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Japan. Just small changes in policy settings. Our view on financial assets

The BoJ is paving the way for a change in policy but there is little reason for equity investors to worry. Kuroda has been talking on a daily basis about the "reversal rate", the point at which monetary easing does more harm than good. Our local sources suggest that with his words, Kuroda is hinting to dial-back its ultra-accommodative stance. Just recall how in 2016 the BoJ abandoned its QE target in favor of a bond yield target which pegs the 10Y JGB yield at zero ("The most appropriate shape of the yield curve can not be achieved by fixing the amount of QE" Kuroda, October 2016).

Now the BoJ seems to consider that a more appropriate shape of the yield curve is a steeper one than at present. That might seem surprising, considering that core inflation is just at 0.83% (far form the BoJ's target of allowing inflation to exceed 2% for a considerable period) but with corporate profitability at record levels (courtesy of Mr. Kuroda) and the labor market tight this new approach may have sense.

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Against this backdrop, it seems that the BoJ is focusing now more on the damage that negative rates do to the financial sector. In other words, we could have reached that "reversal rate". Thus, it seems now that the BoJ is paving the way for a small change in policy to relieve the pressures on earnings of Japanese banks. Do not worry; there is little reason to fear a BoJ retreat from its exceptionally loose monetary settings. The change seems to be aimed at targeting the 5year JGB yield at zero, and allowing longer-dated yields to rise somewhat.

Potential effects following the BoJ's small changes in policy settings.

Well, any such change in policy tack is likely to be negative for bonds and supportive for the Yen. The question is whether this could damage Japanese equities.

Indeed, for the last 12 years, the Yen strength has been negative for Japanese equities; however, over the last six months this tight inverse correlation has broken down, with equities continuing to

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make gains even as the Yen has edged higher (we all know the role the BoJ has performed here). We have reasons to believe that this may continue being the case:

1. There is little reason for equity investors to worry about the prospect of a BoJ retreat.
2. The run up in Japanese stocks has been driven by domestic players, with foreign investors being largely absent.
3. The Yen remain deeply undervalued (according to general opinion), thus, it does not necessarily follow that a rise in the Yen must severely erode the market share of Japanese exporters.
4. A stronger Yen lifts the purchasing power of Japanese consumers, as it cuts the cost of imported inputs.
5. Corporate profits remain high, courtesy of Kuroda's impetus to lower the funding costs of corporations.
6. Steeper yield curve (apparently the new approach of the monetary policy), will boost profitability in the unloved financial sector.

We advocate holding Japanese equities in our portfolios.

The upshot is that in accordance with what has been exposed so far, we advocate holding Japanese equities in our portfolios. Leaving the JPY unhedged in anticipation of currency gains.

Our view on Japanese financial markets remains as follows:

- Bonds – Govies: NEGATIVE
- Forex – USDJPY: NEUTRAL/POSITIVE
- Equities – Nikkei 225: NEUTRAL/POSITIVE

Best regards from Uruguay. The Latin American country better placed in democratic quality, lack of corruption, size of the middle class, prosperity and security.

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