

BIENVILLE MACRO REVIEW

Japan's Improving Prospects

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JAPAN'S IMPROVING PROSPECTS

Summary

As covered in 'Japan's Attempted Reflation' (January 2013), policy in Japan has undergone a profound shift, the announcement of which has had a considerable impact on Japanese equities and the yen, which has weakened by more than 20% since November 2012. A recent research trip to Japan (notes available) confirmed that policymakers have in fact engineered a positive confidence shock and that exiting deflation is a 'national mission.'

- Since the launch of qualitative and quantitative easing (QQE) in April, the BOJ's balance sheet has been expanding rapidly, outpacing other developed country peers, helping to weaken the yen
- Japan is the only developed economy where both monetary and fiscal policy are supporting growth. A weaker yen has given a boost to exports. Meanwhile, public investment, housing demand and consumer confidence have picked up. National manufacturing and regional surveys are also positive. In Q1 2013, Japan's economy grew at an annualized rate of 4.1%
- Similar to the Federal Reserve, the BOJ has hoped to engage the 'portfolio balance channel' where expectations of negative real interest rates force investors into riskier assets, driving asset prices up, and inciting animal spirits, confidence and consumption. There is some evidence this process is underway. Sales at large retail stores, which are correlated with wealth effects, have risen lately
- Increased volatility in Japanese government bonds surrounding mangled comments by the BOJ in May led to a considerable pullback in Japanese equities. Investors understandably wondered if the positive reflexivity created by 'Abenomics' would reverse
- Big movements in the yen have coincided with comments from the Federal Reserve regarding the 'tapering' of QE. Over the past few weeks, the yen has also weakened back towards 100, thanks at least partly to the broad-based rally in the USD
- Recently, as volatility has settled down, equities have begun to rally, breaking above key technical levels. The full scope of Abe's 3rd Arrow will be revealed in the months following the July 21st Upper House elections. Expectations seem low, leaving the potential for upside surprises
- Because Japan's reflationary policies are largely dependent on changing psychology, their ultimate success remains uncertain, requiring investors to be nimble. Previous failed rallies over the past two decades have left many investors skeptical. Nonetheless, policymakers seem cohesively committed to ending deflation and changing the trajectory of nominal growth

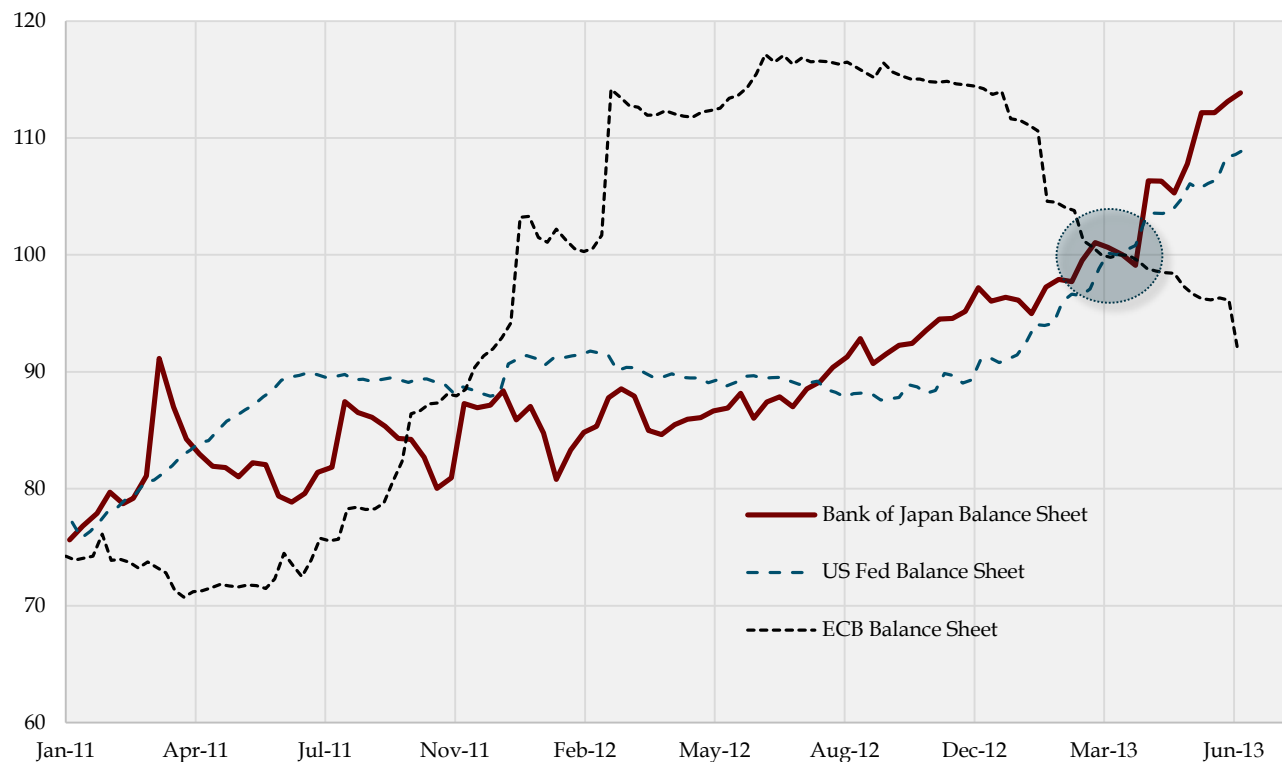


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With the introduction of QQE in April, the Bank of Japan's balance sheet has been expanding rapidly, outpacing both the Fed's and the ECB's, which is now declining. More expansive monetary policy has helped weaken the yen...

Since April, the BOJ's balance sheet has been expanding at an annualized rate of 83%

Central Bank Balance Sheets (rebased to April 2013)



Source: Bloomberg; Bienville Capital Management, LLC



*Any financial indicators or benchmarks shown are for illustrative and/or comparative purposes only. Certain information has been provided by and/or is based on third party sources and, although believed to be reliable, such information has not been independently verified and its accuracy, timeliness or completeness cannot be guaranteed.

