<u>JAPAN: FINANCIAL ARCHERY, SHOOTING ARROWS</u>

© Leo Haviland, 646-295-8385 October 5, 2018

The famous military philosopher and analyst Carl von Clausewitz states in "On War" (Book Two, chapter 3; italics in original): "Rather than comparing it [war] to art we could more accurately compare it to commerce, which is also a conflict of human interests and activities; and it is *still* closer to politics, which in turn may be considered as a kind of commerce on a larger scale."

****

OVERVIEW AND CONCLUSION

In late 2012, the Japanese political leadership dramatically unveiled its three "arrows" of easy money, flexible fiscal policy, and structural reform to improve the country's economic performance. In practice, those Japanese political authorities generally represent major financial (corporate; commercial) interests ("Japan, Inc."). The Bank of Japan's policies since late 2012, though nominally independent of political and economic power centers, in practice reflects the goals of Japan's substantial entrenched economic groups and the political representatives and bureaucrats aligned with them.

Monetary policy of course is not the only factor affecting GDP, inflation, and other intertwined variables. Yet Japan's ongoing government fiscal deficit, though somewhat helpful for promoting growth and inflation, is not the most noteworthy element in the country's policy array since end-2012. Moreover, the general government debt burden remains massive and likely will remain so for many years. According to the International Monetary Fund, Japan's general government gross debt as a percent of GDP was 236.4 percent in 2017 (contrast the G-7 average of 118.6pc that year) and forecast at 236.0pc for 2018 and 234.2pc in 2019, dipping only slightly to 229.6pc by 2023 ("Fiscal Monitor", April 2018, Table A7; the October 2018 update probably will not change Japan's government debt as a percent of GDP statistics substantially). And structural reform in Japan, which usually crawls forward slowly, has been unremarkable.

The extremely easy monetary policy arrow embraced by the accommodative Japanese central bank for almost six years is the country's critical weapon. The central bank chief faithfully and repeatedly proclaims that sustained inflation of two percent is a praiseworthy goal (as essentially do the sermons preached by other leading central banks such as the Federal Reserve Board and the European Central Bank). The Bank of Japan's ongoing tools to achieve its aims include sustained yield repression and massive quantitative easing (money printing). So far, the Bank of Japan, despite its determination, has not come close to achieving two percent inflation. The consumer price trend in recent months manifests merely minor progress on that front. And although Japan's quarterly GDP for April-June 2018 may signal enhanced year-on-year economic performance, International Monetary Fund forecasts are not as sunny.

Yet what else has the Bank of Japan (as a representative and reflection of the country's political and economic generals) really battled to achieve via its remarkably lax monetary strategy? A notion of improved and acceptable economic growth and frequent reference to an iconic two percent "price stability target" do not offer a complete story. Moreover, the enthusiastic declaration of assorted monetary policy plans and tactics does not directly reveal important aspects about the economic (financial; commercial; marketplace) landscape within which the interrelated GDP and inflation goals are targeted and such extraordinary easy money programs are designed and applied.

In practice, what are the intermediate connections (means; methods) to the achievement of the allegedly ultimate ends of satisfactory growth and sufficient inflation? One key approach of the Bank of Japan's magnificent scheme relates to currency depreciation, the other to stock marketplace appreciation. Japan's central bank sentinel quietly has aimed to achieve the related objectives of Yen weakness and Japanese stock marketplace strength.

In recent times, Japan deliberately has kept a relatively low profile in foreign exchange, trade, and tariff conflicts. Compare the furious racket nowadays, especially since the advent of the Trump presidency, around the United States and China (and also in regard to the European Union, Mexico/Canada/NAFTA).

Nevertheless, for several years, Japan has waged a trade war (engaged in fierce currency competition) without capturing much international political attention or media coverage. The Bank of Japan (and its political and economic allies) in recent years has fought vigorously to depreciate the Yen (especially on an effective exchange rate basis) and thereby to bolster Japan's current account surplus. Japan's overall economic growth relies significantly on its net export situation. The Yen's substantial retreat and its subsequent stay at a relatively low level and the significant expansion in the country's current account surplus are glorious triumphs.

