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Japan chooses inflation

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After decades of deflation, Japan is finally embarking upon a harmonious interaction of stimulative monetary and fiscal policy designed to catapult their moribund economy into positive territory.

Newly-appointed central bank governor Haruhiko Kuroda has agreed with Prime Minister Abe to direct monetary policy toward a 2% inflation target. The last time Japan's inflation rate increased by 2% for more than 12 consecutive months was September 2008.

Deflation has been one of the economically-depressing factors which motivated consumers and business to delay purchasing until prices fell further. Bank of Japan interest rates have been hovering around zero since October 2010 forcing the central bank to adopt a quantitative easing strategy. The central bank presently owns US$1.785 trillion of Japanese Government Bonds (JGBs), approximately 30% of GDP, the second largest percentage among major central banks. They believe that rising prices would help raise wage rates which have hovered around zero for months.

Fiscal stimulus

A few months after PM Abe's election he pushed through the Japanese Diet a series of fiscal initiatives that would promote significant infrastructure building in the economy. The new fiscal spending program totals US$107 billion, (1.8% of GDP) to be spent on infrastructure projects over the next 15 months. The government is also counting on a substantial multiplier effect on growth from the interaction of stimulative monetary and fiscal policy.

The economy needs a boost. Real GDP has decreased in each of the past three quarters and is only up 0.2% year-on-year through Q4 2012.

Trade troubles

One factor causing economic decay has been the dwindling Japanese trade surplus. Exports fell 0.3% and imports rose 5.3% in 2012, in part because the dispute with China over the Senkaku-Diaoyu islands has choked off trade with Japan's prime trading partner. Another factor is uncharacteristically slow economic growth in the US and EU, reducing their demand for Japanese exports.

The islands dispute has also pushed Japanese overseas manufacturing to seek more secure sites for present and future plant locations in ASEAN instead of China.

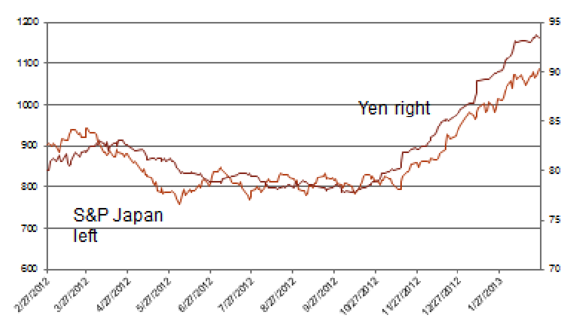
Market rally

The dramatic focus on promoting economic growth in Japan by both PM Abe and new central bank governor Kuroda has ignited a broad rally in the Japanese stock market. Japan's Nikkei index appreciated 45% over the past six months and foreshadows faster economic growth in the future in Japan. Of course it has a long way to recover all of the losses from its historic peak of 38,916 in December 1989. The expected monetary injection from BOJ has also caused the yen to depreciate significantly, falling by 21.8% against the dollar. It signaled that manufacturers will be more competitive and more profitable. Consequently, its depreciation is reinforcing the rally in the Japanese equity market – see chart below.

Turning a corner

It looks like the Japanese government is finally doing everything that the EU authorities are not to promote growth. After a slow start in the first half of 2013, GDP should begin to rise in the second half of the year. However, achieving positive inflation on a year-on-year basis will take more time. The EU will not be as fortunate.

Japan: Weak Yen Strong Equity Market



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	KEY INDICATORS TABLE (AS OF 28 FEB 2013)					
INDEX	**LEVEL**	**%1MO**	**%1YR**	**INDEX**	**LEVEL**	**%1YR**
S&P500	1515	1.36%	13.44%	3MO LIBOR	0.287%	-40.7%
FTSE	9658	-2.60%	7.73%	10YR UST	1.88%	-4.57%
NIKKEI	125	2.68%	6.40%	10YR BUND	1.45%	-20.3%
HANG SENG	2969	10.09%	-2.95%	10YR SPG	5.10%	2.20%
STI	2643	13.64%	-0.31%	10YR SGS	1.52%	3.40%
EUR	1.31	-3.69%	-2.04%	US ISM	54.2	4.43%
YEN	92.37	-1.14%	-14.02%	EU PMI	47.9	-2.24%
CMCI	1548	-4.23%	-5.92%	JP TANKAN	-9	28.6%
Oil	92.95	-6.03%	-13.68%	CHINA IP	10.3	-19.5%

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis)

S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLJ3)
3MO LIBOR: interbank lending rate for 3-month US dollar loans
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)

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