Japan's election and the yen

Louis-Vincent Gave | GaveKal | 25 November 2014

With Japan in the middle of a triple-dip recession, and Japanese households suffering a significant contraction in real disposable income, it might seem at first that Prime Minister Shinzo Abe has chosen an odd time to call a snap election. But that conclusion would ignore the two iron-clad rules of investing in Japan that we never tire of repeating:

> Rule #1: Never underestimate the amount of pain that the Japanese will willingly bear, as long as the pain is taken together, and is seen to be borne for the good of the community.
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> Rule #2: Never underestimate the willingness of Japanese policymakers to test Rule #1.

One other factor explains Abe's decision to ask for the dissolution of parliament. In Japan (unlike the US, UK, France...) the government's performance in opinion polls seems to be tied to the performance of the local stock market. With the Nikkei breaking out to new highs, Abe obviously feels now is the time to try and cement his party's dominant position in the Diet.

But is Abe's decision really such good news for investors? Doesn't it suggest that near term stock market gains may be capped? Obviously Abe, like everyone else, has no clue where the Nikkei will be in six or 12 months time. But, if the prime minister had any more market-boosting tricks up his sleeves, wouldn't he have deployed them first, waited for stocks to rally further, and only then called an election - in which he may have stood a greater chance of winning the two-thirds majority he needs to change the constitution and upgrade Japan's military, his ultimate goal.

The reality of the Japanese equity market in recent years is that it has largely been a play on the yen's exchange rate. Of course, the yen took another leg down - and the market a leg up - when Bank of Japan governor Haruhiko Kuroda announced another aggressive round of quantitative easing at the end of October. But this latest move begs the question: What will drive the yen weaker from here? Given the BoJ's aggressive money printing, and the Government Pension Investment Fund's commitment to invest more abroad, the yen should easily drift down to ¥120 to the US dollar. But beyond that, what will be the catalyst for further yen weakness?

The single most obvious catalyst would be the start of a tightening cycle in the US. Historically, the single biggest driver of US dollar-yen exchange rate has been the difference in interest rates. But if the Federal Reserve refrains from raising rates in the near future, then what else could drive the yen lower? In all probability, it will not be the BoJ, at least in the near term. After Kuroda put his hand in his pocket last month, it is unlikely he will be called upon to act again until the second half of 2015 at the earliest. More importantly, the combination of the decline in the yen over the last two years, the continued gradual decline in global energy prices, and the very slow restart of Japan's nuclear plants means Japan's trade balance is likely to see a net improvement over next few quarters.

Granted, the impact of this improvement on the exchange rate may be overwhelmed by capital flows (from the GPIF and others) out of Japan and into foreign assets. Still, putting everything together, the question has to be whether the yen will fall as far and as fast over the next six months as the consensus expects. Clearly, by calling an election now, Abe is betting that a further big fall in the value of the yen - and a consequent further rise in the Nikkei - is no certainty. Given current market positioning, Japan's macro outlook (a rebound from the latest depressed numbers looks likely), the probable improvement in Japan's trade balance, and the diminishing chance (with weaker oil and a stronger US dollar) that the Fed will opt for an early rate rise, Abe may well be right.

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