Since late 2012, the Bank of Japan also has struggled ferociously to rally the Japanese stock marketplace (boost corporate profits). As of early autumn 2018, this guardian has achieved significant victories in this campaign as well.

BANK OF JAPAN'S EASING CAMPAIGN: LABELS, TIMETABLE, AND POLICIES

On 11/14/12, amidst economic growth worries and deflation fears, Japan called a crucial lower house election. On 12/16/12, the Liberal Democrats won. The incoming Prime Minister, Shinzo Abe (who remains in power today), introduced "Abenomics", with its three "arrows" of easy money, flexible fiscal policy, and structural reform. The monetary arrow represented a significant policy development.

Under new Bank of Japan leadership (Governor Kuroda), 4/4/13 brought "Quantitative and Qualitative Monetary Easing" ("QQE") on scene. The "Expansion of the Quantitative and Qualitative Monetary Easing" (10/31/14) supplemented this. The bank's money printing and interest rate yield repression program includes a "price stability target" (promulgated 1/22/13) of two percent year-on-year for the consumer price index (all items less fresh food). Moreover, as part of its awe-inspiring money printing (QQE; monetary base expansion) enterprise, not only has the central bank been buying large amounts of bonds (JGBs), but also significant quantities exchange-traded funds (ETFs; the BoJ has been buying stocks). The bank also purchases real estate investment trusts.

The central bank sharpshooter added a "QQE with a Negative Interest Rate" scheme (1/29/16). On 9/21/16, the Bank of Japan supplemented QQE's easy money regime with short and long term interest rate "Yield Curve Control" and an "inflation-overshooting commitment" for the two percent CPI target. Recently (7/31/18), this sentinel proclaimed the "Strengthening the Framework for Continuous Powerful Monetary Easing", which included the introduction of "forward guidance for policy rates". The bank's 9/19/18 "Statement on Monetary Policy" continues the highly accommodative bias.

The Bank of Japan's two percent inflation target, interest rate yield repression (the JGB 10 year yield, despite years of monetary easing, is a meager .16 percent as of 10/5/18), and extravagant debt securities acquisition (money printing aim; QE) method parallel those adopted by other leading global central banks such as the Federal Reserve and the European Central Bank. Marketplace history of course demonstrates that sustained central bank yield repression (assisted by mammoth money printing), such as that orchestrated by the Fed, even without direct central bank acquisition of equities, can encourage stock buying (by the general public of individuals and institutions) and thereby help to propel equity prices in general higher.

However, the Bank of Japan's willingness to engage directly in stock buying (via ETFs) differentiates it from the Fed. According to the Nikkei Asian Review (6/27/18), as of three months ago "The BOJ has amassed an estimated 25 trillion yen ($227 billion) of equities as a result of purchasing exchange-traded funds. The tally is equal to nearly 4% of the roughly 652 trillion yen aggregate market value of stocks traded on the first section of the Tokyo Stock Exchange."

****

Although the BoJ has claimed that it executes its JGB purchases in order to conduct monetary policy and not for the purpose of financing fiscal deficits, such debt securities buying nevertheless helps to finance those fiscal shortfalls. Thus it has enabled the nation's political leadership to postpone the creation of credible plans for dealing with the country's gigantic government debt.

The Bank of Japan and the country's political leadership and economic elites are devotedly wedded to the BoJ's lax monetary policy regime. Yet over five years have passed since its advent. No substantial reversal of the current easing policy appears imminent, though some adjustments may occur in the array of techniques currently employed. The August 2018 annual change in Japan's consumer price index (less fresh food) was only .9 percent (Statistics Bureau, 9/21/18; all items rose 1.3pc). The IMF expects that Japan's "inflation is likely to continue its slow upward trend, but will remain below two percent in the next few years."

