CONFIDENTIAL

JAPAN'S "ATTEMPTED" REFLATION

JANUARY 2013

BIENVILLE
CAPITAL MANAGEMENT

Japan's Attempted Reflation

Summary…

- **Monetary policy in Japan is undergoing a monumental change**. **For the first time in Japan's post-bubble era beginning in 1990, it appears policymakers intend to drive real interest rates into negative territory. As a result, we believe the yen could continue to weaken and that Japanese equities could be in the early stages of a powerful rally**
- On October 30, 2012 the Bank of Japan and Ministry of Finance issued a joint statement entitled "Measures Aimed at Overcoming Deflation,"* setting the stage for "powerful easing," including what seems to be an explicit attempt to weaken the yen. On December 16th, 2012, Shinzo Abe was elected Prime Minister with a mandate to end deflation (i.e., to reflate the Japanese economy)
- Although Japan has struggled with a deflating economy for nearly two decades, the timing of these actions is not random. For a variety of idiosyncratic, macro and geopolitical reasons, the Japanese economy is faltering. Partly as a result of a strong yen, industrial production and business surveys have deteriorated, and the revenues of several national export champions have collapsed
- Due to negligible growth and deflation, the level of nominal GDP in Japan remains well below previous highs (Slide 4), a dangerous circumstance for an economy carrying the world's largest sovereign debt burden. As history has proven, debt and deflation cannot coexist
- In return for failing to reflate the Japanese economy, **the Bank of Japan is on the verge of losing its independence**. At the behest of Abe, it seems likely the BOJ will confirm a new 2.0% inflation target on January 22nd. In April 2013, the BOJ's 'hawkish' Governor, Masaaki Shirakawa, is set to retire, likely to be replaced with a far more 'dovish' candidate (Slide 5)
- In implementing monetary policy, the Bank of Japan is authorized to buy domestic and foreign assets, including equities and REITs (Slide 6). **Achieving the 2% inflation target will prove difficult** as domestic deflationary pressures remain. Wages, specifically, are contracting (Slide 7). **Hence policy will need to be highly aggressive**
- **In recent years, although the BOJ has expanded its balance sheet** (Slide 8)**, it has risen far less than other central banks since the financial crisis began** (Slide 9)
- **Regardless of whether the BOJ proves successful in achieving their inflation target, the expectation of aggressive policy can have a meaningful impact on the yen and Japanese equities**, which remain at low levels compared to previous highs (Slide 10 & 11). Recently, equities have rallied and the yen has begun to weaken (Slide 12). But on a "real, trade-weighted basis," the yen could fall another 20% before reaching the levels of 2007
- **To be clear, the intention of the additional policy measures in Japan is to enlist the "portfolio balance channel"**—that is, to drive "real" interest rates negative, forcing Japanese savers out of cash and bonds and into riskier assets (i.e. equities). The Federal Reserve has attempted this process twice recently: in 2003 and 2009 (Slide 13), both of which resulted in higher asset prices. By contrast, real interest rates in Japan have remained positive, benefitting bondholders (Slide 14). High real rates also encourages saving over consumption
- The 2003-2005 analog in Japan is interesting: monetary policy was aggressive, the BOJ's balance sheet expanded by 25%, the yen weakened by 15% and Japanese equities rallied 125%. Of course this occurred during a period of global easing and reflation. In order to achieve today's stated goals, the BOJ will need to be far more aggressive. For instance, in order to peg and maintain the Swiss Franc to the Euro at 1.20, the Swiss National Bank has expanded its balance sheet by 100% since August 2011

*** http://www.boj.or.jp/en/announcements/release_2012/k121030b.pdf**

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- **We believe the primary risk to this theme is lack of policy follow-through—that is, policymakers fail to act to the degree they are currently suggesting, as has occurred in the past.** We currently believe this risk is minimal given the determined and coordinated communications from policymakers, as well as key upcoming events (e.g., Upper House elections, etc.). However, lack of policy follow-through would invalidate the theme
- However, on a valuation basis, **Japanese equities are relatively cheap** (1.2x Price/Book versus 1.5x for other global indices) and yield 2.7%, more than 3x the yield from Japanese government bonds
- **International mutual funds are also currently underweight Japanese equities**. Goldman Sachs believes international mutual funds' allocation to Japan is 4% below benchmark (MSCI EAFE). If portfolio managers feel pressure to "get to benchmark, " some $60 billion could flow into Japanese equities (in addition to the estimated $20 billion of recent inflows)
- Japan's debt-to-GDP ratio is above 200%. Therefore, higher interest rates in Japan could be highly destabilizing. Today policymakers are undergoing a delicate balancing act: attempting to increase inflation and inflation expectations so that investors reallocate savings to riskier assets without causing nominal bond yields to rise. We are unsure of whether they can achieve this and continue to expect significant stress in the JGB market at some point. However, at the moment our focus has been to attempt to profit from a weakening yen and rising Japanese equities
- **To be sure, these events have significant implications for the global economy**. To weaken the yen, the BOJ needs to buy foreign assets, and given the size of the purchases required, the likely candidates would be U.S. Dollar and Euro-denominated assets. Neither the U.S., nor Europe prefer to see a meaningful appreciation of their currencies
- **A materially weaker yen also complicates the necessary global rebalancing process**: the U.S. and parts of Europe—i.e., current account deficit countries—need to move towards trade balance to achieve sustainable growth (i.e., a weaker USD and euro relative to some peers). By contrast, the surplus countries, notably China, Japan and Germany—the world's 2nd, 3rd and 4th largest economies—need to engineer more domestic demand, relying less on exports, or external demand, for growth. A policy-induced shift back towards export-led growth by the surplus countries would only rekindle the global imbalances that erupted in 2008
- Having virtually exhausted its ability to grow through investment, China is unlikely to sit idle as Japan weakens the yen, stealing external demand in the process
- Recently, the yen has weakened by nearly 20% versus the Korean won, one of Japan's primary competitors, threatening Korean exports, which represent 50% of its economy
- **In sum, aggressive actions by the BOJ could escalate into a full-fledged currency war. Investors should be monitoring these events closely**

