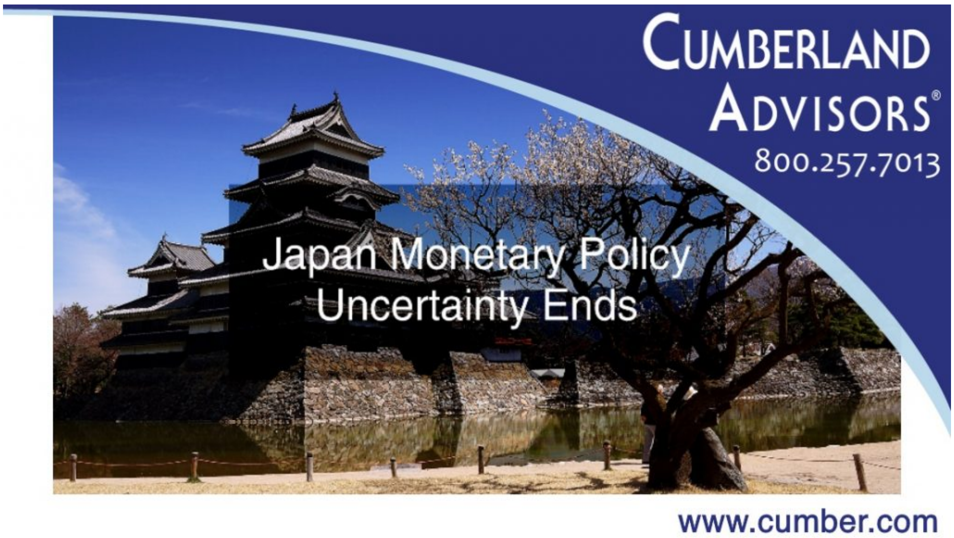
Japan Monetary Policy Uncertainty Ends

Yesterday the Bank of Japan (BOJ) announced in a report "Strengthening the Framework for Continuous Powerful Monetary Easing" that its extraordinary policies will be maintained for an "extended period of time".



During the past week, rumors and speculation about possible monetary policy changes at this week's BOJ meeting caused great uncertainty in Japan's fixed-income market. Much of the confusion related to the BOJ's yield curve control (YCC) policy, with commentators suggesting that greater flexibility may be allowed in the 10-year peg at 0.00%. On Friday, when some traders challenged the 0.100% upper limit of the peg, the BOJ was successful in defending it. The yield on the benchmark 10-year Japan government bond (JGB) closed at 0.095%. The BOJ purchased 94 billion yen of JGBs Friday, only the second time it has had to actually purchase bands in support of its YCC policy. Yesterday it returned to the market to again defend the 10-year peg.

Speculation about modifying the 10-year yield target related to a concern about the adverse effects of negative interest rates on bank profits. The BOJ announced several modest steps that address this issue, while making the current yield control policy more sustainable. The 10-year peg remains at 0.00% but the former +/- 10 bp upper and lower limits have been doubled to +/-20 bp. Also, a smaller part of bank deposits at the BOJ will be subject to a negative rate.

As was widely anticipated, the BOJ also changed the balance in its US$54-billion ETF purchasing program. It has been buying ETFs that are heavily weighted with stocks listed in the Nikkei Index. As a result, the BOJ's positions in some of those stocks are very high. In the future the BOJ will be shifting more of its ETF purchases to ETFs focused on stocks listed in the TOPIX Index.

The BOJ therefore, has made it clear that it is not gradually ending its highly accommodative monetary policies, in contrast to the forward guidance statements of the U.S. Federal Reserve Board and the European Central Bank. The yen eased to its lowest level since July 20.

The concerns in recent months about the future of Prime Minister Shinzo Abe and his "Abenomics" policies have lessened. Abe now appears to have the necessary support to secure a third term in the September leadership election of his party, the LDP, with the opposition parties too weak to offer a serious challenge. The broad outline of current economic policies is expected to remain on course.

