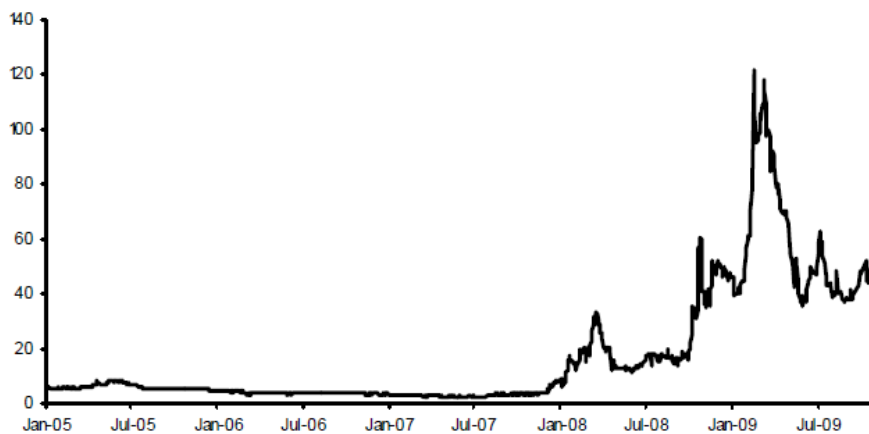
¹ 23rd November 2009.

The last thing the world needs is for JGBs to collapse

As the next two charts below illustrate, the markets have nonetheless started to get jumpy about Japan's ability to continue to fund itself, if not quite yet about resurgent inflation. They show that the price of insurance for the 5-year JGB which, ignoring last year's generalised Armageddon spike, has been on an uptrend since early 2007. It currently costs just under 70 basis points to insure the 5-year JGB or about half the current yield. To put this into context, the UK also trades at around 70 but Italy at 92 and Greece at around 200 would seem to be the better value to us.

The markets have nonetheless started to get jumpy about Japan's ability to continue to fund itself, if not quite yet about resurgent inflation

5-Year JGB Credit default Swaps



Japan 5-year CDS and 10-year bond yield rise

Debt supply concerns mount



Sources: Thomson Reuters, Japan Bond Trading Co Ltd, Markit



Reuters graphic/Claire Morel

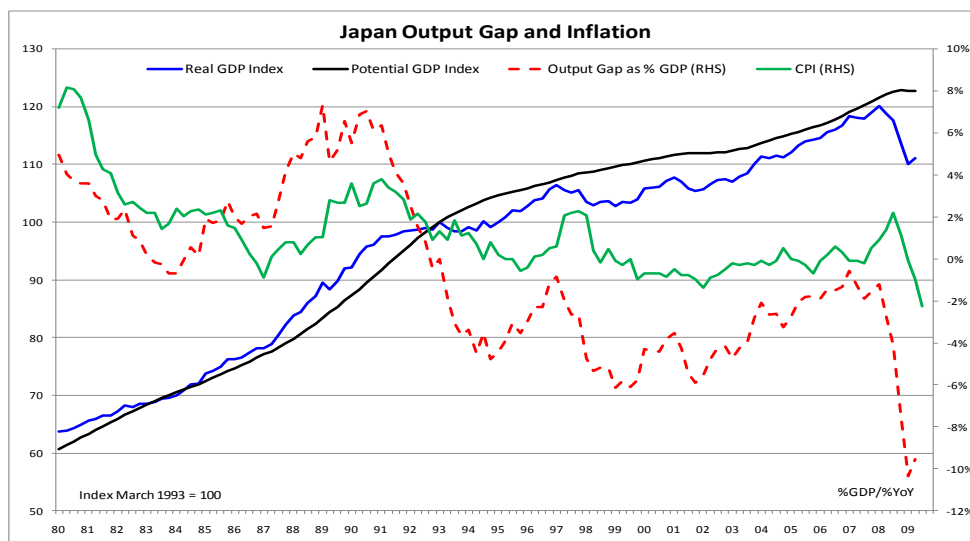
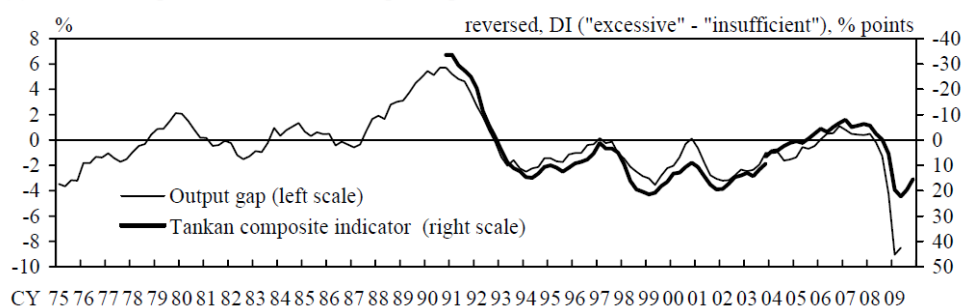