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Since October 2012, the yen has nearly reverted back to pre-crisis levels...

Japanese Yen Spot



The real effective exchange rate is also near pre-crisis lows, improving competitiveness...

In Japan, domestic observers refer to the yen's recent move as a 'correction' from previous overvalued levels, rather than a weakening

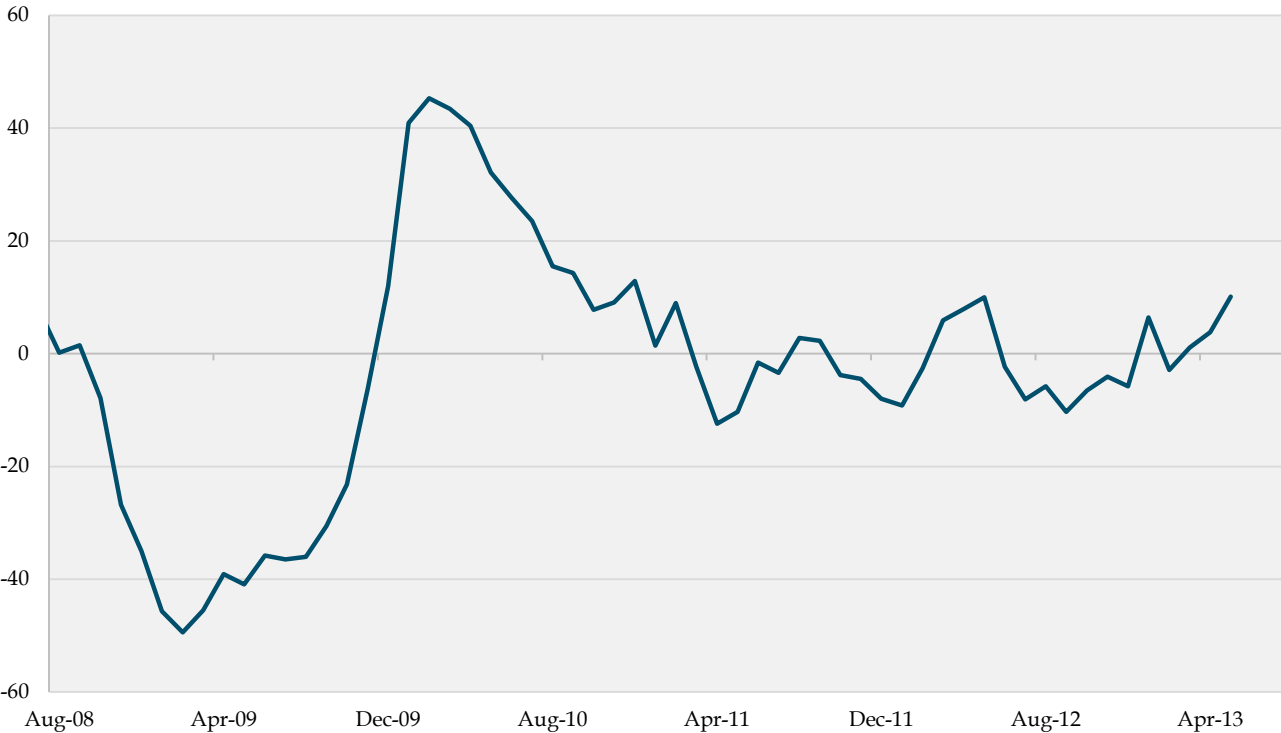
Source: Bloomberg; Bienville Capital Management, LLC



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Exports have accelerated on improved competitiveness...

Japan Merchandise Trade Exports (YOY Change)