[See the International Monetary Fund's Managing Director's "Press Conference on the Conclusion of the Mission for the 2018 Article IV Consultation with Japan" ("Press Conference"; 10/4/18). Note also the IMF's "Japan: Staff Concluding Statement of the 2018 Article IV Mission" ("Staff Conclusion"; 10/4/18). The upcoming release this month of updated statistics for the "World Economic Outlook" and related material will offer more comprehensive and updated statistics for Japan and other nations.]

Yet despite the low inflation figures, Japan's April-June 2018 GDP rose at 3.0 percent annualized (Japan's Cabinet Office, 9/10/18). The IMF (10/4/18 Staff Conclusion) nevertheless projects Japan's economic growth at 1.1 percent in 2018 (above its estimated potential) and about one percent in 2019 (Press Conference). Downside risks for the Japanese economy have increased relative to last year (Staff Conclusion).

According to the IMF, the nation's output gap as a percent of potential GDP has narrowed from a very wide -4.6 percent in 2011 and -3.7pc in 2012 (and compare 2009's huge -7.3pc) to only about -.2pc in 2018. Japan's gap probably will disappear in 2019; the forecast is .1, and since this is a positive number, no gap will exist (World Economic Outlook, April 2018 database). The Staff Conclusion's output gap comments for 2018 and 2019 are consistent with the April 2018 database.

****

What are the Bank of Japan's exit strategies regarding its mountainous holdings of government bonds and its hoard of equities?

YEN DEPRECIATION AND THE JAPANESE STOCK RALLY

In Akira Kurosawa's film "Ran", Saburo Naotora Ichimonji declares: "We too are children of this age…weaned on strife and chaos."

****

Assorted interrelated variables influence the levels and patterns of and the relationships between currency, stock, interest rate, commodity, housing, and other battlefields. Professional marketplace scouts, as their perspectives and narratives are subjective, can and do disagree on the relevance and intertwining (connections) between such factors and their implications for one or more marketplaces. Factors relevant to Japan, particularly in a globalized economy, of course are not confined to so-called Japanese ones. For example, Japan's central bank obviously has not been the only central bank providing highly accommodative assistance in recent years. Moreover, apparent relationships between economic phenomena change, sometimes rapidly. Economic (political) history need not repeat itself, either entirely or even partly.

Historical investigation nevertheless shows the noteworthy relationship (association; linkage) between the depreciating Yen and the rising Japanese stocks in recent years. For predicting trends in these and related marketplace territories, keep easy money policies in Japan and other leading nations (low policy rates and yield repression; money printing/QE) and changes (developments) in them in sight.

****

The Japanese government and other national and international public authorities closely monitor the Japanese Yen versus US dollar cross rate level and travels. So do many Wall Street currency, stock, interest rate, and commodity warriors and numerous Main Street commercial captains and troops. However, the Yen's broad real effective exchange rate heights and adventures ("EER", monthly average; Bank for International Settlements statistics; 9/19/18) are a more comprehensive guide to the Yen "in general" and Japanese official views in regard to it. Analysis of the Yen EER also offers a useful perspective regarding elevations and trends in related foreign exchange, stock, debt, and other financial marketplaces.

Yen EER history suggests that it began a depreciating trend a long time ago. Recall the lower and lower highs in the Yen EER since spring 1995. Following April 1995's 150.8 pinnacle, note September 2000's 128.0, October 2003's 109.6, and January 2009's 106.8 (during the mournful days of the worldwide economic disaster of 2007-09). Subsequent highs in October 2010 (103.9) and January 2012 (104.9) stood beneath January 2009's plateau. The policy dictates of Japan's central bank (generally mirroring the desires of the majority of its economic and political comrades) since around early 2013 probably exacerbated this long run pattern of weakness.

Though the Yen EER ceased its downhill slide when it established an important bottom at 67.9 in June 2015, the Bank of Japan's easy money games have played a key part in keeping the EER relatively feeble since then.

