Conference call
The End of Kurodanomics

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Executive Summary

In our view, the Bank of Japan is likely to be forced to taper its Quantitative and Qualitative Easing (QQE) program within the next few years. If so, the consequences could be disorderly.

Conference call details

Date: Thursday, September 8

Call Time:
Call 1 5:30pm JST | 9:30 am BST
Call 2 2:00pm BST | 9:00 am EST

Duration: 1 Hour

Participation
To register for the call and for further details, please click here or send us an inquiry at info@japanmacroadvisors.com or info@europacifica.com

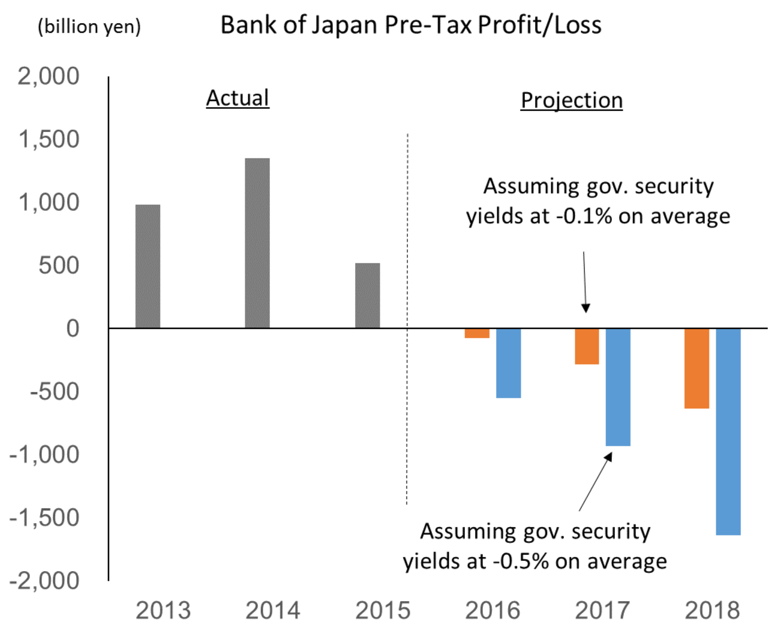
Call for participation

In cooperation with our partner in research Europacifica, we are holding a conference call on "End of Kurodanomics" on September 8. In our view, the Bank of Japan is likely to be forced to taper its Quantitative and Qualitative Easing (QQE) program within the next few years. If so, the consequences could be disorderly. On this call, we examine 1) Sustainability of the BoJ's QQE program, 2) Financial consequences of a sudden stop to QQE, and 3) Impact on financial markets

Introduction

With its 2% inflation target out of reach, the BoJ appears set to continue or even expand its "Qualitative Quantitative Easing" (QQE) strategy for a prolonged period. However, QQE was never meant to be a sustainable strategy over an extended period of time.

BoJ to incur growing losses from 2016 onward



Source: BoJ, Japan Macro Advisors

The longer the policy continues, the greater the distortion inflicted upon financial markets. While the BoJ continues to buy vast amount of negative yielding government bonds, its average cost on its liability remains slightly positive. As a result, the central bank is turning itself into a loss making entity. Without an alteration to its strategy, the BoJ may become insolvent in three to four years.

The accumulation of risk assets is also a particular characteristic of the BOJ's QQE program. By early 2018, the BoJ will own equity assets thrice the size of its capital. A severe downturn in the equity market could wipe out the BoJ's capital. The government could replenish the capital, but it is unprecedented and the consequent political and policy uncertainty is likely to inhibit the ability of the BoJ to credibly continue its QQE program. In our view, exploring the ramifications of a sudden stop of QQE is of utmost importance.

