

Japan: Rising Sun?



Although business investment and labor income conditions to remain anaemic, reflecting the exceptionally low level of economic activity, Japanese economy is likely to return to a growth path somewhat above the potential growth rate of the economy in 2010, mainly driven by a steady increase in exports, particularly those to Asia. As deflation persists well into 2010 amid large economic slack and declines in unit labor cost, the Bank of Japan (BOJ) may see escalating political pressure to act against deflation as the government seeks to remove the threat of a recession relapse before a parliamentary election in July. Finance Minister Naoto Kan, in his second week in office after replacing Hirohisa Fujii, said last week that there were still various policy measures that could be taken by BOJ also praised the BOJ on December 1 introduction of a 10 trillion yen, or US\$109 billion, loan program that came days after he

expected more “monetary support” from the bank. He was economy minister at the time. BOJ policy makers will feel more pressure to take action with Kan in the position. Bloomberg quoted the Yomiuri newspaper as saying that the Democratic Party of Japan’s popularity has slid since it came to power for the first time four months ago promising to end 20 years of economic stagnation. Prime Minister Yukio Hatoyama’s approval rating was at 56% this month, compared with 75% when he took office. Amid the weak economy and political pressure, BOJ might increase its monthly purchases of government bonds and securities from the current 1.8 trillion yen if Hatoyama decides to sell more of the securities to fund any further stimulus spending. Japan’s fiscal condition is deteriorating. Whatsoever, the Finance Ministry forecasts

bond sales will exceed taxes as the main source of funding in the year ending March. Fortunately, government borrowing costs remain contained as deflation attracts bond investors. Japan’s fiscal condition is unlikely to improve over the next couple of years, but high private savings may keep long-term interest rates relatively low in the near future. In fact, the central bank will only act when it sees that there is a responsible and sustainable policy at the Ministry of Finance concerning the public debt, according to Bloomberg. Kan needs to get along well with the BOJ. If he does so, there is a very good chance that deflation finally will be over this year. That will be a major political achievement. In addition, investment sentiment in Japan will revive and its stockmarket will draw global attention. **E**

Microscope

Japan enjoys flood of liquidity around the world. Investors put almost \$3 billion into equity and bond funds in developing nations in the week to Jan. 13, according to Massachusetts-based fund tracker EPFR Global. The inflows are going to lift Asian currencies, especially now that the market is looking at a delay in Fed hikes as weal US retail sales prompted futures traders to pare bets that the Fed will raise its benchmark interest rate from near zero by mid-year. Although it is widely expected that the yen will weaken against the dollar by the end of 2010, China’s unexpectedly announced it would require higher bank reserves, raising the likelihood of the yen gaining as the yuan appreciates. On the other hand, Japan’s 10-year bonds completed the first weekly gain in almost a month as speculation the global economic recovery is still weak boosted demand for the relative safety of government debt. The yield differential between the US’s and Japan’s 10-year notes, which was about 2.37% points last Friday, will widen to 2.48% points by the end of March, according to a Bloomberg News survey of economists, indicating funds are continuously flowing in Japan. **E**

MARKET BRIEFING

YTD % (local curr)

US DJ	10,609 (1.7%)
Nasdaq	2,287 (0.8%)
Euro Stoxx 50	2,940 (-0.9%)
HSI	21,654 (-1.0%)
Japan NK225	10,982 (4.1%)
China Shanghai Composite	3,224 (-1.6%)
Singapore	2,908 (0.4%)
India BSE30	17,554 (0.5%)
Brazil BOVESPA	68,978 (0.6%)
Aus All Ord	4,929 (1.0%)
US-10yr Bond Yield	3.73%

As at 15/01/10

Insight:

“Preparation for “Exit” ”

With recovering economies, central banks are expected to adopt gradual exit strategies. Last week, China suddenly announced to raise banks' reserve, indicating the era of exit is coming. However, major central banks are still providing liquidity support and purchasing financial assets. The Fed, the Bank of Japan has recently committed to extremely low rates for some time, while the UK Monetary Policy Committee further expanded quantitative easing. In fact, central banks should have realized that a framework for policy exit could minimize risks of asset bubbles. They should manage the exit strategies from

extreme monetary accommodation and huge fiscal deficits, without creating further instabilities and denting future growth prospects. In fact, key elements of the exit strategies are already underway, although the Fed officials may be reluctant to back away from the commitment to near-zero rates until labor markets stabilize – conditions that may only come together around mid 2010. As such, exit strategies may have to contend with still very large balance sheets and expanded bank reserves as decisions to raise overnight rates approach perhaps late this year. Meanwhile, investors should be well-prepared in 2H 2010. Those assets' price, driven by ample liquidity, will face sell-off pressure, eg, stocks and commodities. However, after the premium made by liquidity disappears, investors will revert back to fundamentals. **E**

Financial “In & Out”

IN: Drug manufacturers in the US are expected to outperform the benchmark index due to their stable earnings growth even the economic recovery around the globe is still fragile.

OUT: Banking sector in the US faced profit-taking pressure since there is concern about sustained difficulty in consumer lending due to high unemployment rate. **E**



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