****

Key Yen Effective Exchange Rate (EER) High and Lows (date)	**Key Japanese Stock (Nikkei) Highs and Lows (date)**
Interim high January 2012 at 104.9. The EER slumped decisively under 100.0 around November 2012, reaching 82.5 in February 2013. [Note 4Q12's election outcome, the arrows of Abenomics, and Bank of Japan strategy and tactics.]	8619 (11/13/12) take-off point [earlier lows 8136 (11/25/11) and 8239 (6/4/12)]

[The Yen EER's bloody collapse under 100.0 rapidly breached the critical prior support around 96.0. Recall the bottoms of August 1998 (96.2), August 2009 (96.6), and April 2011 (96.4).

The Yen attained its Y75.4 cross rate peak against the dollar on 10/31/11. Noteworthy lower tops near that ensued on 6/1/12 at Y77.7, Y77.2 on 9/13/12, and Y79.2 on 11/9/12.]

67.9 June 2015	20953 (6/24/15)

[The June 2015 Yen EER plummeted 35.3 percent from January 2012's top and crashed 55.0 percent from April 1995's celestial high.]

Key Yen Effective Exchange Rate (EER) High and Lows (date)	**Key Japanese Stock (Nikkei) Highs and Lows (date)**

The broad real trade-weighted US dollar ("TWD"; Federal Reserve Board, March 1973=100; monthly average) established a significant interim high in January 2016 at 101.1. The S+P 500 (1812 on 1/20/16 and 1810 on 2/11/16) and many other key stock marketplaces, including Japan's, made important bottoms around then.

The Yen EER's modest ascent from January 2016's still-weak 74.6 to June 2015's	14866 (2/12/16); see also 14864 (6/24/16)

81.5 probably encouraged the Nikkei's dip to its June 2016 bottom. Although August 2016's 84.4 minor top edged above the June level (and February 2013's 82.5), the Bank of Japan remedied this by bringing out further easing firepower in mid-September 2016.

[The Yen EER high since June 2015 remains August 2016's 84.4. It was 73.2 in January 2018, with August 2018's (the most recent data point) 76.3 the highest since then. The Yen EER average from February 2013 (roughly the time when Japan's central bank ambitious monetary easing program embarked) through August 2018 is only 75.8. The February 2013/August 2018 average tumbled 27.7 percent from January 2012's elevation and nearly fifty percent from April 1995's majestic top. The sustained Yen EER weakness over that span underscores the Bank of Japan's brave dedication to both a feeble Yen (and higher inflation and acceptable GDP growth), and higher Japanese stock marketplace prices.

	24129 (1/23/18)
	24448 (10/2/18)

****

All else equal, in general a relatively weak Yen assists Japanese exports (and tends to reduce imports). Substantial exports and a current account surplus are very important to Japan's economy. According to the International Monetary Fund, Japan's current account balance (surplus) was 3.85 percent of GDP in 2006 and 4.70pc in 2007 (April 2018 "World Economic

Outlook" database; the IMF may update these and other statistics in the near future in conjunction with its October 2018 meeting). Though the surplus shrank to 2.78pc in 2009, it rebounded to 3.88pc in 2010. However, it slid sharply thereafter, reaching .96pc of GDP in 2012, .89pc in 2013, and .75pc in 2014 (beneath one percent for three consecutive years).

In regard to this slump in the nation's current account surplus, recall the Bank of Japan's rhetoric and actions. Also, highlight the Yen EER depreciation (which began in early 2012) that accelerated in November 2012 as well as the effort to sustain a weak Yen EER in recent years. Japan's current account surplus grew substantially after 2014. It was 3.05 percent in 2015, 3.80pc in 2016, 4.01pc in 2017, and estimated at 3.76pc for 2018 and 3.71pc for 2019 (the IMF's 10/4/18 Staff Conclusion essentially agrees with the 2017 and 2018 statistics from the IMF's April 2018 database).

****

All else equal, growing corporate profits help to propel stock prices higher.