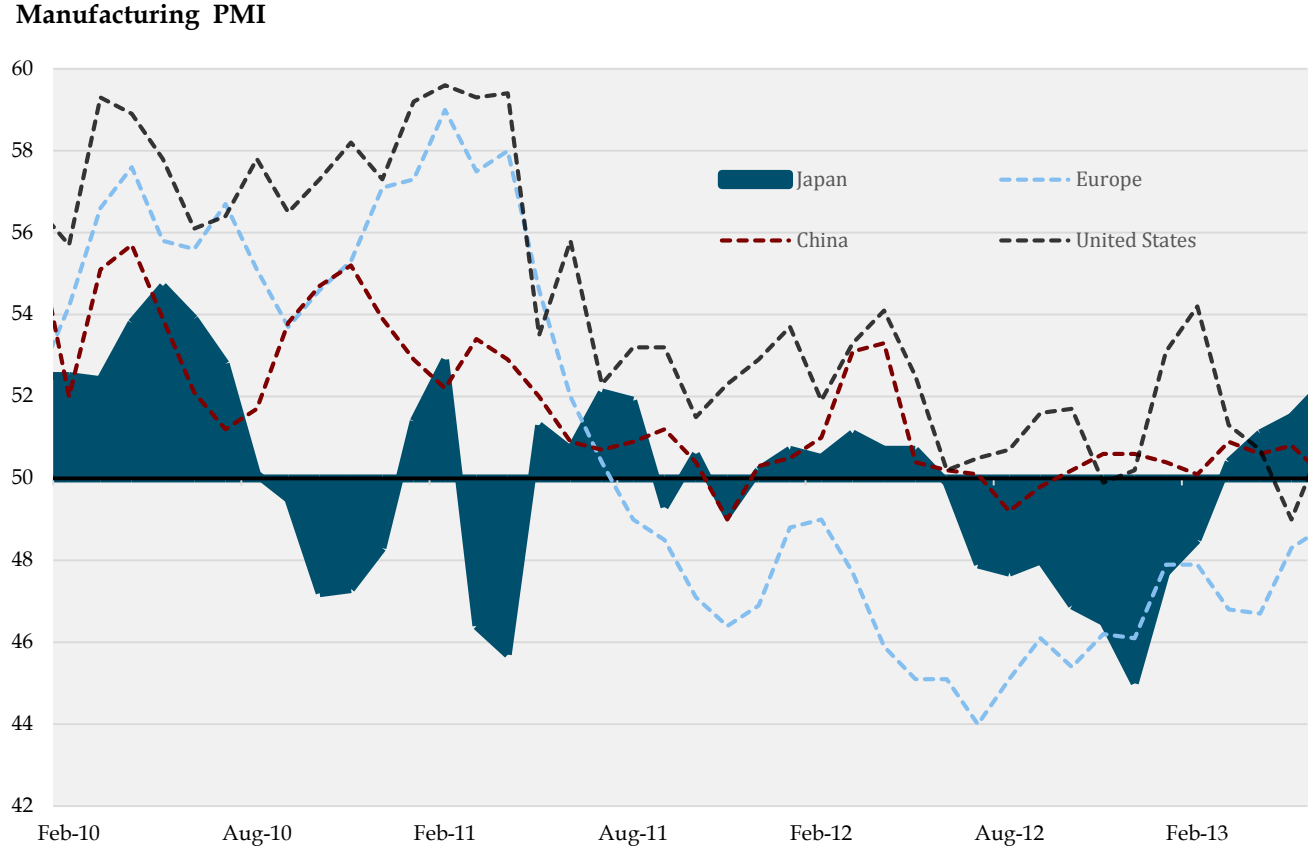


Source: Bloomberg; Bienville Capital Management, LLC



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Japan's PMI has also picked up, especially relative to peers...



Source: Bloomberg; Bienville Capital Management, LLC



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The BOJ's regional assessment survey also shows considerable improvement...

Region	Assessment in April 2013		Assessment in July 2013
Hokkaido	The economy has continued to pick up.	↑	The economy has been picking up.
Tohoku	The economy has begun to recover with production having stopped declining.	→	The economy has begun to recover.
Hokuriku	The economy has shown some signs of picking up.	↑	The economy has been picking up.
Kanto-Koshinetsu	The economy has stopped weakening.	↑	The economy has been picking up.
Tokai	The economy has been picking up moderately.	↑	The economy has been picking up.
Kinki	The economy has remained relatively weak, but signs of picking up have gradually become widespread.	↑	The economy has been picking up moderately.
Chugoku	The economy has started to pick up as a whole, albeit with differences depending on the industry and size of the firms.	↑	The economy has been picking up moderately as a whole.
Shikoku	The economy has been resilient, although it has shown some signs of weakness.	↑	The economy has begun to pick up.
Kyushu-Okinawa	The economy has continued to be more or less unchanged as a whole, but it has shown some signs of picking up, mainly in domestic demand oriented sectors.	↑	The economy has been picking up.

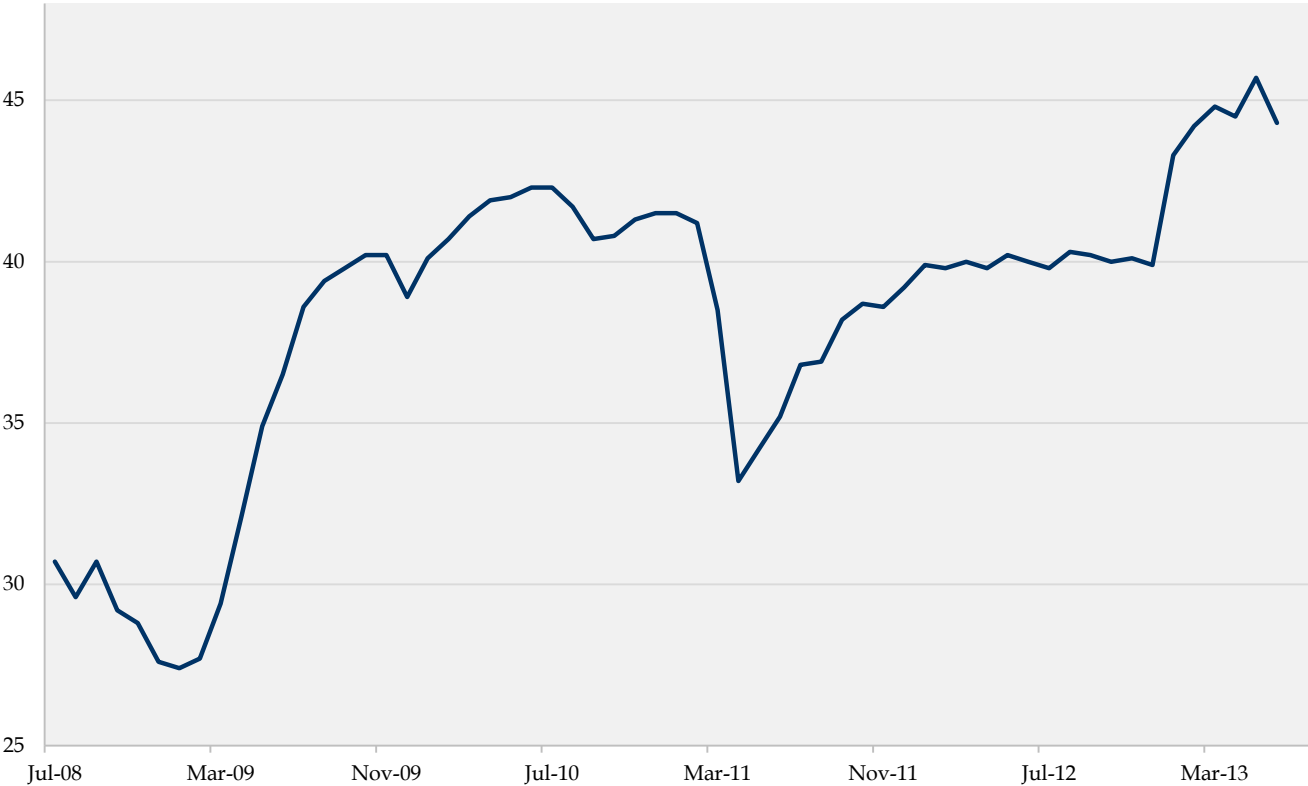
Source: Bank of Japan



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Household confidence has accelerated...

