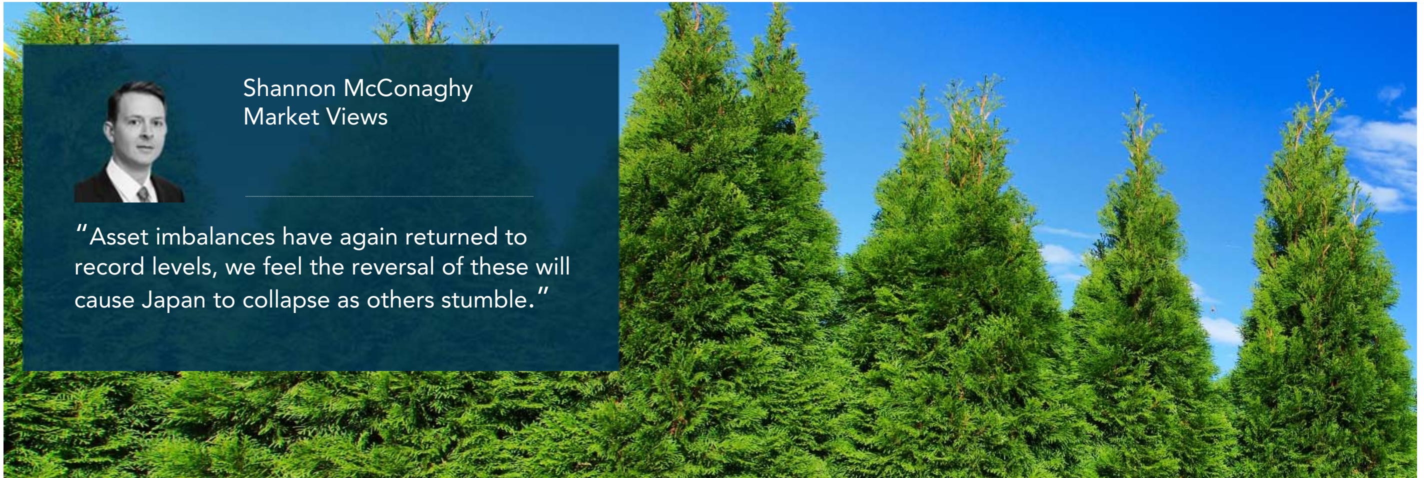
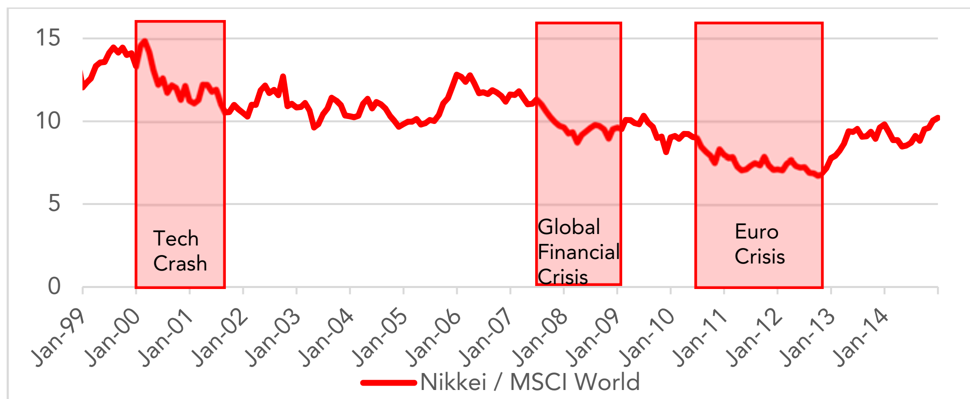
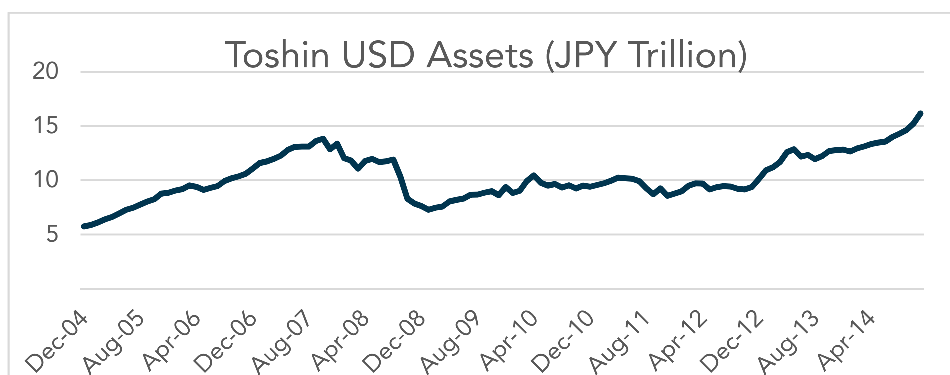
Japan - An Excellent Hedge As Asset Imbalances Return