The Japanese economy's performance remains solid, but there have been some indications that momentum is slowing. The BOJ has reduced its inflation forecasts, projecting inflation in 2020 will be at 1.6%, still well below the 2.0% target. The Japan Purchasing Managers' Index for manufacturing fell from 53.0 in June to a 20-month low of 51.6 in July, probably reflecting in part the effects of heavy rains and flooding. Slowing demand is seen as worrying. Japanese export demand was reported to have deteriorated despite yen depreciation and continued robust global growth. Future export performance depends very much on US-Japan and also US-China trade negotiations.

Japanese equities have held up relatively well despite the negative trends affecting global equity markets other than that of the US thus far this year. While the benchmark iShares MSCI ACWI EX US ETF, ACWX, is down 2.86% year-to-date, the iShares MSCI Japan ETF, EWJ, is down just -1.59%. We are maintaining our Japanese positions in our International and Global Portfolios while monitoring closely developments on the trade front.

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Sources: Markit Economics, *Financial Times,* Barclays Research, CNBC.com, Jeff Uscher's *Japan Insider,* bbh.com

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Japan's Domestic Political Turmoil versus Stocks

So far this year, the US equity market has not been affected significantly by the high level of domestic political discord. The volatility we have seen in US equities appears to have been driven largely by concerns about rising interest rates and external factors such as trade war fears. US stocks now are about where they started the year, with the SPDR S&P 500 ETF up 1%.

Similarly, the United Kingdom is struggling with how to proceed with exiting the European Union ("BREXIT"). The question of whether to seek to remain in the customs union is not only an extremely difficult crunch item in negotiations with Brussels, it is dividing the country and even dividing the ruling Conservative Party and its cabinet. That government, headed by Prime Minister May, is barely hanging on. Should the Labor Party come to lead the country, its policies would surely be unfriendly to markets. Yet UK equities have not unduly suffered. The iShares MSCI United Kingdom ETF, EWU, remains up 2.32% year-to-date.

Likewise, across the Channel the popular Macron government in France is facing railroad and airline strikes and numerous demonstrations in opposition to the substantial and much-needed economic reforms that Macron is pressing ahead with in sensitive areas such as labor and pensions. Yet the French equity market continues to outperform. The iShares MSCI France ETF, EWQ, is up 4.1% year-to-date.

In this note we take a closer look at Japan, where the equity market has also so far weathered some very dramatic domestic political storms. Prime Minister Shinzo Abe, who had been riding on high ratings in the polls while pursuing with some sensitive reforms, encountered serious problems when a private school, Moritomo Gakuen, which has a nationalist curriculum, acquired land for a new school from the national government at an 89% discount to its appraised value. First Lady Akie Abe is friends with the wife of the school's chairman. Opposition politicians charged undue political influence, and the scandal worsened as altered government documents came to light, a Ministry of Finance official who did the altering committed suicide and other documents went missing. Prime Minister Abe is also accused of using his influence to support another school's application to open a veterinary school.

In late April the opposition parties launched an 18-day boycott of Diet proceedings. They demanded that Minister of

Finance Taro Aso resign to take responsibility for allegations of sexual harassment against a former senior Ministry of Finance official. They also wanted Abe's former personal aide Tadao Yanase to testify about the veterinary school matter. The finance minister is not resigning, but Abe's LDP Party has agreed to have Yanase testify, though not under oath, on May 10th. The six opposition parties decided to return to the Diet this week, not fully satisfied but recognizing that there is important work to be done, including labor reform legislation.

These political scandals have caused Abe's approval rating to plummet, although there has been a small recovery recently. Given the divided state of the opposition, the LPD looks sure to remain in power, but Abe's future is less certain. He has rivals within the LPD that have stepped up their efforts against his remaining as the LPD president. While markets have not reacted to this turmoil, they would pay attention if Abe departed, because any foreseeable LPD replacement would follow considerably more restrictive fiscal policies.

Thus far this year Japan's equity market has not been swayed by the volatile domestic political developments. The iShares MSCI Japan ETF, EWJ, is up 0.9% year-to-date, similar to the performance of the US market. As in the three markets briefly discussed above, Japanese investors focused less on domestic issues and more on fundamental economic and earnings prospects and on external developments such as trade war concerns and the possibility of reduced tensions with North Korea. While Abe's future is not certain, investors have confidence in the ability of the central bank, the Bank of Japan, with recently reappointed Governor Haruhiko Kuroda at the helm, to steer the Japanese economy on a wise course.