Japan Consumer Confidence



Expectations and confidence are critical to the success of 'Abenomics'

Consumers need to believe deflation is ending, pulling forward future purchases

Changing expectations about the future alters behavior today, potentially leading to a self-fulfilling cycle

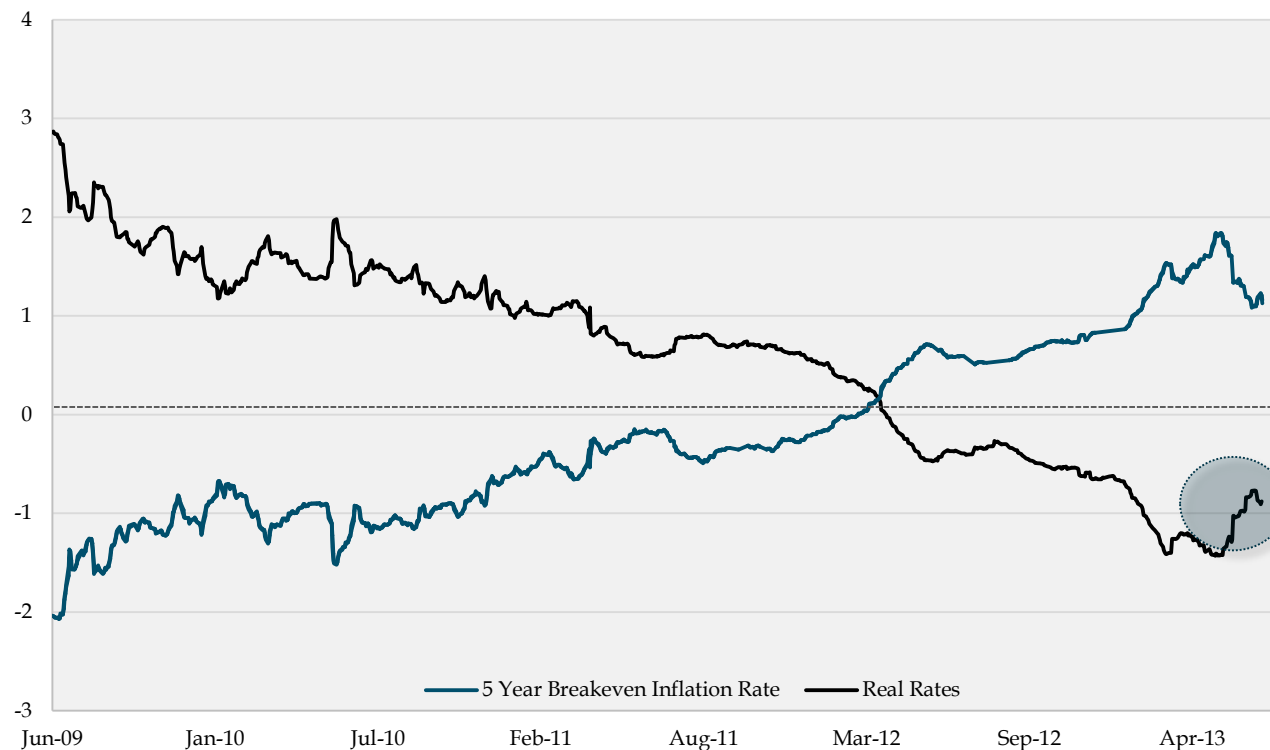
Source: Bloomberg; Bienville Capital Management, LLC



JAPAN'S IMPROVING PROSPECTS

Deflation expectations have kept real interest rates positive. As inflation expectations have turned positive, real rates are now negative...

Japan Breakeven Interest Rate vs. Real Rates



Source: Bloomberg; Bienville Capital Management, LLC

Negative rates, although a form of 'financial repression,' stimulate the economy

Positive inflation expectations have helped to reduce real interest rates

Japanese households have nearly ¥850 trillion (\$8.5 trillion) of currency and deposits, representing over 50% of their net worth

Holding cash is a sensible option in deflation. In contrast, negative real rates reduce the attractiveness of doing so



JAPAN'S IMPROVING PROSPECTS

In launching QQE, the BOJ extended the duration of asset prices to an average of 7 years

By lengthening the duration, the BOJ will more likely be buying assets from insurance companies and pensions, rather than banks. The result should be a greater boost to the money supply. A faster rising money supply increases the odds of exiting deflation

An increasing money supply boosts asset prices, particularly real estate, lifting collateral values, which potentially leads to increased borrowing...

...credit creation results in more bank deposits (e.g., money growth) and more increases to broad money – that is, a virtuous cycle

Broad money has indeed accelerated...

Japan Money Stock YoY Change (M2)



Source: Bloomberg; Bienville Capital Management, LLC



JAPAN'S IMPROVING PROSPECTS

The Bank of Japan's policy continues "further into uncharted territory" in order to defeat the deflation that has plagued the Japanese economy. The BOJ describes this path in 6 steps...