Japan is a highly cyclical market often driven by carry trade pressures, speculative currency positioning and extreme volatility in the expectations of the foreign "swing" investor. These factors have contributed to Japanese equities outperforming as asset imbalances build during the good times, then subsequently falling further than regions seemingly at the very epi-centre of any major crisis as imbalances unwind. This has happened during each global correction this century with the Nikkei index falling further than the S&P during the tech crash, the S&P during the global financial crisis and MSCI Europe between mid-2010 and mid-2012. Asset imbalances have again returned to record levels, we feel the reversal of these will cause Japan to collapse as others stumble. As such current conditions appear ripe again for magnified short returns in Japan on almost any substantial global risk off event. The risk reward is appealing with equity and currency markets already anticipating a smooth increase in US rates and exit from global deflationary pressures. Whilst seemingly disregarding Japan's disproportionate exposure to any emerging markets debt blowback if US rates do rise.

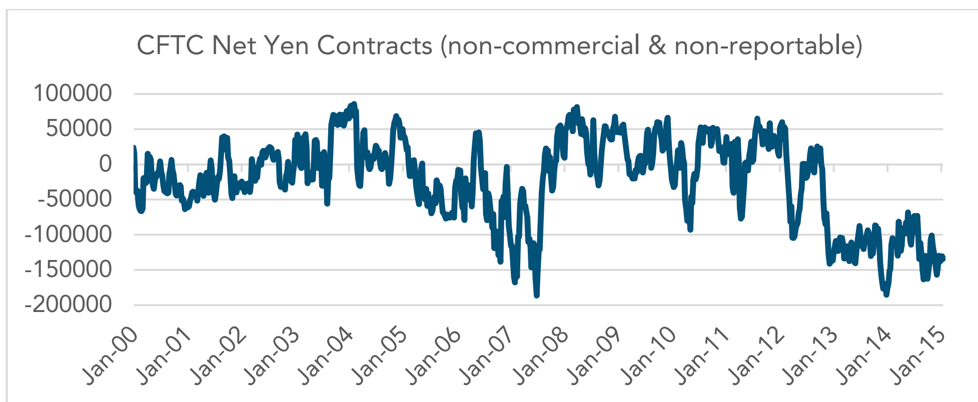


A critical reason for Japan's outsized fall during the Global Financial Crisis was the unwinding of vast Japanese carry positions that had built up in the years prior to the crash. Pushing currency conditions from highly favourable to highly unfavourable for Japanese export companies. Carry trades are again primed for a reversal on any global risk off catalyst with US Dollar denominated Toshin (the most common retail foreign currency investment vehicle) balances back above the 2007 peak according to data from the Japan Investment Trust Association.