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In nominal terms, economic activity in Japan is below the level of the mid-1990s, representing a potential disaster for a country with Japan's growing debt burden and declining population…

Japan Nominal GDP
(in billions of yen)

Source: Bloomberg, Bienville Capital Management, LLC

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Therefore, the newly-elected Abe administration has embarked on a national mandate to generate inflation and higher nominal GDP growth. As a consequence, the Bank of Japan’s independence appears to be in jeopardy…

The Japan Times, January 14, 2012

Prime Minister Shinzo Abe said Sunday that his government will set a medium-term 2 percent inflation target with the Bank of Japan in a joint statement expected later this month to help shore up the recession-hit economy.

"What will be important is properly including the price goal of 2 percent," Abe said during a program on NHK in his latest move to pressure the central bank to be more aggressive in combatting the country's chronic deflation ahead of its next monetary policy meeting on Jan. 21 and 22.

Abe said the BOJ's current goal of 1 percent inflation lacks "strong determination" and that the government and central bank will come up with "a definite goal and write that it will be 2 percent."

Abe claimed the new target needs to be achieved under a medium-term scenario rather than a long-term one or financial markets "will not react."

The prime minister said he believes the next BOJ governor, who will replace Masaaki Shirakawa when his tenure ends in April, should be someone who can take "bold monetary steps and is in line with our points."

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To generate higher inflation and a weaker yen, the Bank of Japan will have to be highly aggressive. Fortunately it has a lot of options at its disposal, more so than other central banks…

Eligible Assets to Purchase	Federal Reserve	European Central Bank	Bank of England	Bank of Japan
Government Bonds (Domestic)	✓	✓	✓	✓
Government Bonds (International)				✓
Mortgage-Backed Securities (RMBS)	✓			✓
Asset-Backed Securities (ABS)				✓
Corporate Bonds (Domestic)			✓	✓
Equities				✓
Commercial Paper			✓	✓
REITs				✓

Source: Bank of Japan; Federal Reserve; ECB; BOE; Jefferies; Bienville Capital Management, LLC

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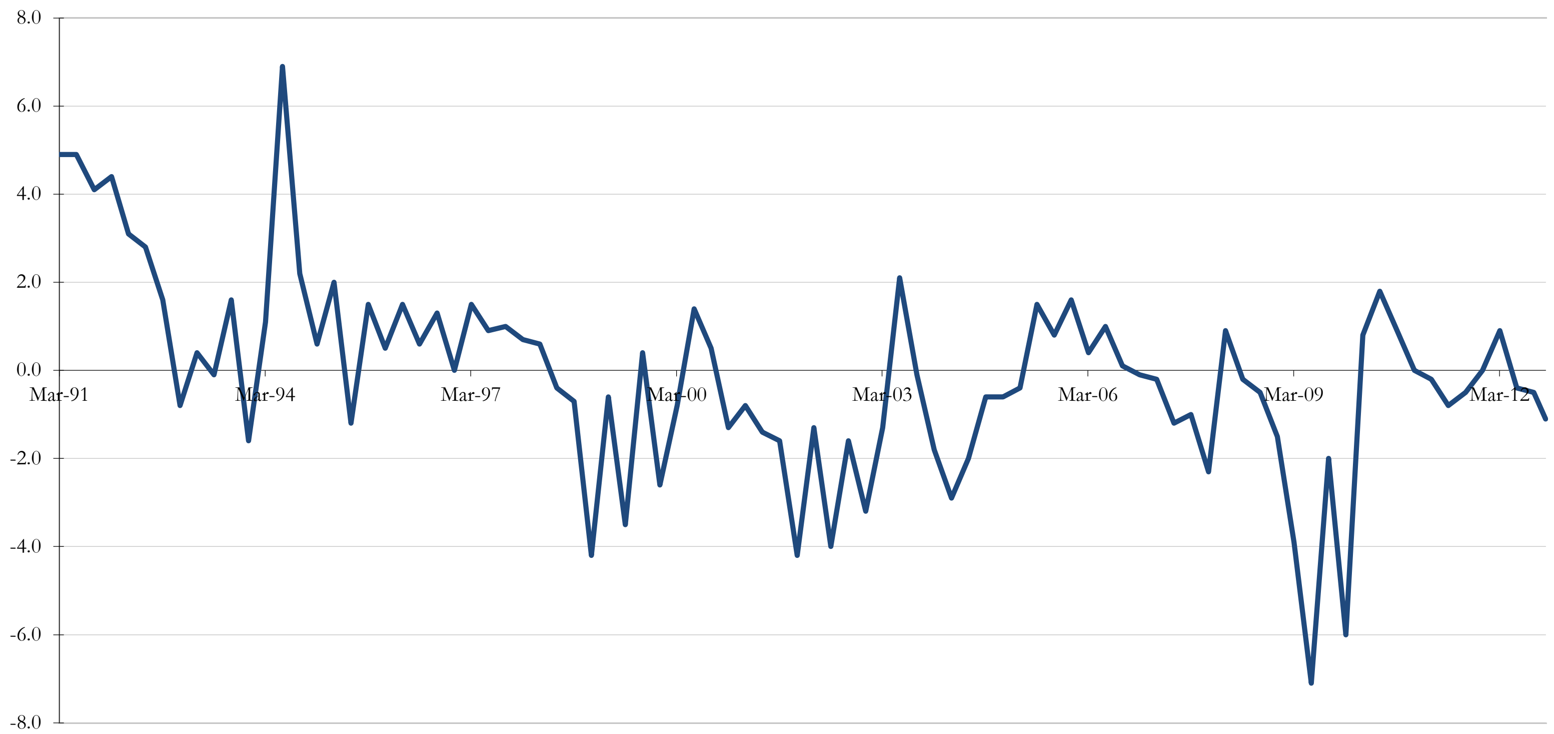
Wages continue to deflate, depressing domestic inflation and suggesting the 2% inflation target will be difficult to achieve. To engineer both inflation and growth for its export-oriented economy, policymakers are focusing on the trade channel, i.e., a weaker yen. However imports represent less than 20% of Japan's economy, meaning the inflation from imports, which includes natural resources, would have to overwhelm the entrenched domestic deflation without harming consumption…