Step	Path to Achieving 2% ⁰ (according to the BOJ)	Translation to Bienville's Framework
1.	"The recovery in overseas economies will strengthen the recovery trend in Japan's production and exports, thereby increasing corporate profits"	A de facto devaluation of the yen has restored export competitiveness, boosting external demand and profits...
2.	"Financial conditions including asset prices will become even more accommodative. Behind that are several factors, such as the continued trend of investor's active risk-taking...and strong monetary easing by the Bank of Japan"	QQE attempts to engage the portfolio balance channel whereby the prospect of negative real interest rates forces investors into riskier assets, pushing up asset prices and inciting 'animal spirits'...
3.	"These two steps will encourage firm's positive initiatives to make fixed investment and implement structural reform. That will bring a gradual rise in the potential growth rate of Japan's economy"	Increased confidence should lead to capital investment, providing domestic demand and ultimately, increased productivity...
4.	"With the expectations for sustainable economic recovery, household spending should stay firm and prices should gradually increase, accompanied by the narrowing of the negative output gap"	The 'wealth effect' leads to spending, which should lead to higher <i>future</i> inflation. Expectations for higher <i>future</i> inflation should pull forward demand, creating the very inflationary pressure policymakers desire...
5.	"Public inflation expectations rise"	As inflation expectations rise, the trajectory of nominal GDP is positively altered
6.	"The virtuous cycle is maintained, economic recovery will continue"	Higher inflation leads to increased wages and credit demand, leading to a self-reinforcing cycle

Source: *Central Banking into Further Uncharted Territory*; Ryuzo Miyao, Member of the Policy Board Bank of Japan; May 28, 2013

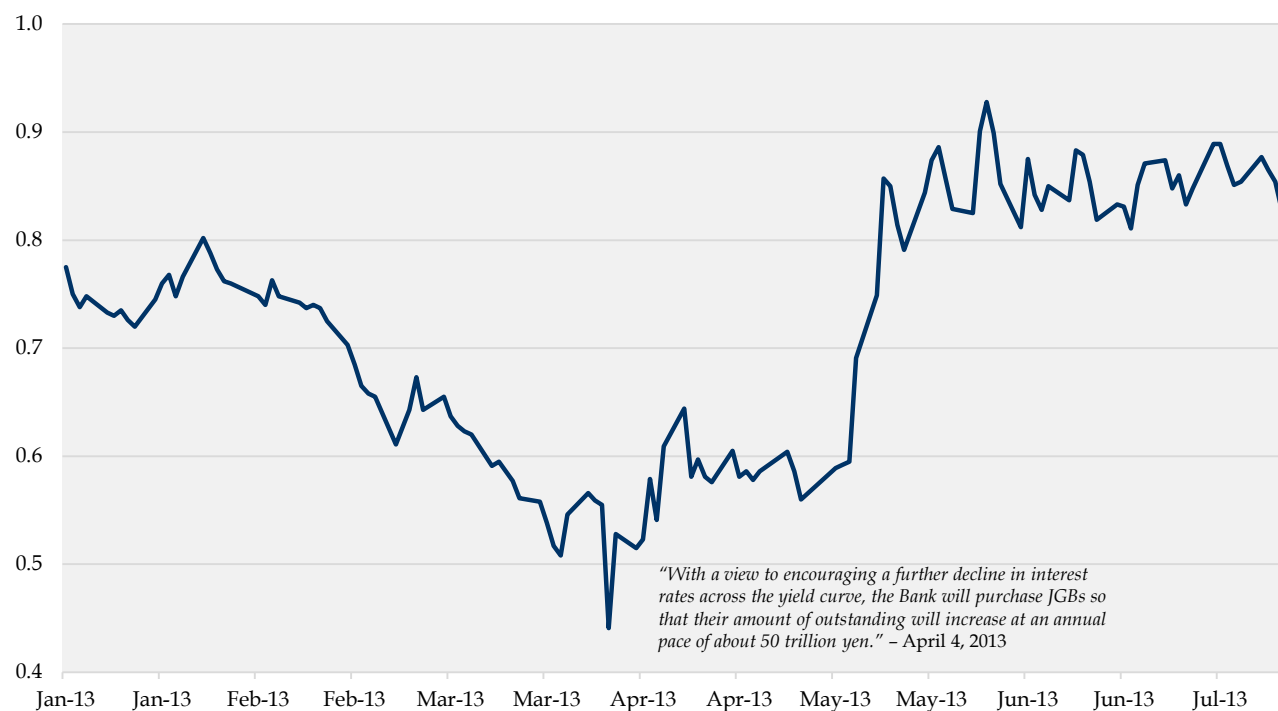


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Mangled communication on the part of the BOJ – first suggesting rates should fall, then claiming they should rise as growth prospects improved – confused market participants and amplified volatility...

In May, JGB yields spiked, following rapid declines after the BOJ's April meeting when it announced QQE. Increased volatility resulted in a VaR shock, which transmitted through the currency and equities markets, causing positions to be rapidly unwound. Rates have since settled down ...

10-Year JGB Yields



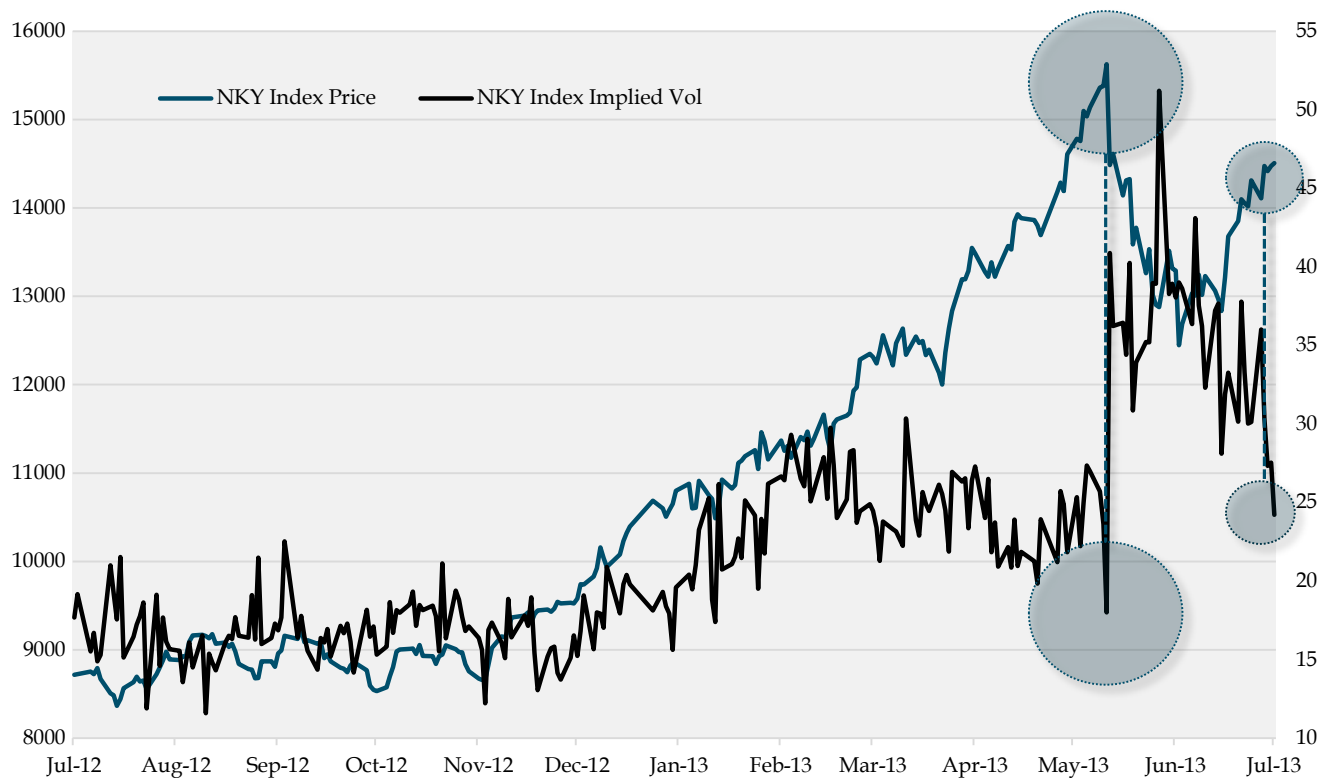
Source: Bloomberg; Bienville Capital Management, LLC



