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Weekly commentary

Big in Japan?

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September 19, 2016

Key takeaways

- Investors were navigating calmer waters as market volatility slowed, after having to recalibrate to less aggressive monetary policy expectations over the previous weeks.
- Outcome of Bank of Japan's (BoJ) comprehensive policy stance review is uncertain, but additional easing measures should be on the agenda.
- Probabilities for foreign bond purchases and "helicopter money" are low.

Full commentary

Investors were navigating calmer waters as market volatility slowed, after having to recalibrate to less aggressive monetary policy expectations over the previous weeks. In Europe, the European Central Bank's (ECB) openness to modifying their asset purchasing program moved more into the spotlight and the Bank of England (BoE), while leaving their policy tools untouched, delivered a dovish tilt in their communication.

Most importantly, markets pared back expectations for a U.S. rate hike on September 21. The tone of the final Federal Reserve speakers were generally dovish, and the highly anticipated remarks from Board Governor, Lael Brainard, closed with a focus on the downside risks to the economic outlook and risk management considerations. Moreover, U.S. economic data received last week further confirmed that economic momentum slowed in August. While Consumer Price Index (CPI) numbers printed modestly above market expectations, both retail sales and industrial production both dropped, adding to the set of weaker leading indicators, such as the Institute for Supply Management (ISM) surveys. With overall tighter financial conditions and the fact that a Federal Reserve rate hike has never materialized when market pricing is as subdued as today, markets attach a probability of less than 20% to a rate increase this week. This should put the final nail in the coffin for all rate hike speculations.

All of this leaves the Bank of Japan (BoJ) meeting ending on September 21, as the elephant in the room, questioning whether Governor Haruhiko Kuroda goes "big" again. With the inflation target apparently receding from reach, the BoJ announced in July that it would embark on a "comprehensive review" of its three-dimensional policy approach of quantitative and qualitative easing (QQE) with a negative interest rate. Analysts expect a wide range of potential outcomes - including the possibility that the BoJ effectively admits defeat and scales back its aggressive QQE program - given negative side effects of the current policy setting, such as reduced profitability of banks and a decline in investment returns for pension funds and insurance companies. These speculations have markedly contributed to the growing fears of the death of easy money and, hence, helped to drive the steepening of yield curves across the globe. Term premia have expanded, albeit from record lows, and buying of foreign bonds from Japanese investors has slowed markedly; especially in the U.S. and Australia, where bid-to-cover-ratios in government bond auctions have dropped to the lowest level since 1985.

Nevertheless, while uncertainty is admittedly elevated, a combination of policy measures designed to sharpen monetary accommodation and bolster BoJ credibility is most likely, in our view. Various speakers and press articles stressed the importance of achieving the 2% inflation target at the earliest possible time, and it was emphasized that benefits of the currently employed policy tools, including negative rates, outweigh the costs. Furthermore, the decline in interest rates has helped not only the government but also the private sector. Corporations with capital market access have enjoyed all-time low yields and new corporate bond issuance has jumped this year with a notable increase in long maturities. Lower bond yields have also filtered through to falling rates on bank loans, with both the average prime lending rate and fixed-rate mortgage rates dropping to all-time lows. With weak economic activity, ongoing declines in all inflation measures and inflation expectations further support the case for easier monetary policy from the macroeconomic side; additional easing measures and a dovish signal should be on the agenda in Japan this week.

This week's market developments

Monday, September 12

- Japan Machine Tool Orders growth (prelim estimate) decreased to -8.4% for August

Tuesday, September 13

- UK CPI growth increased to 0.3% m.o.m. (s.a.) for August
- UK Core CPI growth remained at 1.3% m.o.m. (s.a.) for August
- UK PPI Output growth decreased to 0.1% m.o.m. for August

Wednesday, September 14

- Eurozone Industrial Production growth decreased to -1.1% m.o.m. (s.a.) for July

Thursday, September 15

- Eurozone CPI growth increased to 0.1% m.o.m. (s.a.) for August
- US Retail Sales Advance growth decreased to -0.3% m.o.m. (s.a.) for August
- US PPI Final Demand growth increased to 0.0% m.o.m. (s.a.) for August
- US Industrial Production growth decreased to -0.4% m.o.m. (s.a.) for August

Friday, September 16

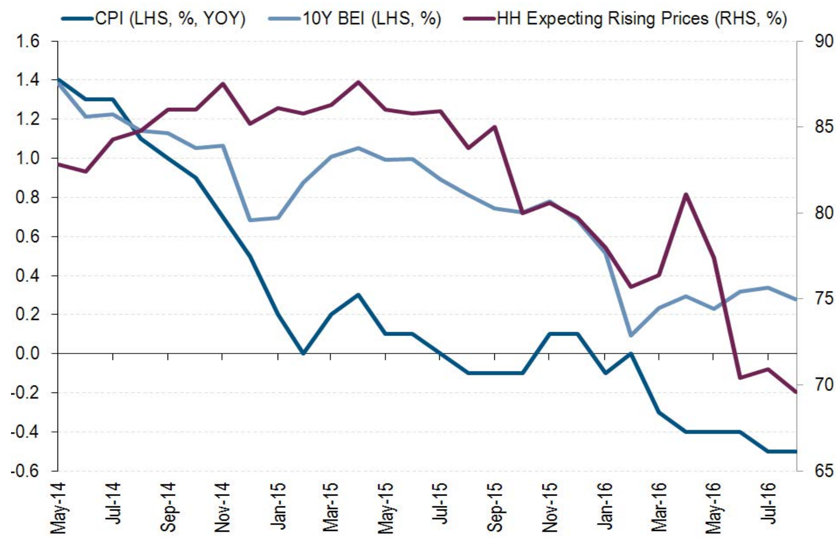
- US CPI growth increased to 0.2% m.o.m. (s.a.) for August

Source: Bloomberg, as of September 19 2016

At the same time, the probabilities for the announcement of both foreign bond purchases and "helicopter money" should be rather low for the time being, as Governor Kuroda is a notable proponent of fiscal consolidation and legal challenges are significant. Therefore, changes in Japan's monetary policy this week might not be "big". Dovish policy momentum should pick up, potentially through lower interest rates and effective policy enhancements; such as a more explicit forward guidance for the BoJ's balance sheet or the loan support program allowing financial institutions to borrow at negative interest rates.

Chart of the week

Inflation and Inflation Expectations Are Falling in Japan



Source: Bloomberg, as of September 19, 2016

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on December 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.50 %	September 21, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.21 %	October 20, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.01 %	September 21, 2016
BoE	-25 basis points	August 4, 2016	0.25 %	0.31 %	November 3, 2016

Source: Bloomberg, as of September 19, 2016

Next week's market developments

Tuesday, September 20

- US Housing Starts are expected to decrease to 1,119,000 (s.a.a.r.) for August
- US Building Permits are expected to increase to 1,165,000 (s.a.a.r.) for August

Thursday, September 22

- US Existing Home Sales are expected to increase to 5,450,000 (s.a.a.r.) for August
- US Leading Index growth is expected to decrease to 0.0% m.o.m. for August

Friday, September 23

- Japan All Industry Activity Index growth is expected to decrease to 0.2% m.o.m. for July
- Eurozone Markit Manufacturing PMI Index (prelim estimate) is expected to decrease to 51.5 for September
- Eurozone Markit Services PMI Index (prelim estimate) is expected to remain at 52.8 for September
- US Markit Manufacturing PMI Index (prelim estimate) is expected to remain at 52.0 for September

Source: Bloomberg, as of September 19, 2016