Japan Average Monthly Earnings
(in %)



Source: Bloomberg, Bienville Capital Management, LLC

Japan's Attempted Reflation

Although the Bank of Japan's balance sheet has been expanding over the past few years…

Bank of Japan - Total Assets
(in billion yen)

Source: Bloomberg, Bienville Capital Management, LLC

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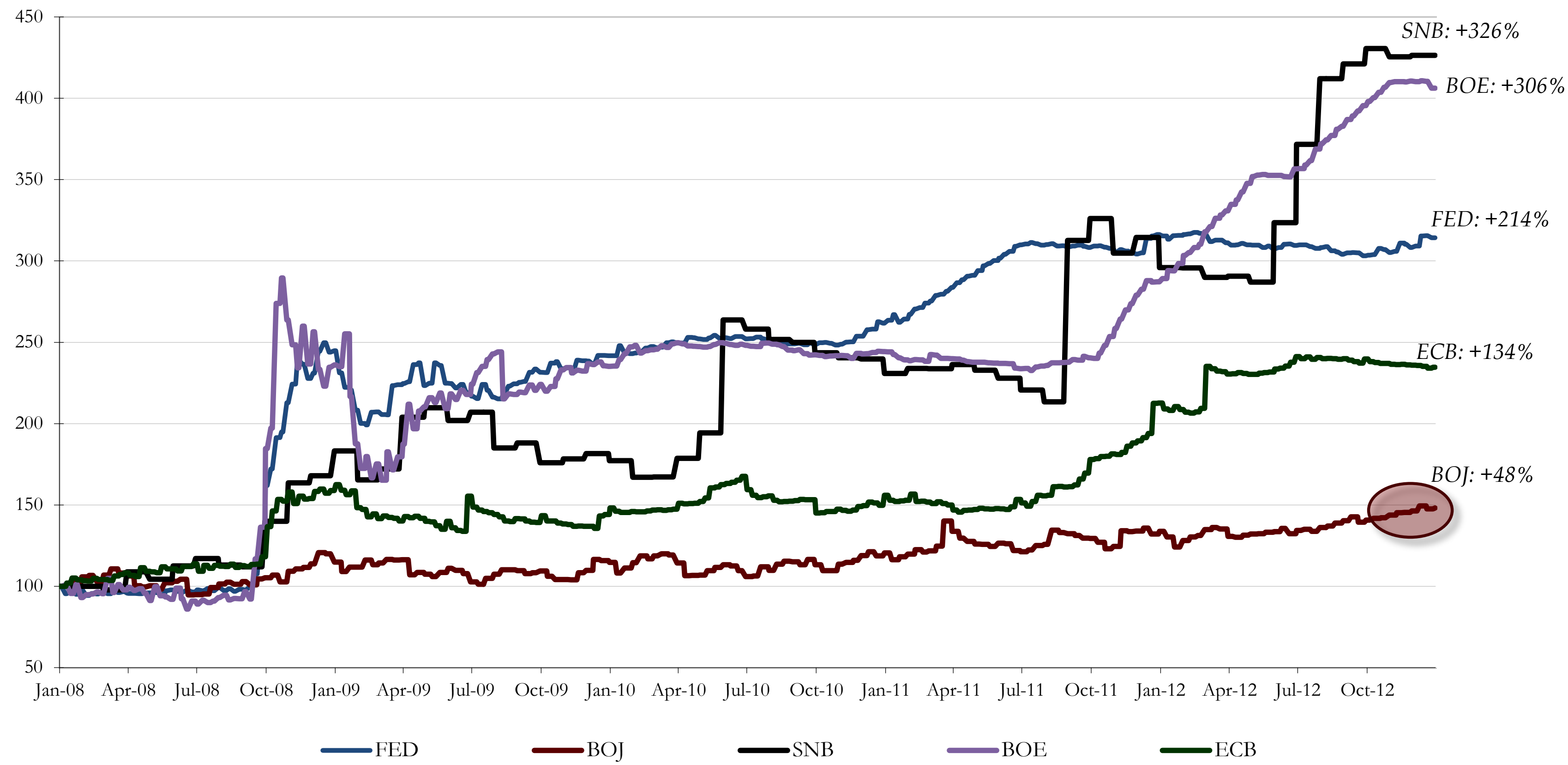
…its aggressiveness pails in comparison to other central banks since the onset of the financial crisis.

