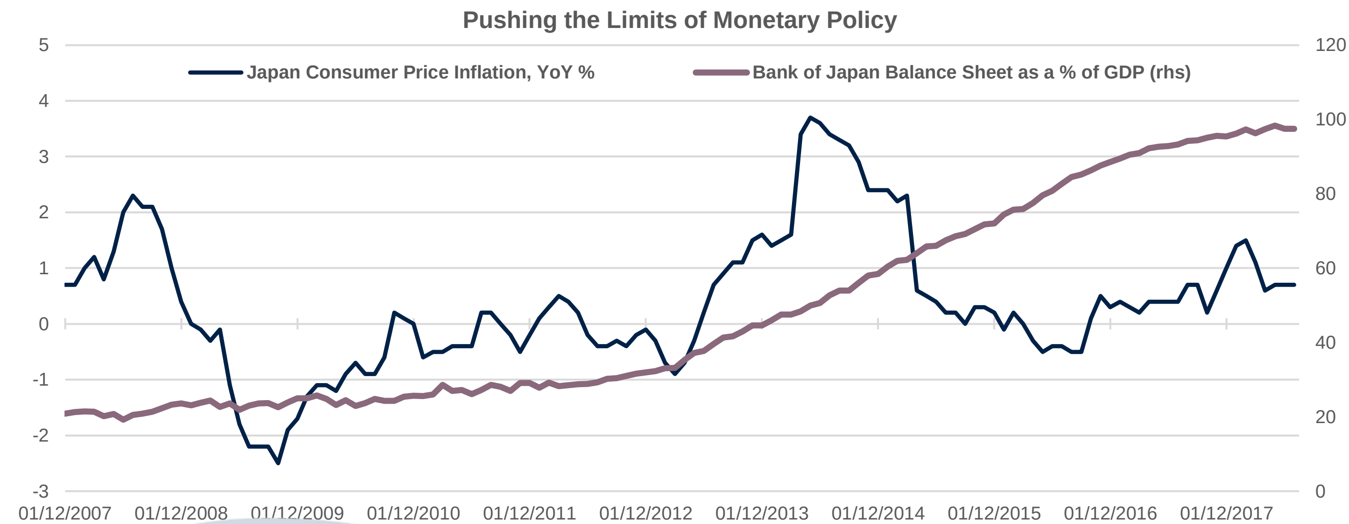
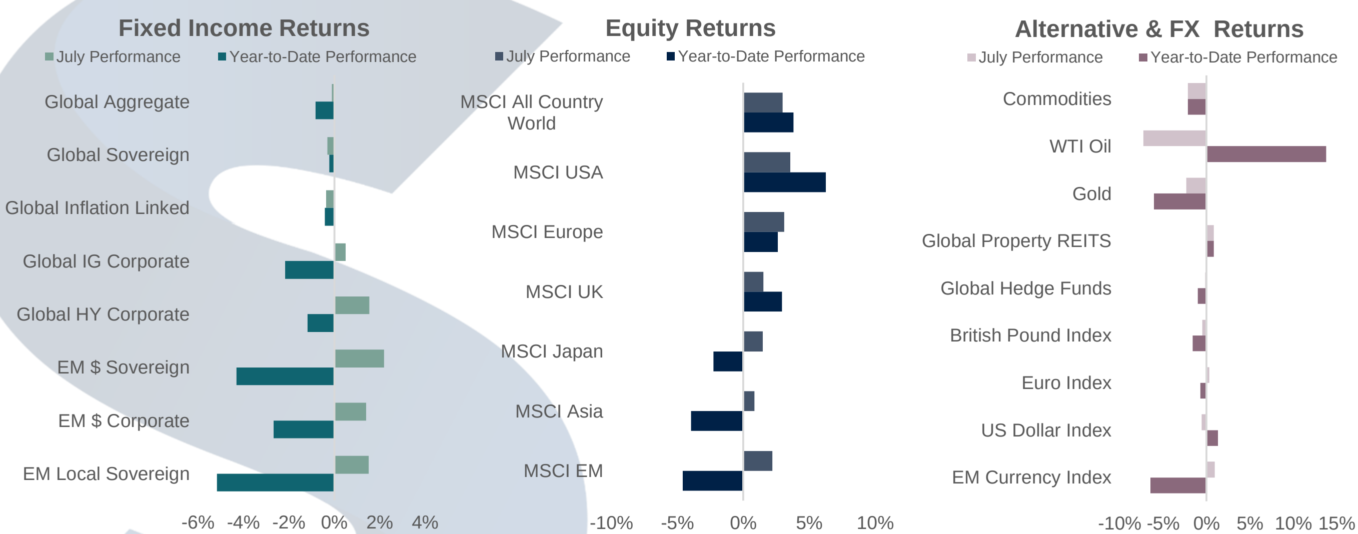
The Curious Case of the Bank of Japan

