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THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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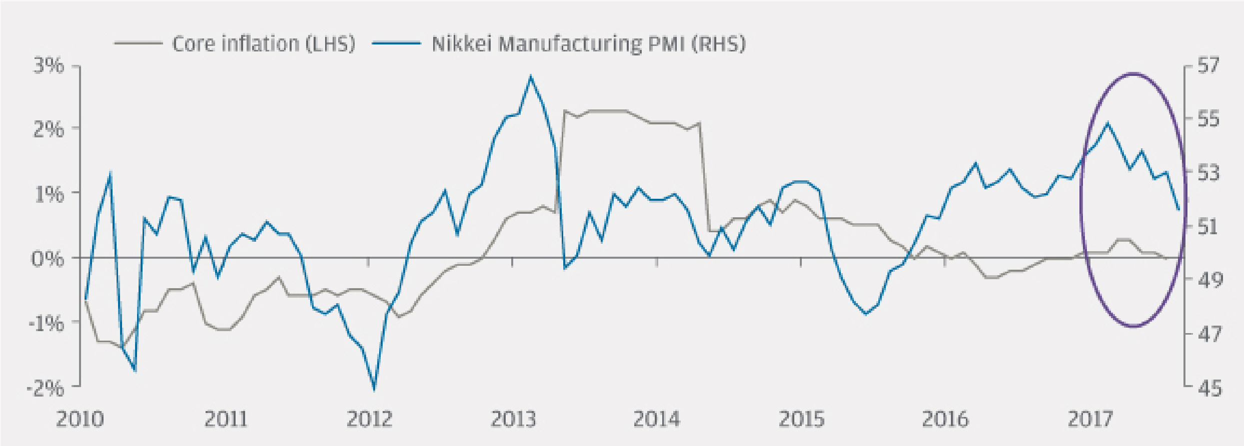
A domino of fiscal policy?

Global growth is showing signs of strength and wage growth is slowly feeding through to inflation. However, it's a very different picture in Japan. What impact could Japan's stagnation have on monetary and fiscal policy?

Fundamentals:

Inflationary pressure remains very muted in Japan, with the June print of 0.0% year on year (excluding food and energy) signalling downward momentum. Economic activity indicators paint a similarly bleak picture, as the Nikkei Manufacturing purchasing managers' index disappointed at 51.6 in July, well off the peak earlier this year of 54.8. And yet, the Bank of Japan has been enacting extremely accommodative policy—anchoring 10-year government bond yields at 0% and conducting a sizeable bond purchase programme—in an attempt to stimulate the economy. These measures do not appear to be having the desired effect. With Japanese banks in particular suffering from the negative interest rate environment, could Japan be about to change tack and look to fiscal policy to revive its economy? Several other countries, including the United States, the United Kingdom, China and Italy, have recently enacted or proposed fiscal stimulus measures (albeit with varying justifications for doing so) and it is possible that Japan could be the next domino to fall.

Inflation and economic activity in Japan are both trending downward, despite loose monetary policy



Source: Bloomberg; data as of 25 July 2018. PMI: Purchasing managers' index.

Quantitative valuations:

Headlines regarding a potential shift in the Bank of Japan's monetary policy have led to a meaningful repricing of core government bond yields over the past several days. 10-year Japanese government bond yields, which have been in a very tight range of 0.03% to 0.06% since March, broke higher by 4 basis points (bps) to 0.09% (on the week to 24 July). Global bond yields have proven highly correlated, with 10-year US Treasury yields rising 9 bps to 2.95%, and 10-year German Bund yields rising 5 bps to 0.40%, over the same period. The ultimate actions by the Bank of Japan could have meaningful implications for core rates, so it will be key to watch if it tightens policy by raising rates, and to assess any messaging that accompanies its decision.

Technicals:

If fiscal policy begins to pick up the slack in an effort to revive the Japanese economy, it will need to be funded somehow. With a debt-to-GDP level that is already one of the highest across developed markets, at more than 200%, it could be a challenge for Japan to issue more debt as a way to fund meaningful fiscal stimulus. A change in the Bank of Japan's monetary policy may also have a notable impact on flows: if the central bank adjusts the 10-year part of the curve, higher yields may entice Japanese investors back to their domestic market and cause a repatriation of assets currently invested overseas. But, if the front-end of the curve is targeted, the hedging cost from US dollars to Japanese yen will be reduced, thereby making US assets increasingly attractive for Japanese investors.

What does this mean for fixed income investors?

The Bank of Japan currently faces a conundrum: how does it raise rates out of negative territory when inflation is falling? One potential solution could be if the government takes the reins and implements fiscal spending to offset higher rates. And if Japan is the next domino in the fiscal spending camp, will others follow? We do not expect the Bank of Japan to raise rates at its meeting on 30-31 July, as its mandate is to act in the interest of the entire economy, not just on behalf of the banks. However, it is likely that it will commission a study to assess the costs and benefits of any changes to its monetary policy, with the potential for future adjustments. Watch closely for a signal on the future direction of core rates.

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