All else equal, a depreciating (or relatively weak) Yen tends to boost corporate profits (in nominal Yen terms) for many Japanese corporations, or at least those that are substantially export-based. The United States is a very important trading partner for Japan (according to the BIS, based on 2011-13 trade, America is 15.2 percent of Japan's broad real EER), but it is not the largest one. China, with its huge 31.0 percent share, wins that honor (the Euro area represents 13.0 percent of Japan's EER). However, much of international trade is in dollars. Thus the weakness in the Yen EER in general and the withering of the Japanese Yen against the United States dollar in particular since around the beginning of 2012 arguably have aided Japanese corporate profitability.

In calendar 2Q18 (April-June), Japanese corporate profits ("ordinary profits" of all industries; manufacturing and nonmanufacturing industries, but not including finance and insurance ones) hit an all-time high of 26,401 billion Yen, up 17.9 percent from calendar 2Q17's 22,390 billion Yen height and 30.9 percent relative to 1Q18's 20,165 billion Yen (Ministry of Finance's Policy Research Institute). Including finance and insurance, ordinary profits in calendar 2Q18 rose 15.5pc year-on-year.

With the substantial and ongoing monetary easing by the Bank of Japan since around the start of 2013 in view, let's survey second calendar quarter (April-June) ordinary profits (all industries, not including finance and insurance) for several preceding years. Surely Japan's economic and political leaders (and Main Street Japan as well) wanted corporate profits to skyrocket from 2Q09's financial disaster depth of 7,237 billion Yen (and thereby to assist climbs in Japanese GDP and stocks).

Second quarter profits during the span of 2010-2012 stood above those of 2Q09; 2010's were 13,275 billion Yen, 2011's 11,342 and 2012's 12,646. However, Japan's 2010-2012 profitability still remained significantly beneath that achieved in 2007 and 2008 as the global financial crisis emerged and began to worsen, 2007's 16,240 and 2008's 15,394. Surely after the 2012 election and as 2013 dawned, the heroic Bank of Japan could perform extremely important duties on behalf of the Japanese nation by performing remarkable monetary easing acrobatics! Watch what happened to corporate profits as the Yen EER collapsed. Those for second quarter 2013 grew to 15,679 billion Yen, and 2014's marched up to 16,386. However, 2013 and 2014's profits only matched those achieved in 2007 and 2008. So why not maintain or even expand the easy money policy? Remember the BoJ's 10/31//14 "Expansion". Ordinary profits rose to 20,288 in 2015. However, they trailed off to 18,264 billion Yen in April-June 2016; recall the Nikkei's troubling lows in February and June 2016. Time for more valiant rescue efforts from the Bank of Japan! Note its January and September 2016 innovations and commitments.

Despite the jump in corporate profits in second quarter 2017 and the further leap in 2Q18, the Bank of Japan on 7/31/18 generously provided its "Strengthening the Framework for Continuous Powerful Monetary Easing".

MARKETPLACE TRENDS AND TURNING POINTS

Looking forward, to what extent will the Bank of Japan be able to keep the Yen EER relatively weak? Despite its resolve, powers, and programs (including low interest rates; note also the nation's fiscal problems), a world of currency wars and competitive depreciation probably makes this foreign exchange policy objective challenging. A modest Yen EER rally from the February 2013/August 2018 average of 75.8 would not be surprising. A five percent move from 75.8 is 79.6; a ten percent climb gives 83.4. In this context, monitor China's EER and the movement of the broad real-trade weighted dollar (Federal Reserve, H.10; monthly average).

After China's EER peaked at 131.1 in July/November 2015, it sagged to 118.6 in May 2017. Though the China EER appreciated to 127.6 in February 2018, August 2018's 121.8 level is not very distant from May 2017's depth. According to the Bank for International Settlements, China is a 31.0 percent share in Japan's EER, whereas Japan has a 14.1pc weight in China's EER. As for the broad real trade-weighted dollar, September 2018's 101.2 neighbors January 2016's important 101.1 high and is fairly near the December 2016 103.3/January 2017 103.1 resistance barrier. The Yen EER peak of January 2012 at 104.9 occurred only a few months after July 2011's major low in the TWD. If weakness emerges in the TWD (watch the TWD's critical peak during the international economic crisis, March 2009's 96.6), the Yen EER probably will rally toward its 84.4 August 2016 high.