Growth of Central Bank Balance Sheets
(January 2008 = 100)



Source: Bloomberg, Bienville Capital Management, LLC

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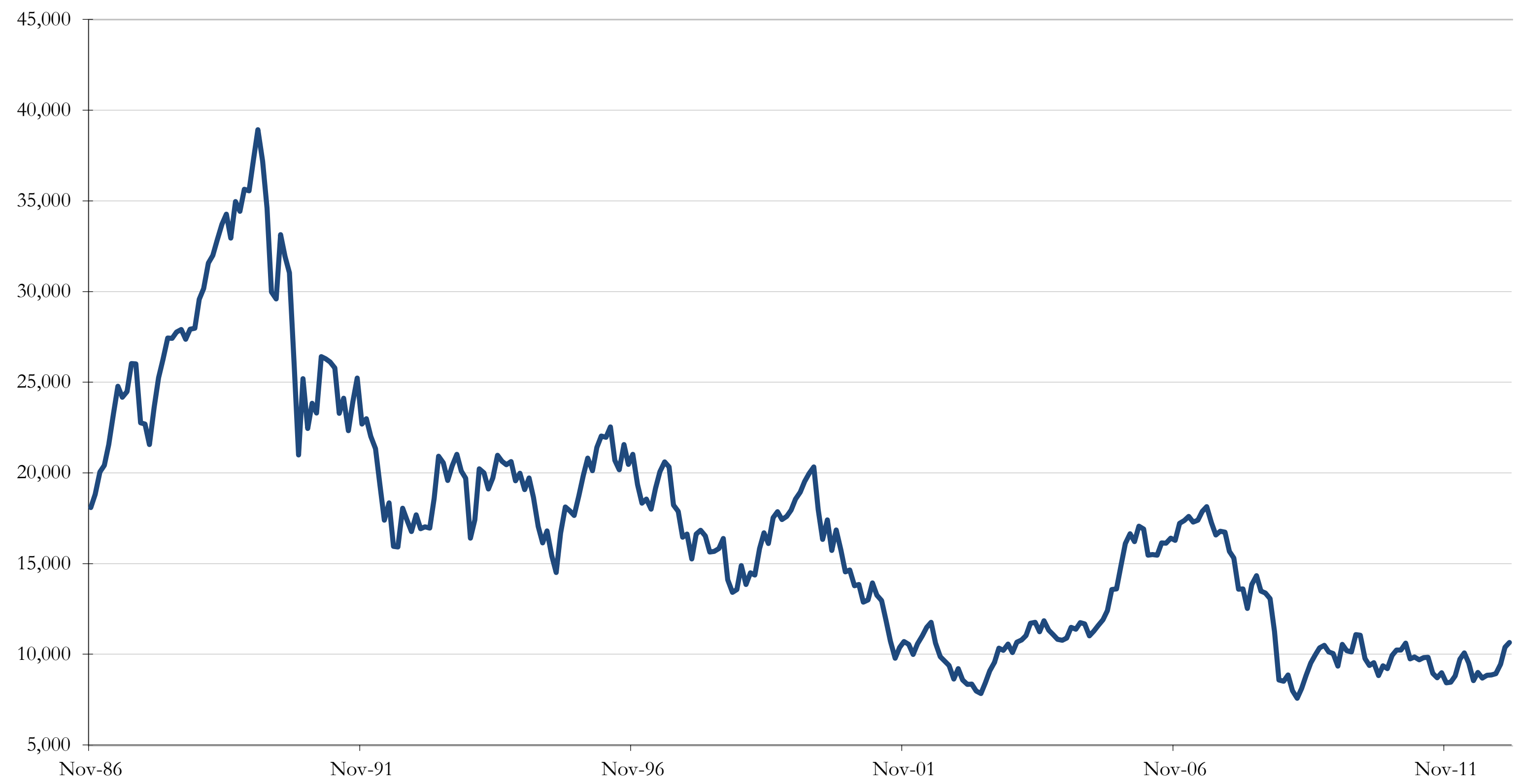
The Nikkei remains more than 70% below 1989's bubble highs…