Open any classic economics text book and under the monetary policy section you will find a seemingly straight forward explanation as to how central banks use interest rates as a tool for controlling the behavioural dynamics of their economies and thus the direction of residing consumer price inflation (CPI). When inflation runs too hot, central banks turn 'hawkish' by hiking rates to encourage consumers to spend less and save more, causing the price of consumer goods and services to fall, and vice versa when inflation levels run too low and central banks turn 'dovish' by cutting rates.

Unfortunately for the Bank of Japan, it has had to tear up its economics text book a long time ago. It is has been battling with an economy flirting with deflation (negative inflation) for decades, with an average annual inflation level of just 0.1% since the mid-nineties. This forced it to reject traditional monetary policy tools and conduct the first ever quantitative easing (QE) operations of the modern era in March 2001. The situation got worse in 2009 when the global financial crisis pushed Japanese CPI down to an all-time low of -2.5%, prompting the central bank to dramatically change its approach to QE by significantly increasing the size of its asset purchases to depreciate the Japanese Yen and import higher inflation into the domestic economy. Its balance sheet is now roughly equal to the size of Japan's gross domestic product (98% of GDP), and its Governor, Haruhiko Kuroda, is languishing at adopting multiple non-traditional policies such as negative interest rates, equity and real estate ETF purchases, yield curve control, and forward guidance to further stimulate consumer price inflation.



Source: Bloomberg



Global Agg: Bloomberg Global Aggregate TR Hedged GBP; Global Sovereign: Bloomberg Global Treasury TR Hedged GBP; Global IL: Bloomberg World Govt Inflation Linked Bonds 1-10Y TR Hedged GBP; Global IG: Bloomberg Global Corporate TR Hedged GBP; Global HY: Bloomberg Global High Yield TR Hedged GBP; EM$ Sov: Bloomberg Emerging Markets Sovereigns TR Hedged GBP; EM$ Corp: Bloomberg EM USD Corporate 10% Cap Hedged GBP; EM Local Sov: Bloomberg EM Local Currency Govt TR Unhedged USD; Equities: MSCI indices reflect net total returns in local currency, except Asia and EM in USD; Commodities: Bloomberg Commodity TR Index; Global Property REITS: FTSE EPRA/NAREIT Global Index; Global Hedge Fund: HFRX Global Hedge Fund Index; British Pound: Bloomberg British Pound Index; Euro: Bloomberg Euro Index; US Dollar: Bloomberg US Dollar Index; EM Currency: JP Morgan Emerging Market Currency Index. Source: Bloomberg. **Data as at 31/07/2018.**

Fixed Income

- Global sovereign bonds posted a slightly negative performance in July as the US Federal reserve kept policy unchanged but issued a more hawkish statement that might point to more monetary policy tightening than has been priced in by the market. The Bank of England raised their policy rate to 0.75%, the highest in 10 years.
- Global investment grade and high yield credit both posted positive results this month on the back of strong corporate earnings results and strong technical forces, namely low issuance.
- Emerging market debt has staged a modest recovery, barring certain idiosyncratic developments in Turkey and on the back of a relatively calm US dollar in July.