The last thing the world needs is for JGBs to collapse

As noted earlier, the jitters are not because the markets, or indeed even the central bank, are looking for inflation to return any time soon. Indeed, the BoJ seems resigned to continued deflation. In its October 2009 *Outlook for Economic Activity and Prices* the BoJ forecast that core inflation would remain stubbornly negative: -1.5% during fiscal year 2009 (to March 31st 2010) moderating to -0.8% in fiscal 2010 and -0.4% in fiscal 2011. Over the same period, it expected real GDP growth to recover to 1.2% and 2.1% in fiscal 2010 and 2011 respectively.

The BoJ seems resigned to continued deflation

(3) Tankan Composite Indicator and Output Gap



The persistence of deflation is partly attributable to a yawning output gap which the central bank estimates to be around 8-9% of GDP, a not dissimilar number to our own (almost certainly far less econometrically robust) calculation.² As the BoJ states on Page 2 of the aforementioned *Outlook*: “in fiscal 2011 the growth rate of Japan’s economy is likely to reach a

² For our regional survey of output gaps see: “Cut Me Some Slack”, 24th August 2009.

The last thing the world needs is for JGBs to collapse

level clearly above the potential growth rate. According to the latest estimate using available data, Japan's potential growth rate appears to have declined from the level previously estimated, mainly reflecting the decline in the growth of capital stock due mainly to the significant deterioration in economic conditions. The Bank of Japan estimates that the potential growth rate during the current projection period has declined to "around 0.5 percent" from the "around 1 percent" estimated in the April 2009 *Outlook for Economic Activity and Prices*. It should be noted that, when fluctuations in economic activity are large as at present, estimates of the potential growth rate should be interpreted with care."

The monetary authority continues on Page 8 "The second risk factor concerns the high uncertainty with respect to gauging the degree of slack in the economy or the state of utilization of labor and production capacity. When the economy is deteriorating substantially with structural changes in demand, it is possible that the supply capacity of the economy and the potential growth rate are also declining owing to obsolescence or a cutback in capital stock. In this case, if the degree of economic slack is estimated based on the output gap derived from past data, there is a risk of overestimating the downward pressure on prices."

This is all well and good but in truth it sounds like a central bank grasping for reasons not to try to expand its monetary interventions. For even if the output gap is indeed somewhat smaller than the 8-9% kicked out by the BoJ's number crunchers, it still suggests that the economy can grow at a pretty fair lick for a number of quarters before inflation would make a return. The likely reality is that the central bank is still trying to hold onto its vestiges of independence and has wanted to hang tough in the face of calls from the politicians to take a far more aggressive and proactive monetary stance. As our set of charts overleaf show, the BoJ's balance sheet expansion over the past year has been extremely parsimonious compared to its peers in other parts of the developed world. Indeed, the absolute size of its balance sheet is still considerably below the peaks reached in 2005.

The BoJ's retort is that unlike in America and Europe, the broader monetary and credit aggregates have not collapsed (i.e. the banking system remains relatively functional albeit demand for credit has been weak). Moreover, it has always argued that monetary policy can only do so much and that smarter fiscal policy and domestic supply side reforms should also play their part. No matter since neither seem to be on the agenda under the new DPJ government, not that they ever were either under the LDP, aside from a brief period under Koizumi.