JAPAN'S IMPROVING PROSPECTS

As implied volatility spiked, long equity positions were rapidly unwound. Over the past few weeks, volatility has settled down a bit...

Nikkei Index vs. Nikkei Implied Volatility



Source: Bloomberg; Bienville Capital Management, LLC

For most of 2013, volatility had been steady as the NKY rose, resulting in exceptional risk-adjusted returns...

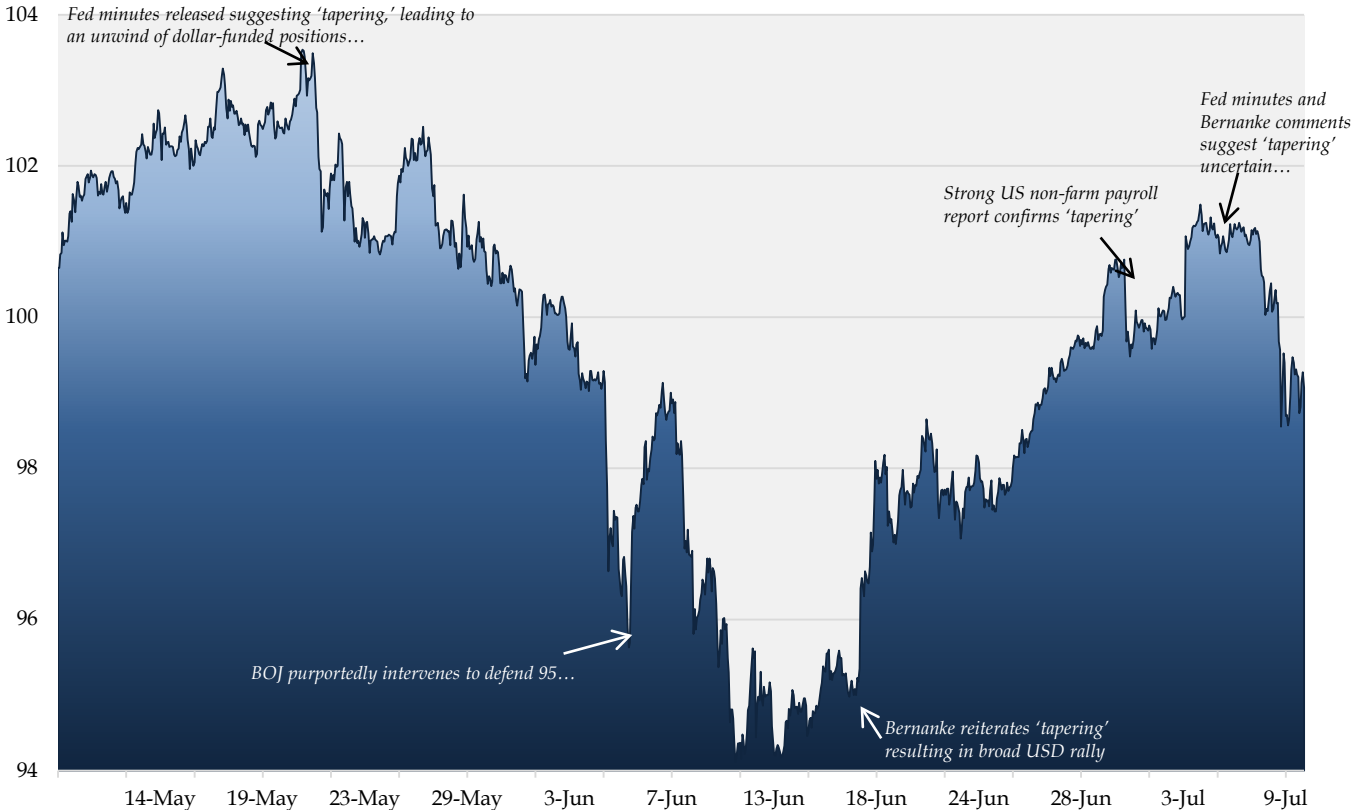
...but as volatility rose, forward-looking Sharpe ratios collapsed, leading to aggressive selling...



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The moves in the yen have also been correlated with the Federal Reserve's commentary on the 'tapering' of QE...

