Investment update

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Stewart joined OMAM in June 2009 from Newton Investment Management where he held a similar role and managed the Newton International Bond Fund and BNY Mellon Global Bond Funds, both rated AAA by Standard & Poor's. He has more than 20 years' experience of global fixed income markets, having begun his career in 1987 as a broker before subsequently switching to fund management.

Shorting the Japanese bond market via futures

Strengths become weaknesses

Japan has stood aloof from other heavily indebted states due to its ability to fund itself domestically. Will it last?

Whatever makes you strong will, one day, make you weak. Got a good left hook? Someone will send a haymaker to your right. Got an economy with a dominant financial sector? Watch out for a banking crisis. Foreigners love giving you money? Watch out for them going elsewhere. Got a domestic financial institution that gives you lots of money to fund your economy? What if they stop buying your bonds? It is this final point that we are going to look at.

Our subject is Japan. It's a well-rehearsed argument. Japan's demographics and propensity to longevity combined with a low fertility rate have combined disastrously. At the same time, Japan's long-term economic malaise has caused its government to spend money (issue bonds) like it invented Quantitative Easing (QE). With a political establishment that has a typical tenure not unlike the shelf life of milk, this means that Prime Ministers come and go at just the right rate such that nothing ever changes in any real sense. It's been like this for at least a decade. Frankly, as someone who started his career looking at Japan, I've given up watching the details anymore. It's best to concentrate on the big stuff.

The issuance of bonds is now so massive that in absolute terms Japan is neck and neck with America as the largest government debtor in the world. Takahira Ogawa, director of sovereign ratings at S&P in Singapore said last week, "Japan's finances are getting worse and worse every day, every second." Another downgrade beckons. Standard & Poor's have signalled it ahead of time just as they did with the US. This sad picture isn't very different from a number of nations not least of which are the United States of America and the United Kingdom. What is different about Japan is how it is funded. It is this that allows it to have the lowest bond yields in the world and a government debt to GDP ratio of more than 230%.

For those who like to argue that it's all right to have bloated public finances and unending QE, "Just look at Japan" they opine, there should be no objection to the odd eye roll when they repeat their mantra. Whereas the countries like the US and UK depend on the funding of others the Japanese are resolutely and self-reliant on their own nations' savings to fund their deficit. As a consequence, some 94% of the Japanese bond market is owned by the Japanese people themselves and domestic institutions (see Figure 1). As recently as 2010 there was even a national campaign pointing out that Japanese males may be more attractive to women if they owned Japanese government bonds because it demonstrated their thriftiness, security and good sense. I'd like to see that tried in the US or UK; "Government Bonds – Your Gilty Pleasure" could be the slogan here.

But, as we stated at the beginning, whatever makes you strong will one day make you weak. The fact that the postal bank in Japan has 75% of its assets in Japanese government bonds puts a fault line down the middle of Japan's finances. Should yields rise because of loss of faith in the creditworthiness of their government, it will be the Japanese people who are left

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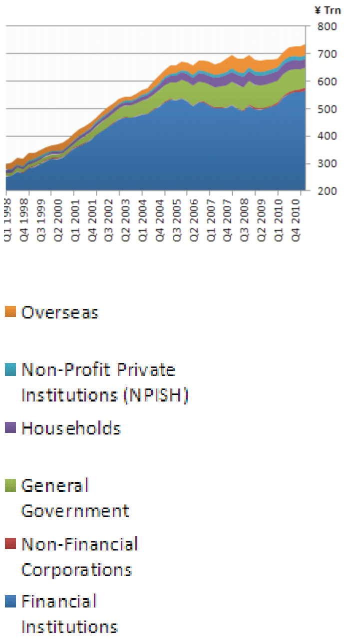
Figure 1: Total JGB Holdings



Source: ThomsonDatastream, OMAM.

impoverished just at a time when they need their savings the most. Banks have recently upped their JGB allocations – but pension funds and insurance companies have gotten the message and stopped buying. Foreign money has taken up the slack to some degree but this is only partly positive because of the fickle nature of foreign capital when trouble appears.

The fact that western fund managers have for decades called for the impending implosion of Japan has been because they insist on seeing it through the prism of western financial sensibilities. They have simply made the call too early. But as things stand, the pressure on Japanese finances really start to mount in the next two years. The total debt of the Japanese government now stands at $12trn and is increasing at a rate of 10% per annum. According to Japan's own figures on Bloomberg some $400bn of debt will mature each year going forwards which will have to be rolled over by institutions like the postal bank – on top of the 10% deficit. Keeping the Ponzi scheme going will require a heroic show of national unity. There are already signs of trouble being signalled from the credit markets. A five year credit default insurance contract on a Japanese government bond costs 130bp which is double what it was just two years ago and exceeds the yield on a five year government bond by over 90bp.

Although I have consistently been "short" the Japanese bond markets over the past 10 years by "not owning" them in favour of a trade that sees western bond yields converge to their Japanese equivalents, I recently actually shorted the market via futures for the first time. The good news is that it costs very little to the portfolio if you are wrong – yields are so low the negative cost of carry is negligible even over the course of a year. Given the funding pressures and the signals coming out of the markets it seems sensible and reasonable to short the market at this time even if just to signal some intent. This exciting prospect has to be balanced against the pitying looks of acceptance one will get from clients and consultants as this call has been made so many times before by so many fund managers to little or no effect.

Interestingly, JGB futures have declined by 1 ¼ points since inception of the trade, adding 13 basis points to performance. But this isn't the point. We want to signal that many of the things that we have been talking about for a decade are rapidly running towards us. Theory is turning into practice and the Japanese government bond market won't escape that process. Their strength is about to become their weakness.

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