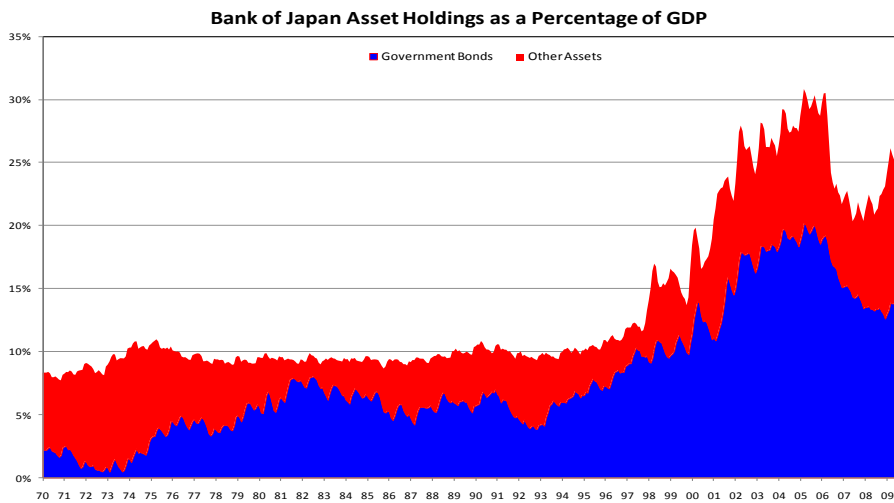
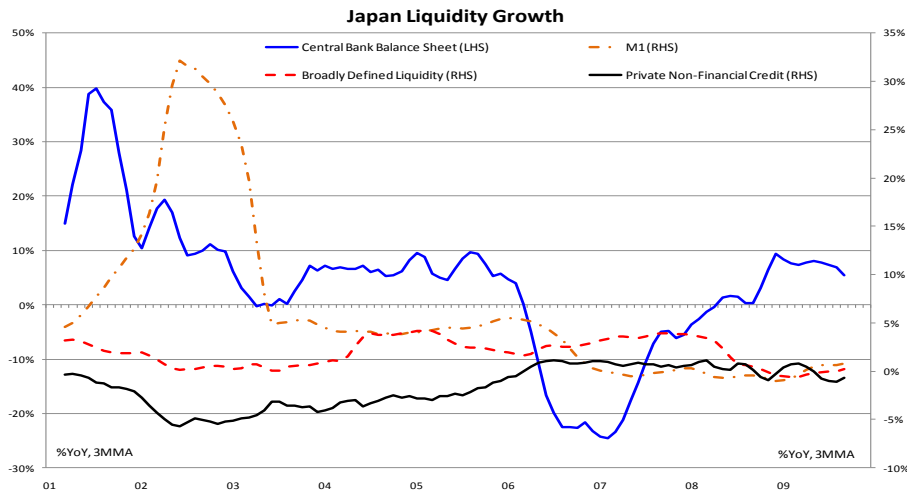
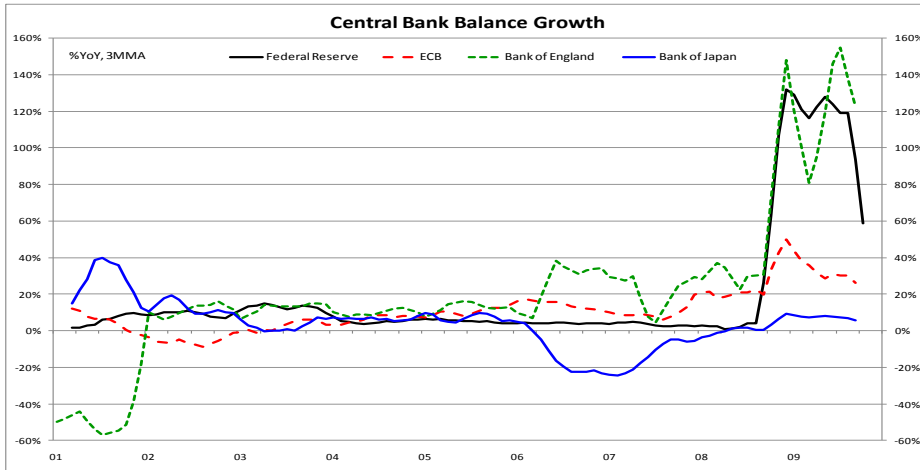
The persistence of deflation is partly attributable to a yawning output gap

The central bank seems to be grasping for reasons not to try to expand its monetary interventions

The BoJ has always argued that monetary policy can only do so much and that smarter fiscal policy and domestic supply side reforms should also play their part. No matter....