The Japanese economy is participating in the global economic recovery that is projected to continue at least through this and next year, and in the accompanying strong growth in global trade, which should persist unless a serious trade war develops. Japan's Nikki Composite Output Index (manufacturing plus services), as reported by IHS Markit, rose in April, continuing a 19-month expansion. Employment and new orders have increased, but economic growth is slowing from last year's 1.7% annual pace to perhaps 1.5% this year. Business confidence has weakened somewhat, and consumption has lost momentum. The stronger yen earlier this year caused exporters and even some domestic companies to reduce their profit guidance for the current year, but these estimates may well change if the yen's weakening since mid-March does not reverse. We are maintaining our Japanese positions for now and monitoring further developments closely.

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Sources: Goldman Sachs Research, Jeff Usher's *Japan Insider,* IHS Markit, *Financial Times*, CNBC

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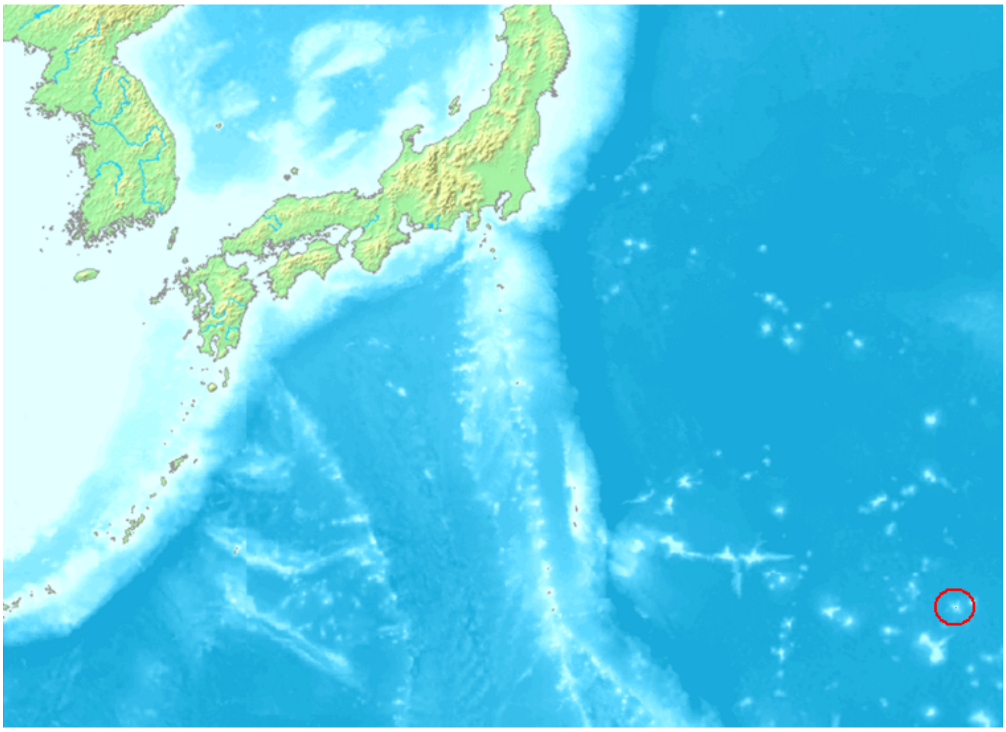
Marcus Island

An isolated Pacific island barely big enough to accommodate an airstrip has gained global importance (see photo: https://en.wikipedia.org/wiki/File:Marcus_Island_DF-ST-87-08298.JPEG). Some 787 miles east of South Iwo Jima, Marcus Island, or as the Japanese call it, Minami-Tori-shima, meaning "Southern Bird Island," is the southernmost island under Japanese governance and within the Japanese economic security zone. In its history (detailed on Wikipedia at https://en.wikipedia.org/wiki/Minami-Tori-shima) Marcus Island has been under American sovereignty and governance and Japanese sovereignty and governance.

So why is this fleck of land in the vast Pacific now so important?



The answer is compelling: Japanese researchers have discovered huge deposits of rare earths in the seafloor surrounding Marcus Island. One recently released scientific estimate suggests that the 1000 square miles of mud in the area contains “such a high concentration of certain rare-earth elements (REE) that it could meet the world’s REE demand for almost a millennium.” This is a monster upward revision to the initial estimates.