Nikkei 225 Index



Source: Bloomberg, Bienville Capital Management, LLC

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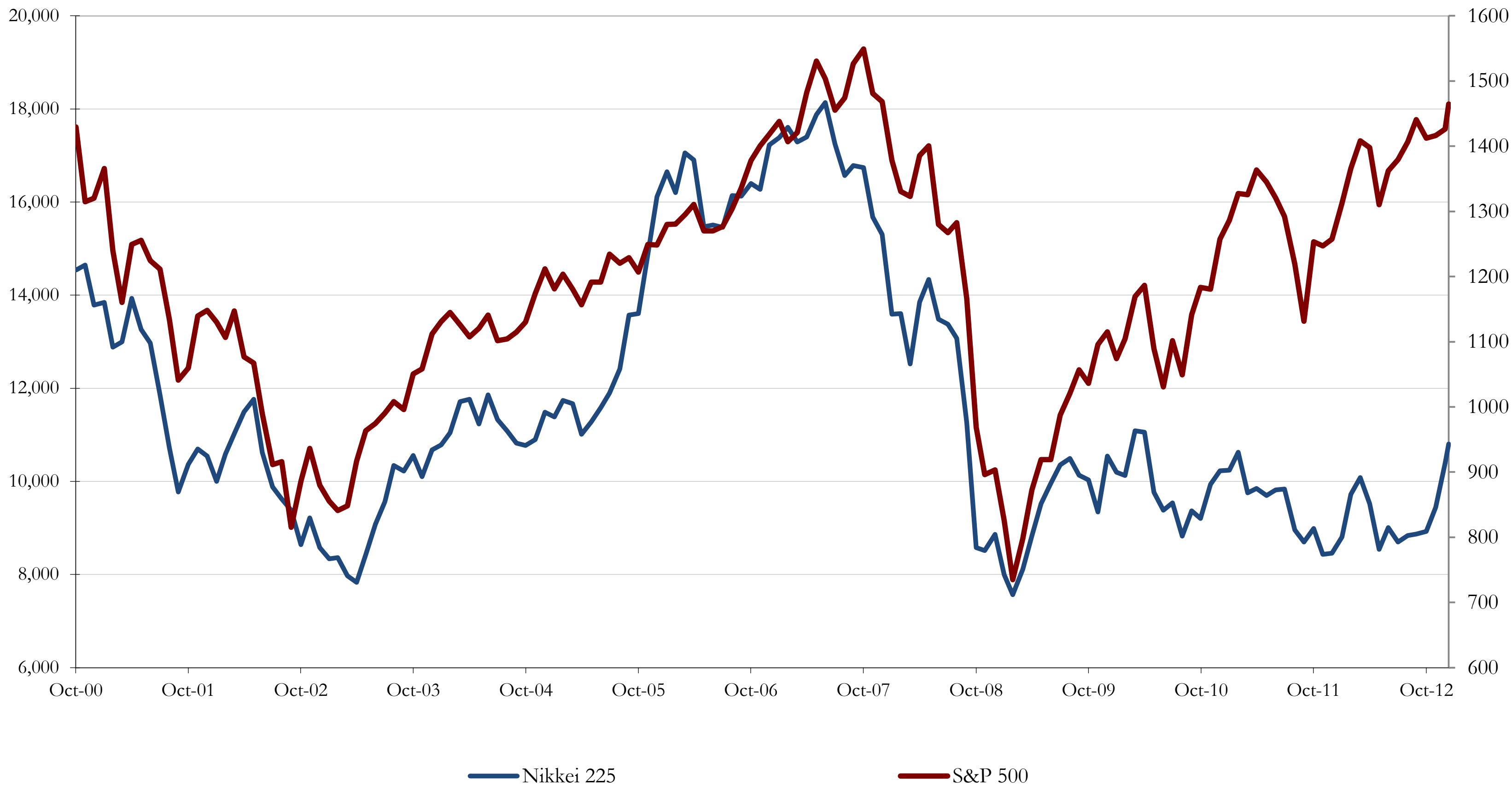
…and 40% below 2007s levels. By contrast, thanks to aggressive monetary stimulus which drove real rates negative, U.S. equities are approaching all-time highs.

Nikkei 225 vs. S&P 500
(Index)



Source: Bloomberg, Bienville Capital Management, LLC

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The dollar-yen exchange rate has broken a long-term trend and appears to be moving towards 100, a level that would please both Japanese policymakers and export-oriented companies…

Source: Bloomberg, Bienville Capital Management, LLC

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On a real, trade-weighted basis, which accounts for the deflation of wages in Japan, the yen could fall another 20% before reaching the lows of 2007…

Japanese yen
(Real Effective Trade-Weighted Exchange Rate)