The last thing the world needs is for JGBs to collapse



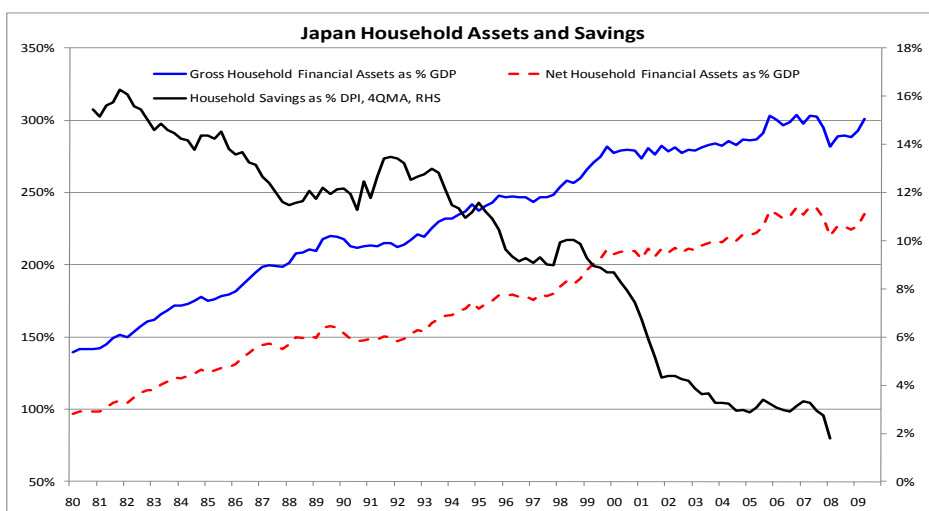
The last thing the world needs is for JGBs to collapse

In recent days, the central bank appears to have given some ground. It has resisted the call for now for further rate cuts (and a further step back towards ZIRP) but has offered JPY10 trillion of three month financing to the banking system against the normal range of collateral. It is also expected, though we have not seen a formal announcement,³ that the BoJ will increase its commitments to purchase of JGB's, currently running at JPY1.8 trillion a month.

In recent days, the central bank appears to have given some ground

This brings us to the crux of the matter. Even if monetary and output gap developments all point towards persistent deflation, the DPJ's flamboyant expenditure proposals combined with its sparse details of how it intends to fund them, do risk bond supply indigestion. Especially as the household savings rate has been trending inexorably downward as a consequence of two decades of stagnant real income growth and an aging population. Japanese households have tremendously strong balance sheets in terms of their net financial assets,⁴ but a paucity of cashflow to live off. Deposit interest rates are hardly likely to be rising anytime soon and while the idea that higher dividend payout ratios could help provide an alternative income source is a valid one, Mrs Watanabe has yet to be seduced by a genuine improvement in this metric relative to both government and corporate bonds.

Even if monetary and output gap developments all point towards persistent deflation, the DPJ's flamboyant expenditure proposals combined with its sparse details of how it intends to fund them, do risk bond supply indigestion



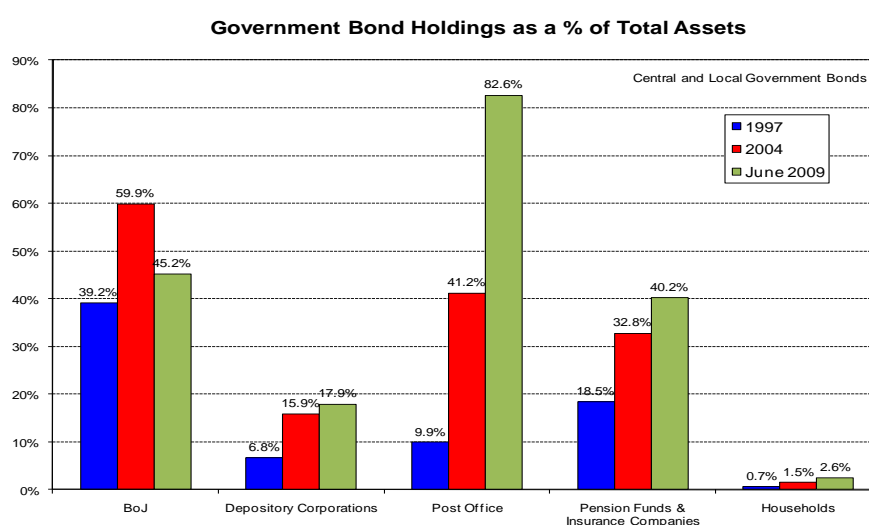
³ We are on the road currently so may have missed it.

⁴ Older Japanese anyway. The youngsters have no savings and will inherit all the debts. This was why we were relatively excited about Koizumi's inheritance and gift tax reforms, but these were sadly temporary and have now been phased out.

The last thing the world needs is for JGBs to collapse

A number of commentators have been emphasising the falling household savings rate trend for some time now but to us, it seems rather a secondary consideration. As our next chart shows, households have never been big direct buyers of JGBs (they may be forced to become so in due course but that is another story – think “war bonds” and other potentially non-voluntary appeals to patriotism; and not just in Japan). Rather it is the state and the financial sector (quite often one and the same thing) which have hitherto done the heavy lifting.

