LAND OF THE RISING YEN

Over the past 14 years, we have written ad nauseam about the implications of the extreme monetary policy provisions implemented by central banks following the Global Financial Crisis. Terms like quantitative easing (QE) and zero interest rate policy (ZIRP) have become deeply entrenched in the investment vernacular. While the Bank of Japan (BoJ) was not the first central bank to introduce negative interest rates (that honour goes to the Swedish Riksbank), they were arguably the most experimental. Now, with headline inflation at a 41-year high and Kazuo Ueda replacing long-serving BoJ governor Haruhiko Kuroda, is a change of tack imminent?

For starters, let's review some of the policies in place. The late Shinzo Abe appointed Kuroda to BoJ governor shortly after becoming Prime Minister in late-2012. Abe's famed "Abenomics" agenda consisted of 3 "arrows": monetary stimulus, fiscal expansion and structural reform. Kuroda was tasked with shooting the first arrow. With growth and inflation targets proving to be stubbornly elusive, the BoJ went progressively more psychedelic. The BoJ's balance sheet has grown by approximately 365% since 2013, Japan's policy rate has been -0.1% since 2016, central bank asset purchases have expanded beyond government bonds into corporate bonds, ETFs and J-REITs, and a yield curve control (YCC) policy was implemented in late-2016 to control the shape of the Japanese government bond (JGB) yield curve.

Before Ueda takes the helm, change is already afoot. The plummeting yen had reached a level of discomfort for the normally pro-debasement Japanese policymakers last October. Per the chart below, the 2-sigma collapse of the JPY/USD rate prompted the Ministry of Finance to intervene in foreign exchange markets. A willingness (or perhaps imperative) to let the yen appreciate removes a hurdle to policy normalization. The BoJ modified the parameters of YCC in December, raising the cap on the 10-year JGB yield from 0.25% to 0.5%. Ueda himself has expressed the need for the BoJ to develop an exit strategy from YCC.

But before readers convert their savings accounts to yen, limiting factors must be acknowledged. The MIT-trained Ueda is by no means an uber-hawk. In his recent parliamentary testimony, he stated that Japanese inflation was primarily attributable to rising import costs, as opposed to an acceleration in domestic demand. As monetary policy is more effective in throttling the latter, he argued the need for meaningful changes to the current policy settings was unwarranted. Furthermore, with the BoJ now owning a significant proportion of the market for a number of different Japanese asset classes, any unwinding of the bank's balance sheet would likely need to be a glacial affair to avoid an outsized market impact.

We agree with Ueda…for the most part. Supply chain entanglements, last year's spike in energy prices and the falling yen have indeed exacerbated imported cost-push inflation. However, as we noted in the latest Ask Forstrong, nominal wages are growing at the fastest pace in 26 years and the ratio of new full-time job openings to applicants at its highest since the early 1970s. Additionally, the reopening in China (Japan's largest trading partner) should provide economic tailwinds throughout the Asia Pacific region. In our view, the most likely BoJ policy on the chopping block is YCC, as it has a highly distorting effect on domestic financial markets. With the yen real effective exchange rate still hovering at a depressed level, things could become very interesting if Japanese pensions and other institutions begin to repatriate capital en masse due to improving prospects at home. This creates an attractive asymmetry for the yen: downside limited by acute under-valuation vs. potential for a sharp upwards re-pricing. Keep your savings accounts where they are, but consider adding Japanese exposure to your portfolios!

GLOBAL STRATEGY OVERVIEW

CASH

With rising money market yields and peaking inflation, cash looks appealing as an offset to equity and fixed income risk. However, macro conditions are also becoming more favourable for equities and fixed income. Accordingly, cash and equivalents have been maintained near neutral levels.

BONDS

Short duration and overweight corporate exposure remains our preferred US fixed income positioning. However, the risk-reward trade-off of US senior leveraged loans has skewed negative, as their floating rate structure means that issuers will face cash flow stress much earlier than fixed rate issuers. Leveraged loan exposure has been liquidated and moved into fixed rate US corporate bonds this quarter.

EQUITIES

Economic momentum will decelerate in many countries around the world as tighter financial conditions reduce demand. However, equity bear markets tend to bottom well before the economy does, and in our view, any downturn in growth has already been substantially discounted in many of our favoured equity markets. Equity positioning has been maintained at overweight levels this quarter.

OPPORTUNITIES

The storm clouds are clearing over Chinese equities, as property sector woes are being managed with macroprudential policies, COVID lockdowns are ebbing and policymakers maintain an accommodative stance. Despite the recent recovery in share prices, Chinese shares are still attractively valued relative to historical levels. Chinese equities are a key opportunity holding in balanced and growth-oriented strategies this quarter.

FORSTRONG STRATEGIES	INCEPTION DATE	1 MONTH	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEARS	SINCE INCEPTION
GLOBAL SERIES								
Global Income	30/06/08	-1.58%	1.74%	-0.55%	2.02%	2.52%	5.46%	7.04%
Global Balanced	30/06/03	-2.47%	2.28%	-2.01%	5.37%	4.07%	6.97%	6.80%
Global Growth	30/06/03	-2.90%	3.13%	-2.62%	7.90%	5.44%	8.49%	7.93%
Core Income	30/06/08	-1.24%	2.30%	-1.00%	2.56%	3.03%	4.64%	6.02%
Core Balanced	30/06/03	-2.35%	2.56%	-1.37%	6.03%	4.86%	6.32%	6.91%
Core Growth	30/06/03	-3.09%	3.38%	-2.83%	8.24%	6.03%	7.55%	7.85%
GLOBAL EQUITY								
Emerging Markets Equity Focus	31/01/19	-5.67%	0.85%	-4.33%	3.63%	-	-	1.78%
Global Ex-North America Equity Focus	31/12/19	-2.64%	4.64%	3.25%	6.07%	-	-	3.23%

* Performance as of February 28th, 2023

Performance statistics for ETF Managed Portfolios are calculated from documented actual investment strategies as set by Forstrong's Investment Committee and applied to its portfolios mandates, and are intended to provide an approximation of composite results for separately managed accounts. Actual performance of individual separate accounts may vary with average gross "composite" performance statistics presented here due to client-specific portfolio differences with respect to size, inflow/outflow history, and inception dates, as well as intra-day market volatilities versus daily closing prices. Performance numbers are net of total ETF expense ratios and custody fees, but before withholding taxes, transaction costs and other investment management and advisor fees. Past investment results provide no indication of future performance. Future returns are dependent on the general investment environment, the nature of the investment mandate and specific portfolio risks. A rate of return for one year or less is not annualized.