Initial indications were that about half a century’s worth of global demand of REE could be met from this mud. That was big news to start with. (A lot depends on which chemistry techniques researchers use to determine the estimate.) The original studies we saw were confirmed by research teams from Waseda University, (https://www.waseda.jp/top/en), a school not particularly well-known in the West but a top Japanese university.

The island is now recognized to have strategic importance far beyond historical expectations. Note that there are very few proven deposits of rare earths in the world: China is currently a major global supplier; another is the Republic of Congo, which is an unstable source.

The key issue here for Japan is to be able to develop the mining operation within the Japanese economic zone. You had better believe that REE was a discussion topic at Mar-a-Lago and that the security of the region was on the table. Shinzo and Donald may have enjoyed their golfing rounds, but the REE deposits that make Japan the Saudi Arabia of REE had to be a big part of the conversation.

Note how quickly Donald said that, to get the trade balance right, the Japanese could buy more American weapons. They are doing so. And also note how the relationship has been positively intensified – as it should be, in our view.

The Japanese have had to live with a pacifist constitutional defense limit that was imposed by Douglas MacArthur after World War II. In fact, the draft of the Japanese constitution was written first in English and then translated into Japanese. The Japanese had surrendered, and General MacArthur imposed the conditions. His scriveners did the rest.

So Japan now finds itself limited on expenditures for defense needs that are being continually stretched, while Japanese politics run their course and may eventually lead to a constitutional change. The change would likely have already happened had the prime minister not become embroiled in a scandal over a land deal for a school with which his wife was involved. Meanwhile, his government has experienced resignations stemming from sex scandals. His political opposition senses his weakness and may deny him a third term.

All that said, the underlying trend of expanding Japanese self-defense activities continues and is encouraged by the United States. Now we see a new, overt act as added confirmation. Japan has launched a 2100-person "Amphibious Rapid Deployment Brigade." It is the first such force publicly unleashed since World War II, according to a report by *Geopolitical Futures* (April 11, 2018). See https://geopoliticalfutures.com.

That force is stationed at Sasebo, which also happens to be the base for the USS Wasp amphibious assault ship. The combination of the two Sasebo-based forces is designed to defend and protect the southernmost Japanese islands. Sasebo is a major base in the defense of Minami Torishima. (Japan comprises an array of 6852 islands, only four of which are large.)

Meanwhile trade-war rhetoric continues between the US and China, while the East China Sea and South China Sea grow more and more significant in the geopolitical realm. Japan remains a close and reliable ally of the US, and its importance is growing once again.

Detente with North Korea may ease pressure on Japan. The North Korea–South Korea dance is fascinating, as the US orchestrates via stormy (tongue-in-cheek allusion intended) tweeted diplomacy. My how the language of the tweets has recently changed!

Markets do not expect peace to break out. The recent political changes are not priced in; notwithstanding that they are very positive. The chances of a successful Trump peace initiative are remote and have been mostly overwhelmed by Trumpian bellicosity.

But maybe, just maybe, the Trump haters will have to deal with a peace initiative. What will they do? Maybe, just maybe, the Trump lovers will no longer be able to indulge in belligerence directed at North Korea. What will then energize them?

Maybe just maybe, the midterm elections will produce a surprise outcome. If so, what will markets do?

For markets, uncertainty premia are high. But will tax reform, fiscal front-loaded stimulus, and repatriation overcome the obstacle of the Fed’s gradual tightening and Trump’s trade-war rhetoric? We shall see.

We remain nearly fully invested. We like the Energy sector and continue our overweight position. And we still like the banks as a group, notwithstanding the substantial fines being paid by those that have misbehaved. We also favor the smaller and middle caps, as we have done for months.

We don’t yet know how to play a rare earths mining revolution in Japan by means of an ETF. There, our exposure is limited. Jeff Usher has contributed some single stock suggestions in his newsletter, *Japan Insider* (https://www.japan-insider.com). Jeff offers excellent coverage of Japan, its politics, and its markets.

We do know that the rare earths story is a strategic market positive for Japan and for the United States.