It is the state and the financial sector (quite often one and the same thing) which have hitherto done the heavy JGB lifting



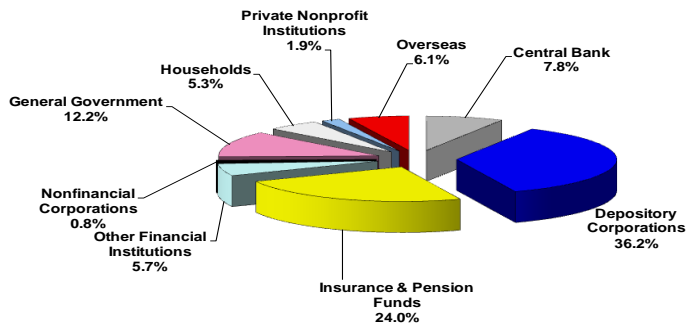
The BoJ has been trying to reduce its JGB dependence in recent years but as discussed, political pressure may force it to begin to play ball again. The banks have a healthy chunk of JGBs but at less than a fifth of their assets, there is surely room for some further compunction dressed up in regulatory language. Recall that India used to have a statutory liquidity ratio of 45% in years gone by though these days it is *only* 25% on marginal deposits. The public funds are already stuffed full of bonds though given their chequered record at managing investments in the public markets, perhaps this is no bad thing. But it is the Post Office that is the stunner with over 80% of its assets now in government bonds. This to us explains why Postal Services Minister Shizuka Kamei – vehemently anti-Koizumi when still in the LDP – has been so keen to ensure that privatisation is reversed and to install a loyal bureaucrat at the helm of the institution.⁵

Having a passive bond buyer is the reason why the DPJ has been so keen to ensure that postal privatisation is reversed and to install a loyal bureaucrat at the helm of the institution

⁵ Koizumi wanted to dismember the Post Office to destroy the money finance lifeblood of the old LDP bosses. With Koizumi’s passing, making sure the government has a passive buyer for its bonds is now the number one priority.

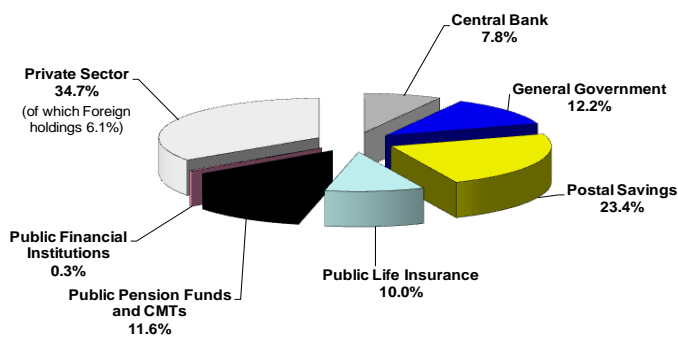
The last thing the world needs is for JGBs to collapse

Sectoral Holdings of Central Government Debt (June 2009)



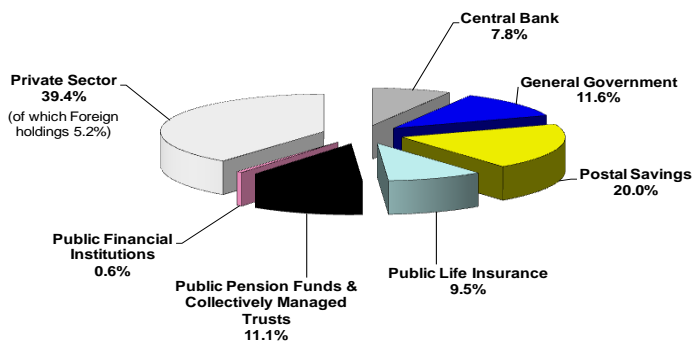
Source: Japanese Government Flow of Funds Data

Sectoral Holdings of Central Government Debt (June 2009)



Source: Japanese Government Flow of Funds Data

Sectoral Holdings of Public Sector Debt (June 2009)