Source: Bloomberg, Bienville Capital Management, LLC

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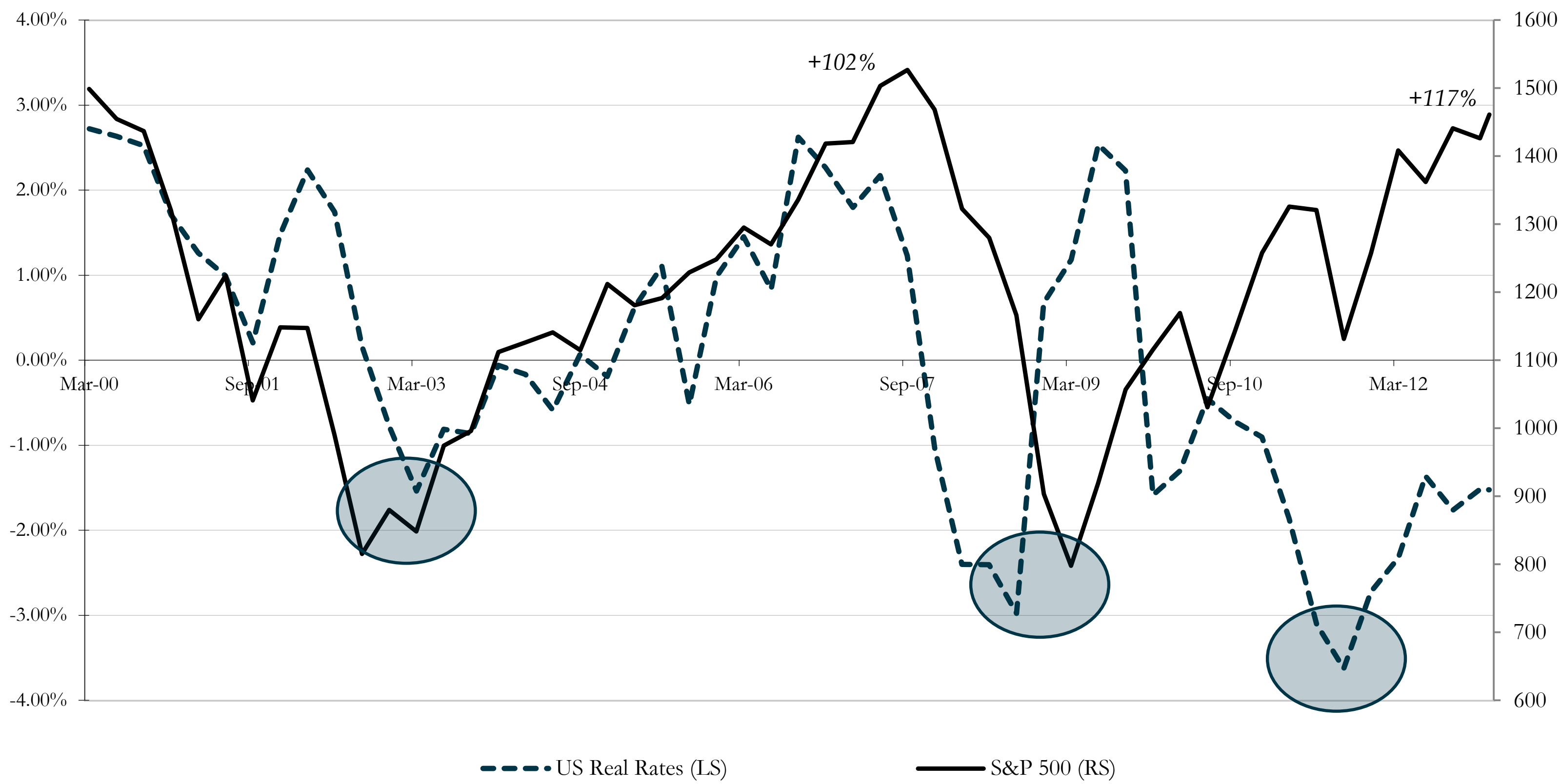
Negative real interest rates in the U.S. have caused significant rallies in risk assets (i.e., the portfolio balance channel). In 2003, both equities and real estate rallied. In 2009, negative real interest rates and QE have caused equities to rally again…

U.S. Real Interest Rates vs. S&P 500
(2-Year Treasury - CPI)



Source: Bloomberg, Bienville Capital Management, LLC

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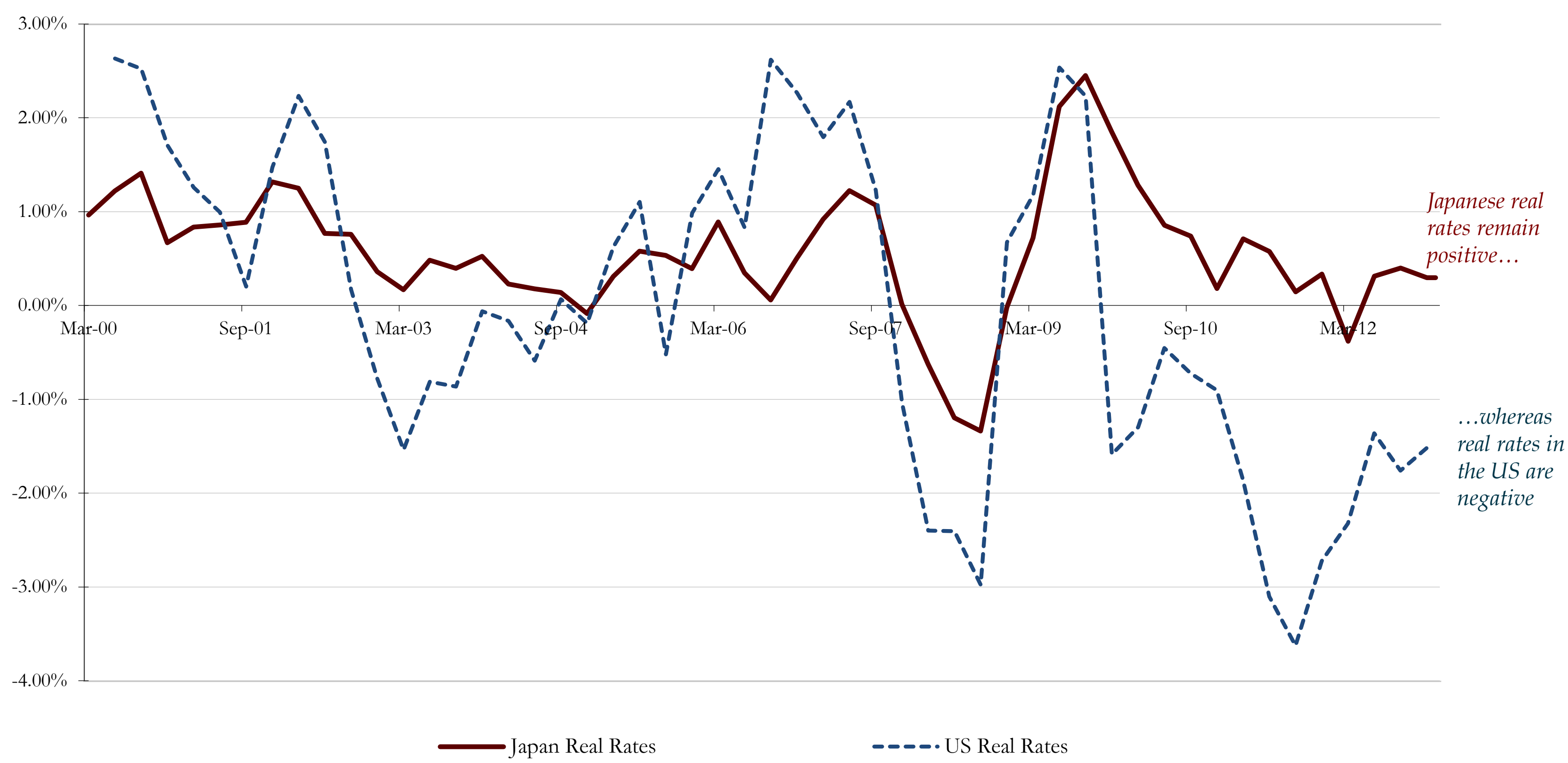
By contrast, real interest rates in Japan have remained largely positive, encouraging savers to place the vast savings in cash and Japanese government bonds (JGBs). If inflation rose, real rates would turn negative, inspiring savers to move out on the risk spectrum…