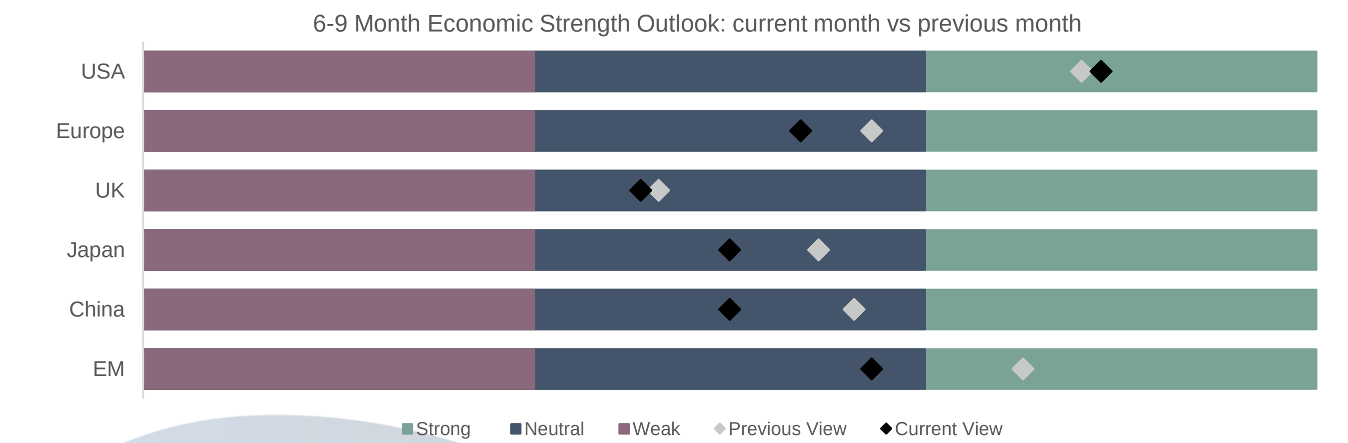
Equities

- US equities recorded the highest returns in July, powered by strong corporate results and excellent economic data.
- European equities also performed well, as political risk abated somewhat and trade war concerns eased.
- UK and Japanese bourses posted modest positive returns, with an uncertain economic backdrop affecting both.
- Asian markets fared worst, with concerns surrounding trade and Chinese equity performance occupying investors.

Alternatives & FX

- Commodities fell as the price of industrial metals suffered from continued China-US trade tensions and oil weakened on a potential reversal of Iran sanctions.
- EM currencies rebounded, most noticeably in Latin America, where concerns over a NAFTA agreement eased, sending the Mexican Peso sharply higher.

Signia Macroeconomic Outlook



Source: Signia Wealth. **Data as at 31/07/2018**

- **USA**: Tailwinds from tax cuts, expansionary fiscal policy and regulatory easing are supporting consumer and business sentiment and this has extended the second longest US economic expansion in history (110 months), now in the latter stages of its cycle but still running strong. Rising trade war tensions with key trading partners is a notable risk but poses no immediate economic threat.

- **Europe**: Economic and earnings recoveries are earlier in their cycles but have lost momentum recently from several key headwinds: a less accommodative ECB, rising concerns of a trade war with the USA, and populist uprisings across the continent. Economic indicators continue to disappoint, whilst inflation, wage growth and consumer sentiment remain buoyant. A potential Italian budget standoff with the EU is a risk.

- **UK**: Positive real wage growth is being stimulated by stabilising consumer price inflation around the Bank of England's 2% target as interest rates were hiked to 0.75% in August, the highest since February 2009. However, corporate profit growth is declining and risks remain to the downside as existential Brexit uncertainty with the European Union continues to weigh on corporate sentiment and business investment.

- **Japan**: The policy mix in Japan is changing. Fiscal stimulus is increasing to help the Bank of Japan in its monetary fight against structurally low consumer price inflation, which continues to defy rising wages and a tight labour market. Prime Minister Abe's ratings have suffered considerably by a prolonged political scandal but has stabilised recently ahead of elections in September.

- **China**: Curbing pollution levels is an environmental positive but comes at an economic cost by slowing industrial output growth at a time when the corporate sector is deleveraging and economic growth is slowing. The People's Bank of China is trying to balance stimulating the economy to counter slowing credit growth and an escalating bilateral trade war with the USA, with curbing high and rising property prices.

- **Emerging Markets**: Robust but patchy economic growth is being tested by the strengthening resolve of the US and its resilient Dollar pressurising the Trump administration targets – China (trade war), Turkey (political war), and Russia (cold war). Buoyant commodity prices and continued above-trend global economic growth remain a notable fillip to the broader EM complex.

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