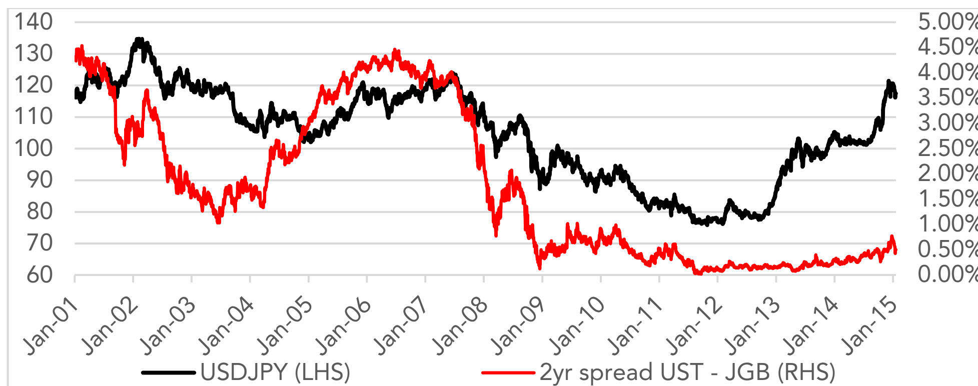


The number of retirees living off investment returns in Japan are higher than ever, meanwhile interest rates in Japan are at a fraction of those on offer during the last carry trade peak in 2007. JGB yields are now negative out to five years and less than half a percent out to fifteen years. Australia has seen particularly large inflows (Australian dollar buying) from Japanese (Japanese Yen selling) seeking yield with Aussie interest rates still above 2% across the spectrum. We estimate that the combined Japanese Toshin and Foreign Currency Annuity positions that have built up in the Australian Dollar are now greater than 5% of Australia's GDP. The total carry positions are likely to be higher still given the growth in complex "currency rate knock-out" structured retail products which are more difficult to quantify but apparently contributing significantly to sales of non-bank financial institutions. The relatively new foreign currency annuities and structured products are sold as providing a foreign monthly interest return on savings for the increasing swathes of retirees in Japan to live off. A popular structured product has been an underlying asset of US high yield shale gas bonds with an AUD or BRL overlay. If the currency or underlying asset price move beyond a certain level much of the interest and capital base are "knocked out". How well the underlying risks are understood by the customer remains to be seen.

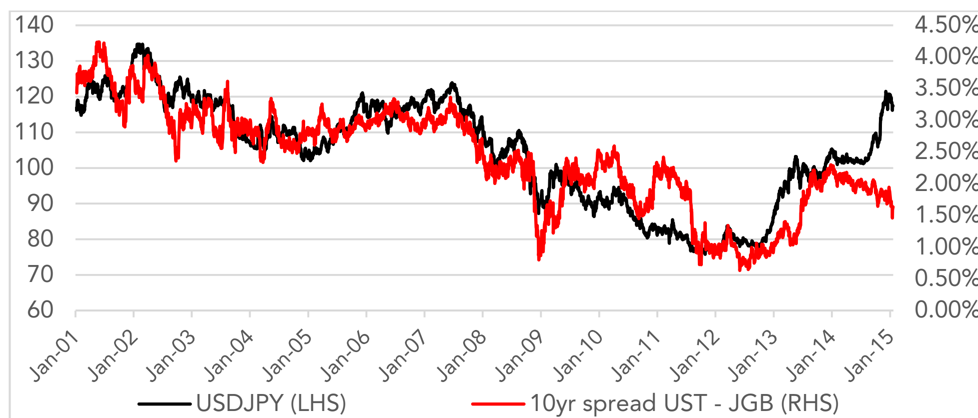
At the same time as these carry positions have sold down the Yen, we have seen near record levels of speculative Yen short selling (as measured by CFTC data). The only time Yen shorting has been materially higher was just prior to the GFC where these positions were also quickly reversed as risk appetite fell.



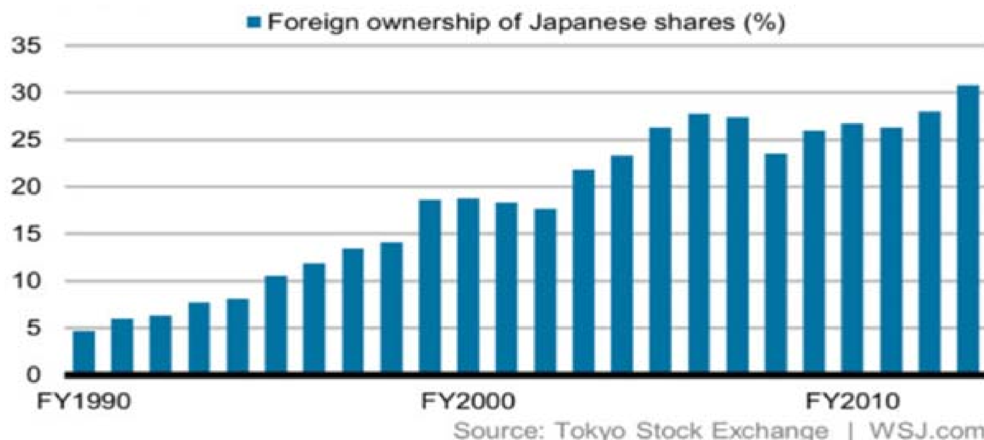
One could argue that the combined carry and speculative short flow has pushed USDJPY to a level that already prices in a substantial increase in the US-Japan 2 year yield spread.