Japan & U.S. Real Interest Rates
(2-Year Government Bond - CPI)



Source: Bloomberg, Bienville Capital Management, LLC

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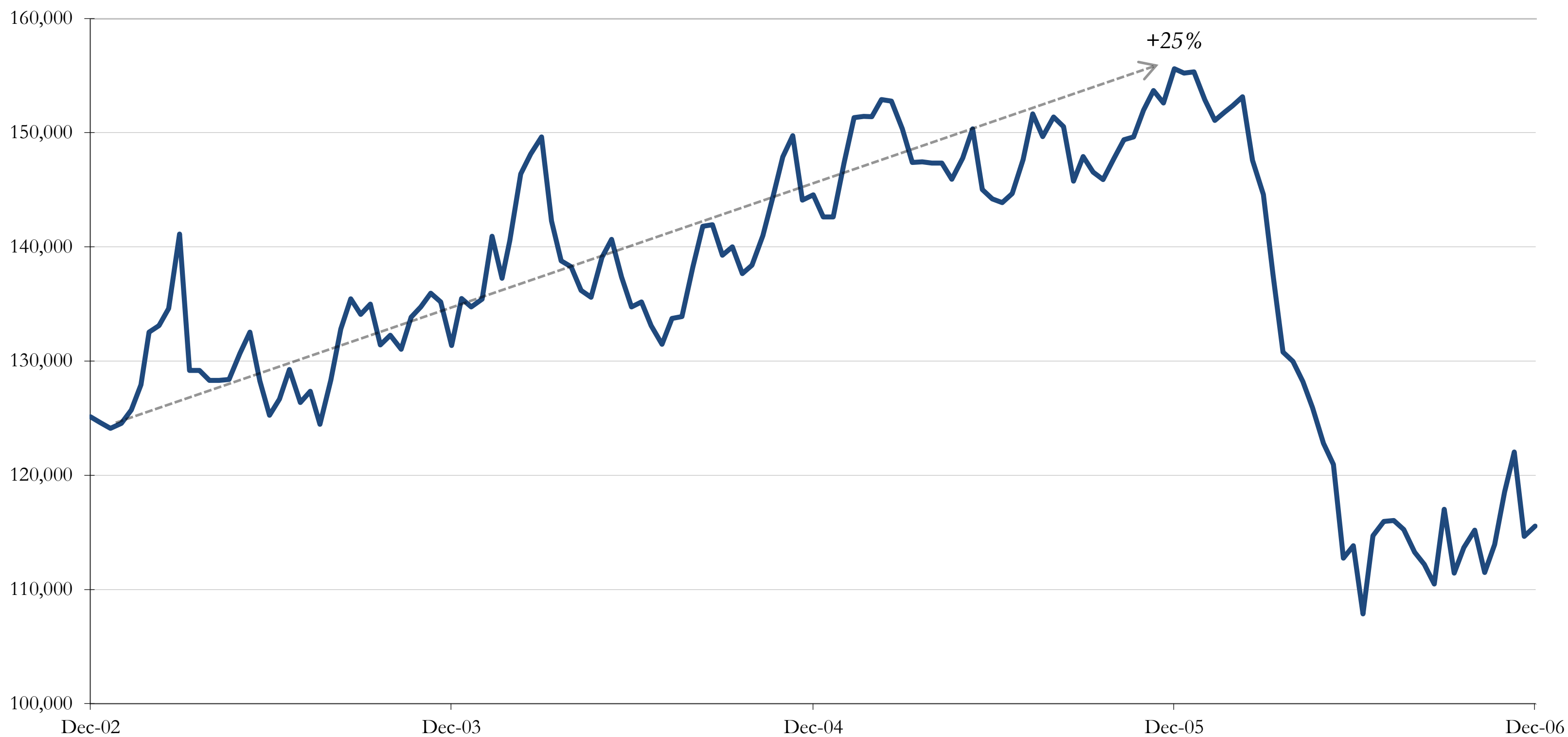
During the last material monetary easing (i.e., 2003 – 2005), which did coincide with a global reflation effort, the Bank of Japan's assets expanded by 25%, which helped to weaken the yen by 15%…