Source: Japanese Government Flow of Funds Data



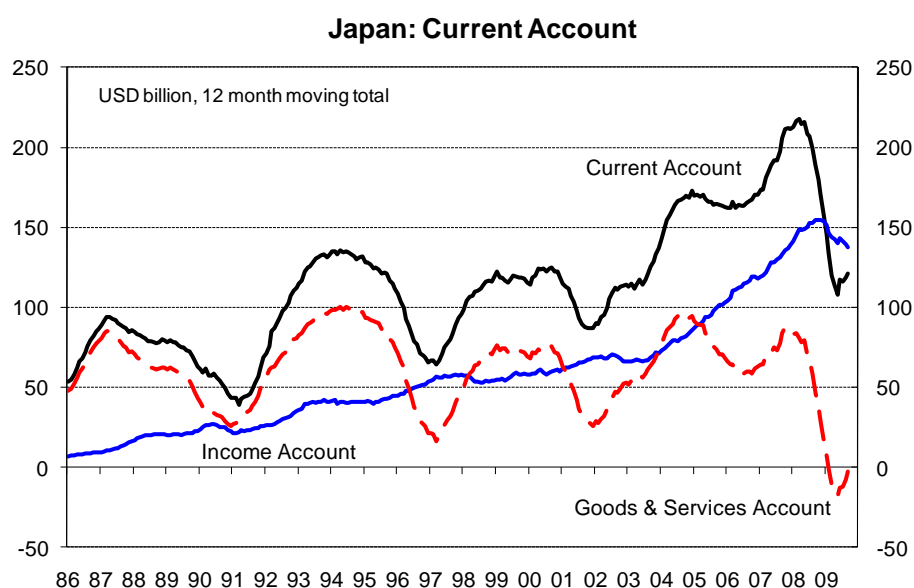
The last thing the world needs is for JGBs to collapse

The three pie-charts on the previous page show how the Post Office is but the most important of the various Japanese government and quasi-government entities who own around 60% of the public debt stock. In essence, there remains the potential to carry out a huge netting-off exercise at some stage. Moreover, stepped up privatisation could also help plug part of the gap though under the DPJ this seems even less likely to be on the agenda. Meanwhile the foreigners own only 5-6% of the outstandings and can therefore exert minimal influence on the whole process.

The Post Office is but the most important of the various Japanese government and quasi-government entities who own around 60% of the public debt stock

The collapse risk has to therefore come from a domestic private sector that in essence loses confidence in the domestic economy and starts exporting capital at an accelerated rate. This is of course, and always has been, a possibility but as yet, one that has still not actualised. And if it did, then once can expect to see mass forced repatriations of government-owned foreign assets (and a lot of pressure exerted on the corporate sector, capital controls etc.) to help plug the hole. We would respectfully suggest that while there would be carnage in the JGB market, the damage done elsewhere would be equally if not even more serious.

The collapse risk has to therefore come from a domestic private sector that in essence loses confidence in the domestic economy and start exporting capital at an accelerated rate



And Japan has a lot of foreign assets. The international investment accounts at the end of 2008 credit the country with JPY519 trillion of foreign assets, or 105% of GDP. As the chart above suggests, this throws off around USD140 billion of interest, profits and dividends which for many years has swamped the goods and services balance in the current account. Recall that Japan has only run a trade deficit in five years since 1970 (all of these were

And if it did, then once can expect to see mass forced repatriations of government-owned foreign assets

The last thing the world needs is for JGBs to collapse

in the 1970s except for 1980) and since 1985 the annual surplus has been 2.9% of GDP on average. To put this into historical perspective, the UK ran *trade*⁶ surpluses of around 5% of GDP from 1713-1780 but has been in more or less constant deficit ever since. The US similarly ran *trade* surpluses averaging 1.5% of GDP from 1874-1970 with only one year, 1888, recording a deficit (-0.3% of GDP). The lesson is that a country can live off its retirement income for a long, long time. The UK has managed its Imperial decline over the last century reasonably well, and in all likelihood, the US will do the same as and when the obituaries (premature in our view) finally come to pass. We see no reason why Japan faces imminent collapse either.

We would also like to suggest that there may be another buyer of JGBs out there – the People’s Republic of China. After all, China suggested only the other week that it stood ready to buy Greek government debt while it has signed a whole raft of swap agreements with what might seem to be dubious counterparties such as Belarus and Argentina. Clearly while there remains an imperative to somewhat diversify the State’s FX reserves, the deployment decision incorporates numerous non-pecuniary variables.

As we have already alluded to, it is in nobody’s interest, least of all Beijing’s, to see Japan’s economy implode. Gentle decline into irrelevance will do very nicely and all other things being equal (which they never are of course) this will cement Chinese hegemony over the region. Hence, why not add a few JGBs to the portfolio – perhaps on special terms – under the diversification guise?

