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The Japanese debt market: "Until the music stops"

Alex Fusté
Chief Economist
alex.fuste@andbank.com

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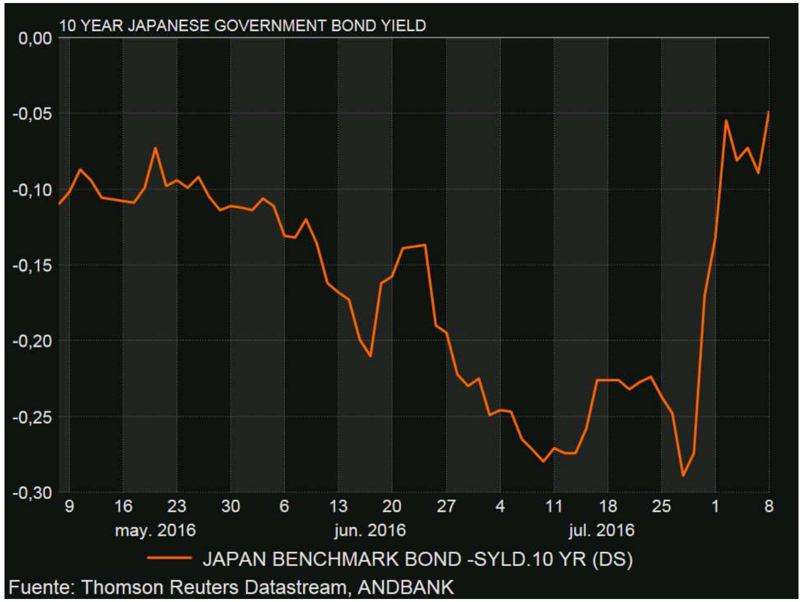
Japanese institutions are facing a twofold dilemma

1. **The JGB market free float is fast diminishing:** If the BoJ is to hit its target of expanding the monetary base it will actually need to buy some ¥120trn in JGB over fiscal 2016. With the Ministry of Finance aiming to issue just ¥34trn of bonds, it is a mathematical certainty that the JGB free float will fast diminish even further. This will force Japanese institutions to look elsewhere for assets and weighing on yields around the world. One proof of that is the big activity of Japanese investors during the first week of July, when they bought ¥2.5trn of foreign bonds (some US$24bn). This is more than they have ever purchased before in a single week, and greater than their total purchases for the entire month of June. At its current rate of buying, the BoJ will own half the entire market by the end of 2016. In six years, the JGB market will vanish entirely (Gavekal projections). Knowing this, it does not come as a surprise the announcement of Bank of Tokyo Mitsubishi (Japan’s largest bank) saying that from now on it will no longer participate in the JGB as a primary dealer).

2. **Foreigners still like to play the “BoJ trade”:** With the BoJ consistently on the bid, foreign investors have increased their exposure to the JGBs (foreigners now own 50% of the JGB market’s free float –Neil Newman & Tom Holland-). Thus, “BoJ trade” has become increasingly crowded even as the tradable pool of JGBs has shrunk in size. The Japan Center for Economic Research reported that there was only some ¥140trn (some US$1.3trn) left available for purchase from domestic institutions (or barely a 10% of the nominal outstanding). Another incentive for domestic Japanese institutions to look elsewhere for assets.

The cracks begin to appear

1. The yield on 10-year JGBs leapt 28bp in just five trading days while the Japanese government was rolling out its latest stimulus package. The spike in yields brought back painful memories of a similar surge in May 2013, and emphasizes how severely four years of QE have damaged the JGB market. "We fear that the current spasm seen in the Japanese debt market looks uncomfortably like the beginning of the JGBs death throes" *(Weiman and Holland).*



2. Disruption in the corporate curve: As traders attempt to second guess which bonds the BoJ will buy next (using its formula of maturities), short dated yields have risen and the corporate curve has inverted.

This situation is clearly unsustainable. the BoJ badly needs an exit route. There are only three possible endgames

I. **Endgame 1: At some point in time the BoJ stops buying JGBs.** Presumably when the balance of JGBs available for purchase from domestic institutions has shrink considerably and there are no real investors in the market. With no BoJ on the bid, and no more real investors in the market, the JGB market will simply crash. The least disruptive option would be for the BoJ to prepare the market for what, at some point, will be a gradual attempt to taper its JGB purchases in the open market. In that case, the JGB may not crash entirely. But much like the US treasury market in 2013, it will sell off until yields are high enough to tempt real investors to return.

II. **Endgame 2: The BoJ keeps buying until the JGB market no longer exists. (A continued QE).** If this road is taken, domestic pension funds and institutions will no longer be able to invest in Japan's sovereign debt and will have to invest in equities, corporate bonds or foreign sovereign in local currency. The problem with this path is that following successive scandals at Olympus, Toshiba, Sharp, IHI, etc. the corporate bonds and the equity market in Japan are seen as carrying unacceptable management risks. Meanwhile, the club of AAA-rated global sovereigns is shrinking fast (with the UK the latest to be ejected and Australia possibly the next). In short, Japanese pensions will have to rely on low-rated foreign bonds and take on more risks. While this could certainly led to a tremendous rally in the global market for EM debt, this will lead to a never seen level of risk misallocation.

… there are only three possible endgames

III. **Endgame 3: Helicopter Money.** Proven that the QE does not grant an increase in the national level of spending, the idea would be for the Government to issue a big size zero coupon perpetual JGB to the BoJ. While drastic, this is the measure advocated by the proponents of the "helicopter money" thesis. With the proceeds, the government could erase half the government's outstanding debt and start a new cycle of fiscal stimulus (tax cuts, infrastructure investment, or directly send bank checks to its citizens). This is considered "Helicopter Money" since the borrowed money can never be repaid. Unlike simple QE (which relies on the private sector to play its part trough a rise in consumption after being ousted from markets –a sequence that is not taking place currently-) the "helicopter money" is aimed at guaranteeing a rise in total spending.

What would be the implications of using helicopter money?

1. This strategy involves the same consequences as the ones detailed in the endgame 2 "Continued QE", but much faster. This is, an accelerated disappearance of the free float in the JGB market, with pension funds and financial institutions no longer being able to invest in JGBs, giving place to an unprecedented misallocation of risk.

2. This would definitely put Japanese policymakers in a point of no return, where the choice at any market seatback will be to constantly double down on its bet (or simply stop providing stimulus and wait for the fate to wash over them).

With no exit route in sight, the endgames that I would bet for are "Endgame 2" or "Endgame 3". Why?

1. So far, the reflationary aims of "Abenomics" have failed, however, Japan has been toying with the Einstein's definition for "insanity" by doing the same thing over and over again hoping for different results. So long as officials believe that they still have options, even if that involves undertaking monetary actions not tried in the modern era of fiat money, the calculus would continue being tilted to "doing something". This is, either continuing with the QQE program until the JGB no longer exists (endgame 2), or make the conversion and embark in the "helicopter money" (endgame 3).

2. To maintain the show of independence, the BoJ has never directly acknowledged government fiscal policy. By talking now of "highly accommodative financial conditions to deliver **synergy**", the BoJ governor has signaled a new era of cooperation between government and central bank, with the likely coordination of public bond issues and BoJ purchases. Some consider this as a "de facto" step towards helicopter money.

3. Monthly turnover in this market has collapsed as domestic institutions have retreated from the market (as QE has swallowed a big chunk of the JGB's tradable float and questions are arising about the validity of price discovery). The current spasm seen in the Japanese debt market looks uncomfortably like the beginning of the JGBs death throes. The beginning of the JGB market's protracted death agony.

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