Stay tuned.

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Asia Equity Markets: Solid Economic Growth Versus Political Risk

Asian economies have begun the year with continued solid – and in some cases robust –performance. Yet the major Asian stock markets have diverged, with some significantly outperforming and others underperforming. In this note we focus on Japan, China, and India.

As this note was written, President Trump announced his administration's intention to impose tariffs on $450 billion of Chinese imports, lodge a WTO dispute against China, and impose restrictions on Chinese investments in the US. Global markets tumbled last Thursday and Friday as fears of a world trade war surged. We share those fears, regretting that the Trump administration had not done as US allies had urged and taken a less risky, multilateral approach, which would have had a better chance of success. Then China responded in a surprisingly moderate way, and over the weekend the US reported that positive talks with China were underway. Also, an important bilateral trade agreement was announced between the US and South Korea, covering steel, autos, and other areas. In addition the European Union, Brazil, and Argentina were exempted from the steel and aluminum tariffs, joining Canada, Mexico, and Australia in that regard. Global equity markets, including those in Asia, recovered since the weekend as fears of a trade war have receded. They then declined again, this time on concerns about the technology sector. We will be writing separately on global markets and trade developments.

While all the stock markets in Asia together do not reach the size of the US equity market, some of them are quite large. Using data provided by the World Federation of Exchanges for year-end 2016 domestic market capitalization (reported in millions of US dollars), China's equity markets, at $7,311,460 million, are the region's largest. Japan's equity market is second largest, at $4,955,300 million. Hong Kong's market, at $3,193,235 million, is third, with fourth place India being very close at $3,106,267 million. Fifth and sixth largest are Australia, at $1,268,494 million, and Taiwan, at $928,366 million. It is noteworthy that the aggregate capitalization of China, Hong Kong, and Taiwan's markets is about the same as the aggregate capitalization of all the European equity markets.

The Japanese economy has looked relatively robust in the first quarter, although the pace of improvement in business conditions appears to have moderated somewhat. In the manufacturing sector, output, new orders, and employment growth rates have all slowed. Looking ahead, firms are anticipating increased skill shortages in a very tight labor market. Yet according to the HIS Markit Japan Business Outlook for February, firms are optimistic about demand growth and profits and expect to increase their workforce numbers and capital expenditures. Despite some slowing in the first quarter, then, overall economic growth for the calendar year 2018, as measured by real GNP, could well surpass the 2017 pace, 1.8% versus 1.7%. While these growth rates look quite modest compared to those of many other advanced countries, they represent full-capacity growth for Japan, with its aging population. The forthcoming March Bank of Japan *Tankan* report should give further information as to whether business sentiment is becoming more negative.

The slight slowing recently in the still strong pace of economic activity in Japan probably is not the most important negative factor affecting business and equity market sentiment. Rather it has been the political storm winds confronting Prime Minister Abe and concerns about whether his economic policy, "Abenomics," which has been very beneficial for the Japanese economy, is now at risk. The so-called Moritomo Gakuen scandal, which involved possible political influence exerted by Prime Minister Abe's wife in a land deal, worsened when it was reported that Ministry of Finance officials admitted to a cover-up attempt by altering public documents. Abe's voter support, as indicated by several polls, plummeted with this news; and fears grew that Abe might be forced out of office. Should that happen, he would very likely be followed by a more fiscally conservative successor. Abe's expansive economic policies probably would not continue.

This is a risk confronting Japanese markets, and it is still evolving. However, we have not yet altered our base-case assumption that Abe will survive politically and be able to win his LDP Party's leadership election in September. Moreover, and perhaps more importantly, the governor of the Bank of Japan has been reappointed to a second five-year term, along with two deputy governors, Masayoshi Amamiya and Masazumi Wakatabe. The three share a strong determination to continue the Bank's reflationist policy, which has been the most effective element in Abenomics. A continuing feature of that policy is the Bank's periodic significant purchases of Japanese equity ETFs in addition to bonds. ETF purchases by the Bank in March have been at a record level.