This is especially pertinent if stories about Beijing’s links with the DPJ have any credence. According to one narrative which generally emanates from various friends in US spookery, the CIA decided to keep the bureaucratic-industrial nexus pretty much in place after World War II in order to buttress the fight against communism. Hence, it was a major supporter, and has remained to this day, of the LDP. By contrast, the DPJ, mongrel organisation that it is, has a number of political strands traditionally more close to Beijing and certainly we are currently seeing some posturing about revisiting the country’s special relationship with Uncle Sam.

We would also like to suggest that there may be another buyer of JGBs out there – the People’s Republic of China

It is in nobody’s interest, least of all Beijing’s, to see Japan’s economy implode

Gentle decline into irrelevance will do very nicely and all other things being equal (which they never are of course) this will cement Chinese hegemony over the region

⁶ We have a lot less in the way of current account data for earlier centuries but it seems a fair assumption that the UK was racking up huge services surpluses throughout the 19th Century and thus was likely still in current account surplus. We continue to dig....

The last thing the world needs is for JGBs to collapse

China has obviously noticed this too and is cultivating its relationships accordingly. And what better way to demonstrate that you really are a friend of Tokyo than to offer to help fund the nation's fiscal deficits? We would not want to overdo the strength of the anti-American bloc in a DPJ which after all contains many ex-LDP stalwarts. Moreover, most Japanese are under no illusion whatsoever as to China's medium term designs on regional dominance and in any case, the poisonous history between the countries makes them unlikely bedfellows. But then again, why not pretend to play nice anyway in order to source another potential backstop for the bond market?

What better way to demonstrate that you really are a friend of Tokyo than to offer to help fund the nation's fiscal deficits?

We will finish with some brief comments on debt service. Again citing standardised OECD calculations of interest payments on outstanding government debt stocks, Japan at 1.2% of GDP currently pays a good deal less than its far less indebted developed world peers. For example, the US shells out around 2% of GDP in interest payments on the national debt while the eurozone and UK have outlays nearer 2.8%. At a broader level, the Japanese Ministry of Finance number for total debt service – i.e. including repayments – was around 3.5% of GDP for fiscal 2008-09 or 24% of total outlays (though it was obviously able to issue new bonds at reasonable rates to pay off those maturing). And to be simplistic (because it helps with the illustrative comments that follow), if we just assume the annual outlay is the running yield on the current outstanding, we come up with a number of around 2.4% of GDP.

Japan at 1.2% of GDP currently pays a good deal less than its far less indebted developed world peers

Consider now the final two charts overleaf. The first shows that assuming structural deficits of around 5% of GDP persist (the record over the past 15 years) and hence issuance remains roughly at current levels, then unless Japan can clock up nominal GDP growth in excess of 2% per annum, its debt burdens will continue to climb unabated. The only problem is that if the markets get a whiff that rapid nominal growth is returning (assuming that this is not a function of massive supply side reforms that boost potential growth) then debt service costs would likely explode.

Unless Japan can clock up nominal GDP growth in excess of 2% per annum, its debt burdens will continue to climb unabated

Hence our long held conclusion that the last thing Japan and indeed the world needs, is for Japan to return to rapid growth. For an aging population sitting on huge piles of liquid assets, low growth and mild deflation are pretty much what the doctor might order. A Yen with a tendency to strength also reduces the temptation to put too much overseas while more positively it has also helped to boost domestic purchasing power even as import penetration has been allowed to rise.