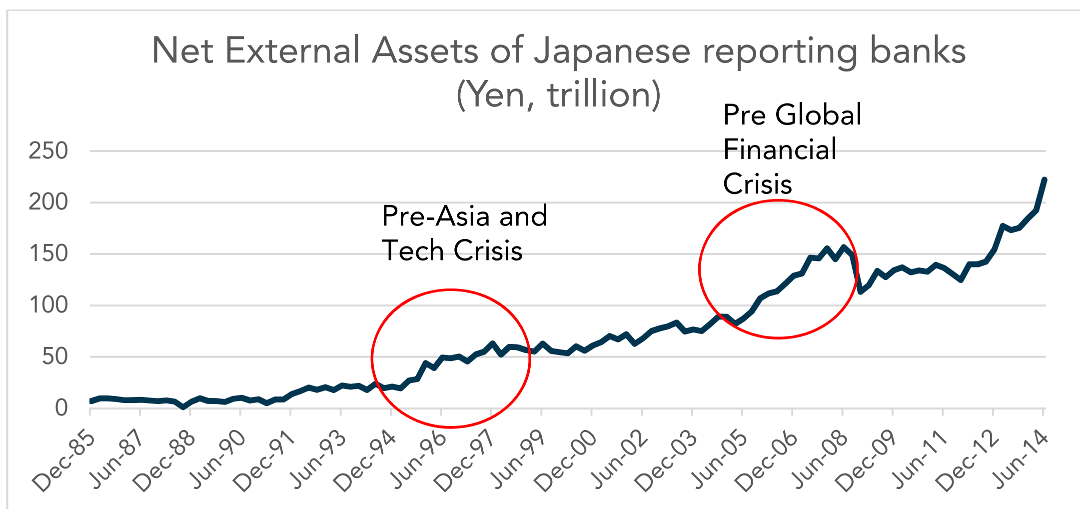
The fact that relative 10 year spreads have been moving in the opposite direction would indicate that the outlook for the US being able to lift rates in the near future while global deflationary pressures persist is perhaps not as clear cut as currency markets seem to be anticipating.



It would also seem that foreign investors, as the "swing buyer" of Japanese equities, are betting again on the carry trade in a way. In that they expect weak Yen currency conditions will remain or become increasingly more accommodative for Japanese corporates. As the chart below shows foreign investors do not have a great track record on timing investment increases in Japan. Excessive foreign investor enthusiasm in Japan during increased risk appetite (as carry weakens the Yen and investors focus less on the structural issues that remain in Japan), the swift exit during risk off further heightens Japan's position as an excellent hedging market.



It is clear to us that a decline in Japanese equity markets from foreign investor selling is highly likely if the high expectations for US rate rises are not met and USDJPY adjusts down towards levels commensurate with current interest rate spreads. If currency market expectations are met and dollar rates do in fact rise then the equity markets could well be surprised by Japan's disproportionately high exposure to any emerging market dollar debt blowback. Not just because emerging markets account for over 59% of Japanese exports and 42% of Japanese FDI in the most recent figures. Emerging markets have also accounted for over 56% of overseas lending by Japanese banks since mid-2007. Overseas lending has also been driven to a record 63% of Japanese GDP by the lack of domestic lending yield. It is worth noting that Japanese banks are historically not the best at timing aggressive overseas lending expansion. Again enhancing Japan's position as an excellent hedging market.



With all of this considered it appears that the conditions are ripe again for Japanese equities to magnify any global market fall. This offers an excellent hedge to any situation leading to global risk off (carry trade reversal) or deviation from US rate increase expectations (global deflation). The risk reward is appealing, with currency and equity markets seemingly already pricing in a scenario of risk on remaining and US rates rises without emerging market blowback. Stock and sector selection remains critical in Japan to both maximise returns and mitigate imbalances in the weightings of indices such as the Nikkei. For further information or discussion please request via the below contact details.

INFORMATION

Issue Date: 19th January 2015

Source: Bloomberg, unless otherwise stated

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