Japanese Yen Spot



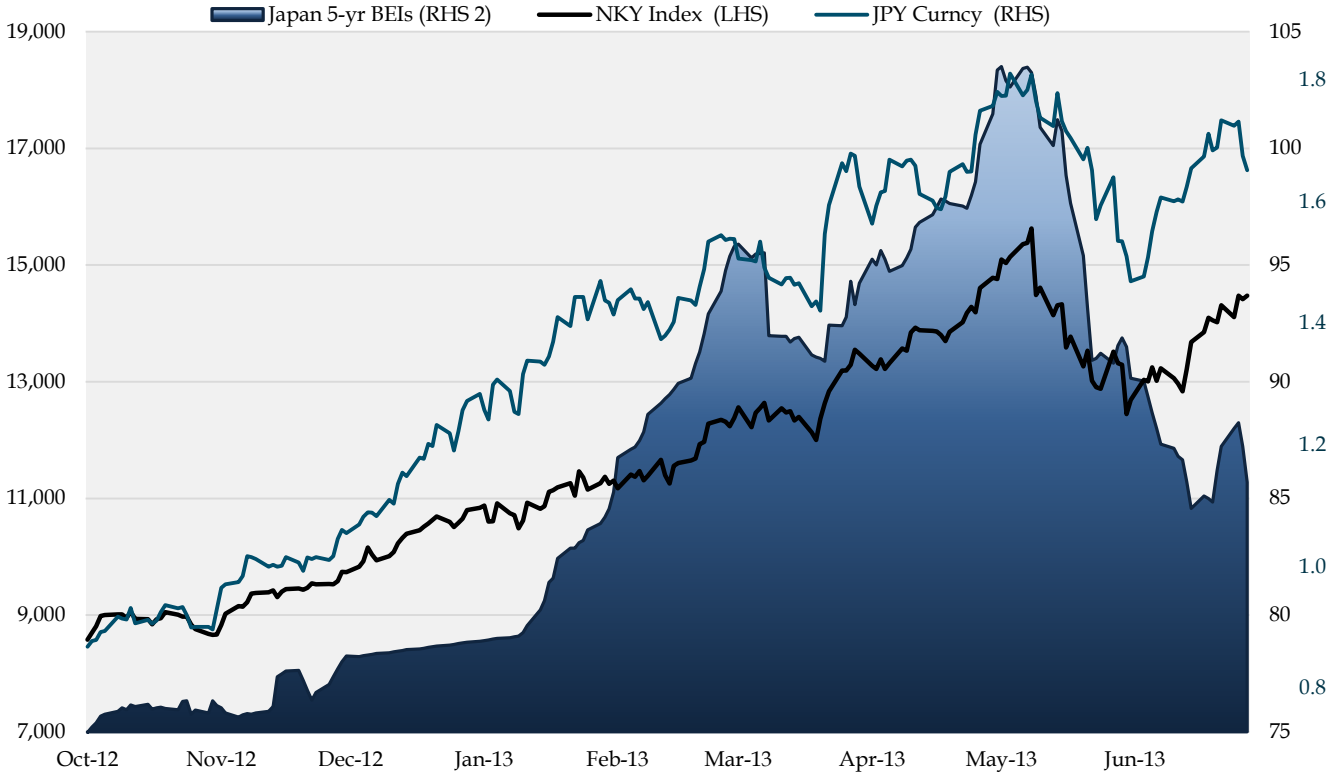
Source: Bloomberg; Bienville Capital Management, LLC



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There has also been a notable correlation between the Japan 5-year breakeven inflation rates, the Nikkei and the yen...

Japan 5 -Year Breakeven Inflation Expectations vs. JPY & Nikkei Index



Source: Bloomberg; Bienville Capital Management, LLC

As BEI rates fell in May, equities declined and the yen has strengthened...