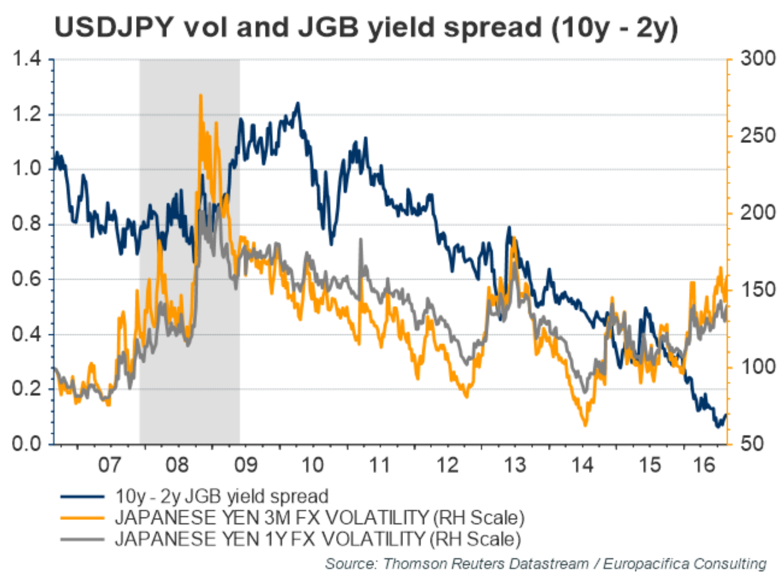
Part 1: The end of Kurodanomics

In the first part of the conference call, we plan to explore following questions.

1) **How long can the QQE program continue? Is there a hard limit?** Multiple factors should prevent the BoJ from continuing on its QQE program for any longer than two to three years. The factors include: accumulation of losses from the negative-carry JGB purchase operation, the increasing dearth of JGB assets and the accumulation of risk assets within the BoJ's portfolio.
2) **What are the financial consequences of exit for BoJ?** Even when the BoJ is to achieve smooth tapering, the BoJ could incur extraordinarily heavy losses as the bank is burdened with zero yielding long term assets while it may need to raise the short term interest rate it pays on the excess reserves on its balancesheet.
3) **What could force the BoJ to prematurely exit from QQE?** There are a few scenarios where the BoJ could be forced to exit QQE in a disorderly manner.

Part 2: Risks and opportunities for investors

JGB yield curve, volatility dynamics may reverse



In the second part of our presentation, we examine yield curve and foreign exchange dynamics under our break-even scenarios:

1) **Carry in the era of negative rates:** A liquidity squeeze in the long end could disrupt the "carry trade" prevalent in the JGB market under negative interest rates

2) **But what if there is a hard stop or taper tantrum?** Alternative avenues in the event there of a liquidity squeeze in the long-end of the JGB curve.

3) **The futures curve – is it correctly priced?** The futures curve may not yet price in the risk of a hard limit on BOJ JGB purchases or sudden exit.

4) **Is volatility correctly priced for a "hard stop"?** Given (3), the market may also underprice the volatility that accompanies the catalyst (reaching the breakeven).

5) **Is the market prepared for potential "Japan selling"?** Cross-currency carry is also likely to be affected by any big catalyst for the JGB market.

6) **Liquidity squeeze plus volatility in JGB's if "taper tantrum":** lower-delta volatilities may also rise if a liquidity squeeze is increasingly priced into the market.

7) **Sovereign risk or liquidity risk?** The emergence of sovereign risk versus liquidity risk would translate to two distinct outcomes for the basis swap market.

We foresee substantial likelihood that the BOJ's balance sheet breakeven may be reached within 2017 and elaborate in further work the specific variables surrounding such an event.

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About Japan Macro Advisors

Our mission is to provide a concise and timely analysis on the Japanese economy for the benefit of global audiences. Communication, especially in foreign languages, has always been a weakness for the Japanese.

For details on our service, please see www.japanmacroadvisors.com/products or send an inquiry to info@japanmacroadvisors.com

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About Europacifica Consulting

Europacifica Consulting is an economic and strategy consultancy, whose capabilities focus upon economic analysis and global financial markets advisory.

For details, please see http://europacifica.com/

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