Last week Japanese equity markets joined the global market pullback in response to increased fears of a possible trade war. Foreign investors were reported to have sold over 2 trillion yen of Japanese stocks during the week.The iShares MSCI Japan ETF, EWJ, fell about as much as the 3.8% drop in the benchmark MSCI All Country Ex United States ETF, ACWX and is participating in this week's global recovery. Before last week, Japan's equity markets had been underperforming other Asian markets since the beginning of the year, with EWJ's increasing barely 0.025%, compared with the 4.29% gain for the iShares MSCI All Country Asia ex Japan ETF, AAXJ. The political scandal, the softness in some economic indicators, and the almost 7% year-to-date strengthening of the yen have all been headwinds. We are maintaining our Japan positions in our International and Global portfolios, as we anticipate stronger economic performance in the coming months and a continuation of Abe's and the Bank of Japan's expansionist economic policies.

China, Asia's largest economy, continues to expand at a rapid rate, contrary to predictions by some for a sharp slowdown. China's macroeconomic fundamentals remain robust. Economic growth has accelerated in the opening months of this year and looks likely to average 6.7% for the year, just slightly below last year's 6.9% pace and above the government's target of 6.5%. Strong global trade momentum will permit exports to continue to support the economic expansion. The government is taking measures to gain better control over excessive credit growth and to reduce financial risks, which have been an area of concern. Yi Gang, China's new central bank chief, has stressed his intention to address the challenge of the high debt levels of state-owned companies, local governments, and households. Reforms to further open the economy to promote competition and to cut excess capacity are continuing.

Up to last week's global equity tumble, China's stock markets had been outperforming strongly this year. For example, the iShares MSCI China ETF, MCHI, was up 8.5% year-to-date. Last week it dropped 7.5% in the wake of Trump's announcement of trade measures against China. This week China's stocks joined in the recovery as trade war fears eased but then joined the tech sector swoon that started in the US.

India's economy is likewise expanding rapidly. Indeed, it led the globe in the final quarter of 2017 with a growth rate of 7.2%, an expansion to which all sectors except mining contributed. The economy is recovering from a marked slowdown in the first half of 2017, triggered by a new goods and services tax and the government's demonetization action in November 2016, which required most cash holdings to be deposited at banks. The latter move was intended to reduce India's huge informal economy. Growth in the first half of this year looks likely to accelerate further to a 7.8% annual pace and then possibly moderate to a 7.6% rate in the second half of the year and in 2019. This growth performance would still lead the globe.

There have been some indications that business confidence among Indian firms softened in the first quarter, despite the strong macroeconomic prospects. That may have been one factor behind the underperformance of India's equity markets in the first quarter. The iShares MSCI India ETF, INDA, was down 5.4% year-to-date before last week, when it lost an additional 2.8%. Probably more important was the unexpected return of the long-term capital gains tax in the budget. Also, there was a major fraud case involving the second largest state-run bank. This scandal countered the positive effects on market sentiment of a $32 billion capital infusion for state-run banks. We are maintaining our India positions in our International and Global portfolios.

We are also our maintaining our positions in the iShares MSCI All Country Asia ex Japan ETF, AAXJ. This ETF provides wide exposure to Asia, excluding Japan and Australia. Over the past 12 months, including this year's volatile period, this ETF gained 19.9%, much better than the benchmark ACWX's gain of

12.2%. The country weights in AAXJ for the top six markets are China, 39%; South Korea, 17.5%; Taiwan, 13%; India, 10%; Hong Kong, 5.75%; and Singapore, 4%. Note that China's 39% weight appears to consist of about 7% Chinese firm stocks listed in Mainland China markets and 32% Chinese firm stocks listed in Hong Kong. We use this ETF to add to our China market exposure while diversifying risk. In last week's market swoon, the positions in less volatile markets such as Taiwan, India, and Hong Kong certainly helped moderate the fall in AAXJ. Going forward, the substantial South Korea position should benefit from the US–South Korea trade agreement and the appearance of some easing of the political tension with North Korea.

Overall, Asian economies are likely to continue to play a leading role in the global economic expansion, which we expect to remain robust despite some recent signs of deceleration, mostly due to seasonal and weather-related factors. Asian equity markets should benefit from fundamental growth forces, but individual national markets will continue to have differing performances due to domestic developments. We expect market volatility in the emerging markets of Asia to continue to be relatively high.

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