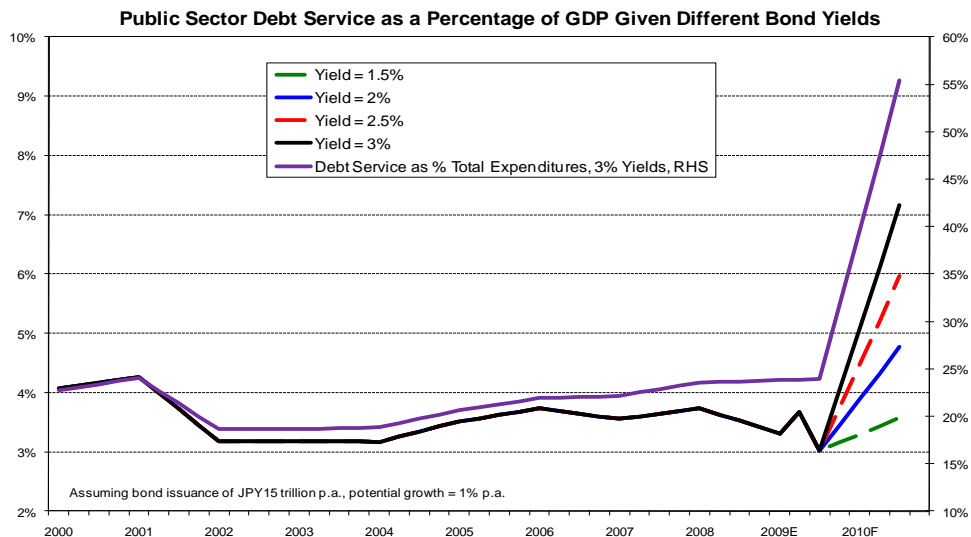
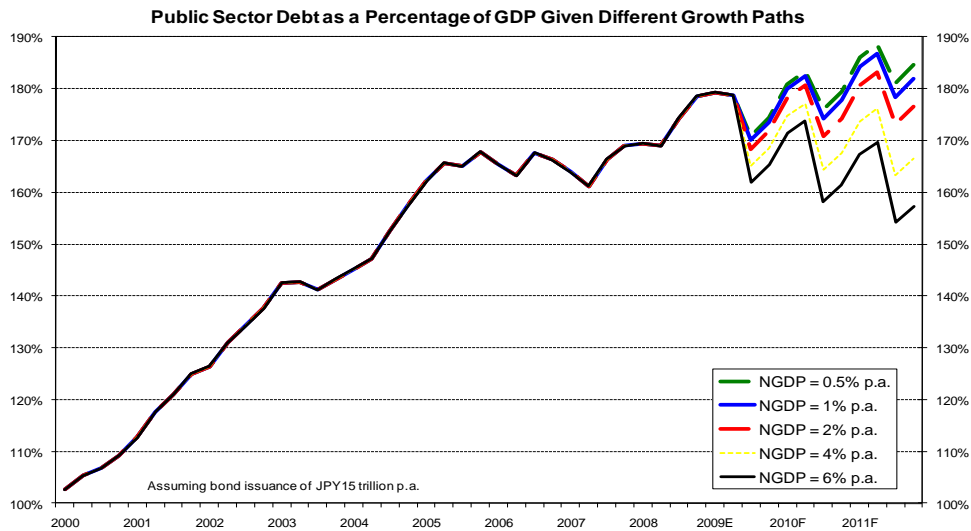
The only problem is that if the markets get a whiff that rapid nominal growth is returning then debt service costs would likely explode



The last thing the world needs is for JGBs to collapse

However, it is the kids and grandkids we puzzle about. Perhaps being able to live at home with mummy and daddy is just too tempting while the expectation must clearly be there that once they die, the asset pool transfers itself over. Not if the government has its way we suspect for even more punitive death duties are surely in the wings. Learn English and/or Chinese and emigrate would be our advice but then again, we might well suggest this to the young of all manner of countries these days. The dystopic amongst you would do well to check out Christopher Buckley's *Boomsday* or re-watch the marvellous yet harrowing *Soylent Green*.

The dystopic amongst you would do well to check out Christopher Buckley's *Boomsday* or re-watch the marvellous yet harrowing *Soylent Green*



The last thing the world needs is for JGBs to collapse

Copyright © **DSGAsia**, DSG Asia Limited and Galaxy Consultancy Limited.

This report has been prepared from sources and data we believe to be reliable but we make no representation as to its accuracy or completeness. Additional information is available upon request. This report is published solely for information purposes and is not an offer to buy or sell, or a solicitation of an offer to buy or sell any security or derivative. This report is not to be construed as providing investment services in any state, country or jurisdiction where the provision of such services would be illegal. Opinions and estimates expressed herein constitute our judgement as of the date appearing on the report and are subject to change without notice.

The price and value of investments mentioned herein, and any income which might accrue from them, may fluctuate and may fall or rise against an investor's interest. Past performance is not necessarily a guide to future performance. This report has no regard to the specific investment objectives, financial situation and particular needs of any specific recipient of this report and investments discussed may not be suitable for all investors. Investors should seek financial advice regarding the suitability of investing in any securities or following any investment strategies discussed in this report. If an investment is denominated in a currency other than the investor's currency, changes in the rates of exchange may have an adverse effect on value, price or income. The levels and bases of taxation may also change from time to time.

DSGAsia is a trademark of DSG Asia Limited and Galaxy Consultancy Limited.