****

The essay "History on Stage: Marketplace Scenes" (8/9/17) emphasized that "many times over the past century, significantly increasing United States interest rates have preceded a noteworthy peak in key stock marketplace benchmarks such as the Dow Jones Industrial Average and S+P 500. The yield climb sometimes has occurred over a rather extended time span, and the arithmetical (basis point) change has not always been large." The US Treasury 10 year note made a major yield bottom at 1.32 percent on 7/6/16. This week, yields broke over 5/18/18's 3.13pc high, reaching around 3.25 percent on 10/5/18.

****

"Stock Marketplace Maneuvers: Convergence and Divergence" (9/4/18) detailed the relationship between various major stock marketplace benchmarks around the globe. The essay concluded that American stock benchmarks probably are establishing an important price peak around current levels.

The S+P 500's record high to date, 9/28/18's 2941, exceeded its important 1/26/18 interim summit by only 2.4 percent. Japan's Nikkei stock benchmark, like the S+P 500, made a notable top in first quarter 2018 (1/23/18 at 24129). However, after around the end of first quarter 2018, the Nikkei diverged for several months to some extent from the S+P 500 (the S+P 500's bull move carried it to new highs, whereas the Nikkei lagged behind). Nevertheless, the Nikkei's notable upward charge in recent weeks has converged with that in the S+P 500. The Nikkei's

24448 high on 10/2/18 rests close in time to the S+P 500's 9/28/18 one, and its assault on 1/23/18's high surpassed it by a paltry 1.3 percent.

Bear moves in emerging marketplace stock benchmarks such as the MSCI Emerging Stock Markets Index (from Morgan Stanley; "MXEF") and the iShares MSCI Emerging Markets ETF ("EEM") remain underway.

The violent Nikkei rally over the past several weeks commenced from 21463 (7/5/18)/21851 (8/13/18). On the timing front, recall the 7/31/18 release of the Bank of Japan's "Strengthening Framework"). The S+P 500 made interim lows around the time of those in the Nikkei, on 6/28/18 at 2692 and 8/15/18 at 2802.

[The recent Japanese Yen cross rate low versus the US dollar was 10/4/18's Y114.6 (compare the 10/2/18 date of the Nikkei high at 24448). This Yen decline stage started at Y104.6 (3/26/18). Yet note a later interim Yen high, 8/21/18's Y109.8 (the Nikkei rallied from 8/13/18's 21851). Compare 10/4/18's Yen low against the dollar with 11/6/17's Y114.7 trough.

See "China at a Crossroads: Economic and Political Danger Signs" (8/5/18). Suppose China grows less than expected. Such a Chinese deceleration probably will help to slow Japanese (and worldwide) economic growth, with ominous warnings for Japanese and American and other stock marketplaces.

Three times the Nikkei's 11/25/11 major bottom at 8136 equals 24408. The recent Nikkei high is about a ten year diagonal bull move from 10/28/08's major bottom at 6995 (that low times 3.5 is 24483).

The S+P 500's 10/11/07 pinnacle at 1576 occurred on about the same calendar month/day as the S+P 500's record high to date (9/28/18) and the Nikkei's recent high (10/2/18).

History reveals that price (and time) convergence often exists or develops between Japanese and American stock benchmarks. For example, recall their bottoms during first quarter 2016. Near the end of the global economic disaster, the S+P 500's major trough at 667 on 3/6/09 occurred alongside the Nikkei's second key low, 3/10/09's 7021. At the close of the marvelous Goldilocks Era, the S+P 500 created interim highs on 2/22/07 at 1462 and 7/16/07 at 1556 prior to 10/11/07's peak at 1576. The Nikkei's final top also was on 10/11/07 (at 17489); 2/26/07's major high at 18300 and its second top at 6/20/07 at 18297 occurred close in time to important summits in the S+P 500.

****