Bank of Japan - Total Assets
(in billion yen)



Source: Bloomberg, Bienville Capital Management, LLC

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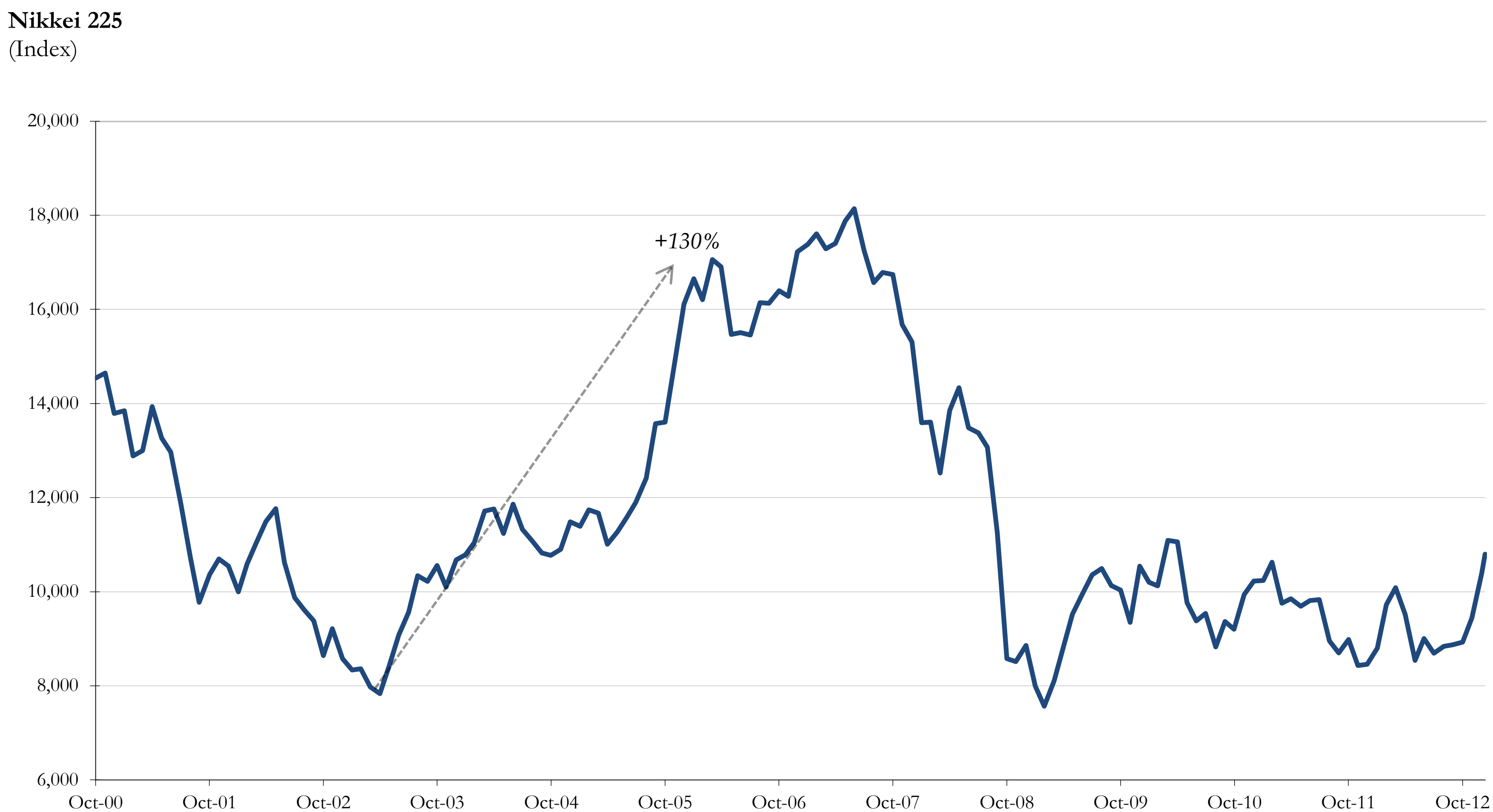
…while the Nikkei rallied by over 100% (before declining 60% during the financial crisis).



Source: Bloomberg, Bienville Capital Management, LLC

CONTACT INFORMATION

If you have any questions or would like to speak with us further, please contact:

Cullen Thompson
Cullen.Thompson@bienvillecapital.com
212-226-7348 (w)
917-749-1375 (c)

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About Us

Bienville Capital Management, LLC is an SEC-registered, independent investment management and advisory firm offering investment solutions to a select number of sophisticated investors. Our investment process is research-intensive and thematic, focusing on asset allocation, direct investments, manager selection and portfolio construction.

The members of the Bienville team have broad and complementary expertise in the investment business, including over 100 years of collective experience in private wealth management, institutional investment management, trading, investment banking and private equity. We have established a performance-driven culture focused on delivering exceptional advice and service. We communicate candidly and frequently with our investors in order to articulate our views.

Bienville Capital Management, LLC is the investment manager for Bienville Capital Partners, LP and the Gulf Coast Opportunities Fund. We are headquartered in New York, NY.