A recent turnaround has once again coincided with a rally in the NKY and USD/JPY

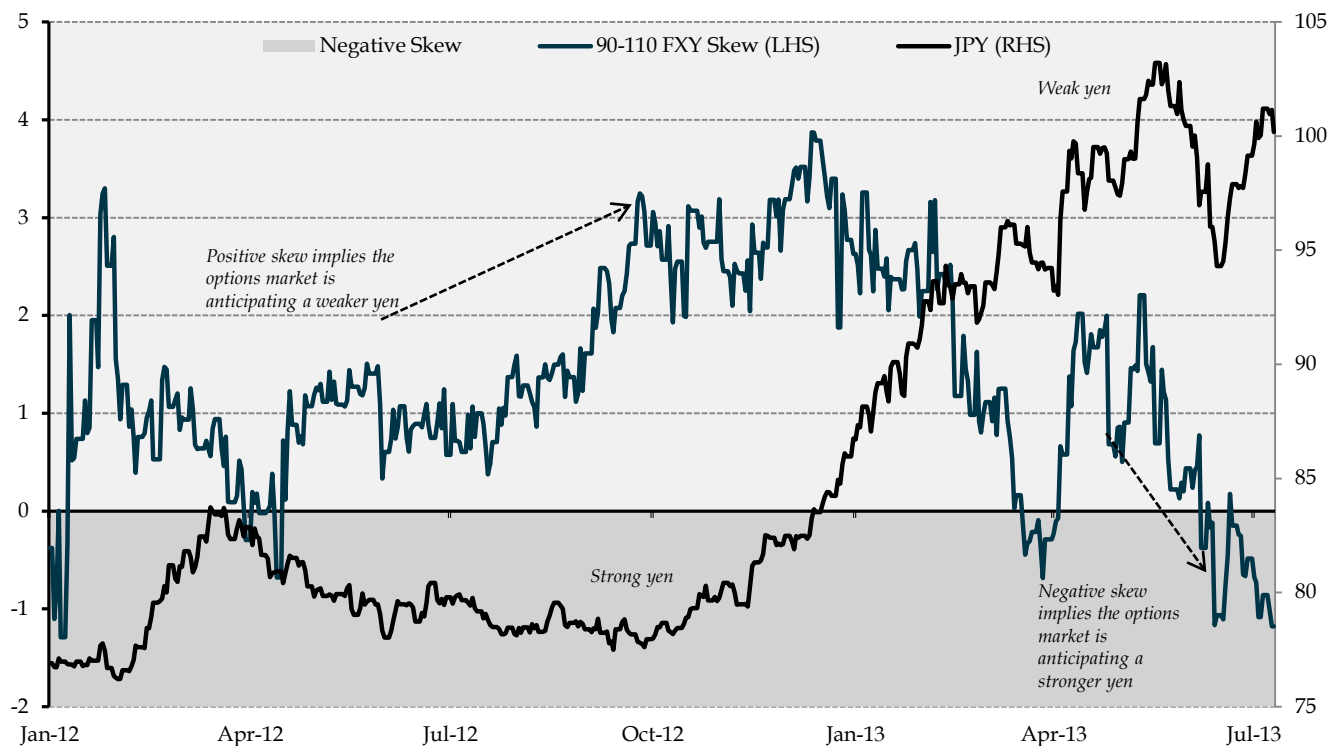


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Since May the skew in Japanese yen options has shifted. According to the options market, more participants are positioning for the yen to strengthen, setting up good entry points for shorting the yen...

Japanese Yen vs. Skew

We measure skew by the difference between the 90% put vol and the 110% call vol in the 3-month FX options...



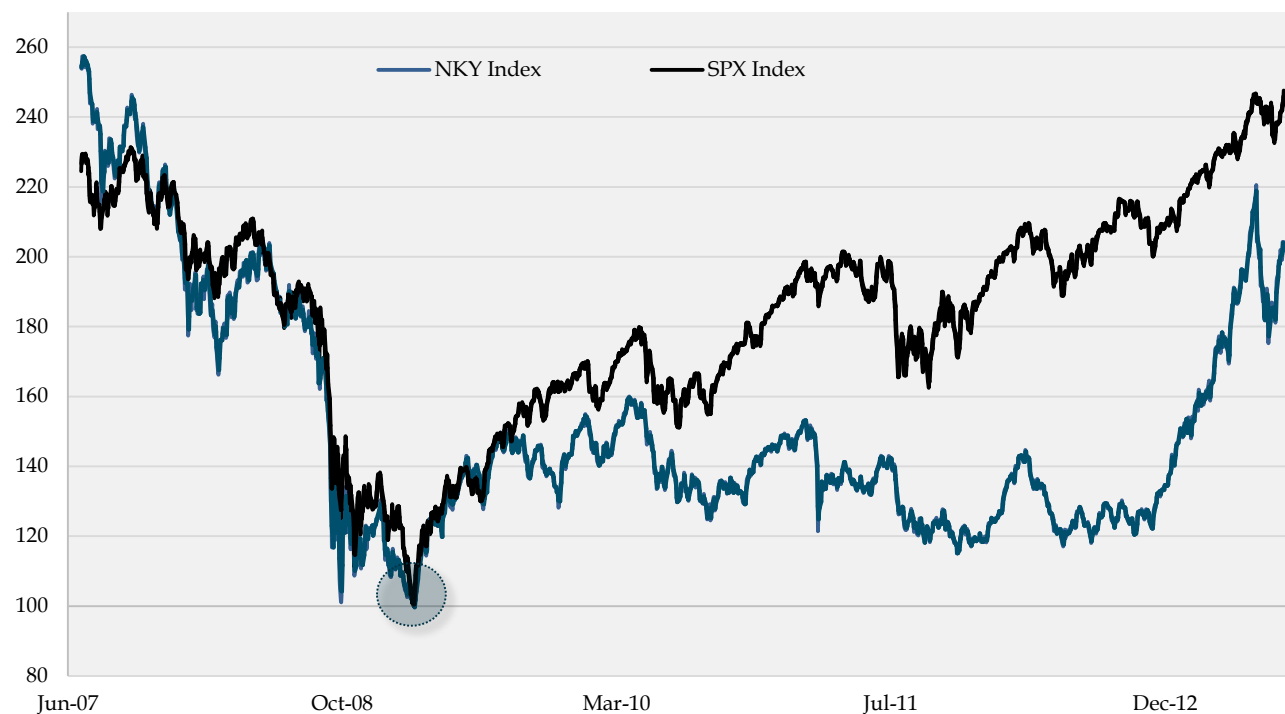
Source: Bloomberg; Bienville Capital Management, LLC



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Despite a powerful rally in the Nikkei, the rally still lags the recovery of the S&P 500, yet on a price-to-book basis, equities still remain cheap, earnings are accelerating aggressively, and policy in Japan is more stimulative...

NKY and SPX Bottom



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In the coming months, the full measure of Abe's 3rd arrow will be revealed...

'Arrow'	Goals	Status
1 - Monetary Policy	<ul style="list-style-type: none"> • Double the monetary base over the next two years. This program is roughly 1.7x the size of the US Federal Reserve's current policy on a GDP-weighted basis • The BoJ has extended the maturity of the Japanese Government Bonds it will buy from three years to seven years. This is expected to impact the broad money supply more than a shorter-term bond buying program because approximately 50% of the longer-dated JGBs are held by nonbank private sector investors, allowing for a more direct transfer of money to the economy • Additionally, the BoJ is directly purchasing equity ETFs and REITs in an attempt to lower the risk premia of asset prices 	✓
2 - Fiscal Policy	<ul style="list-style-type: none"> • Centered around a 10.3 trillion yen public works spending program. Abe expects this program will add 600,000 jobs to the economy and boost real GDP by 2% target 	✓
3 - Structural Economic Reform	<ul style="list-style-type: none"> • A loosening of government regulation, labor market reform and free-trade participation. Abe has already committed to talks with regional free trade partnerships (Trans-Pacific Partnership) and a deregulation of the utility industry • This requires significant legislative implementation via Japan's Upper House. As such, these reforms are not expected until after the July 21st Upper House elections 	?

Source: Bank of Japan; Bienville Capital Management, LLC



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