

An elusive inflation target becoming ever more e-lusive

*I'm addicted to coffee, addicted to QE,
I think bloated balance sheets are addicted to me.
Got a light Haruhiko?¹*

Japanese monetary policy conduct garners immense and arguably disproportionate attention. However, the real story of recent years has been steady if unspectacular “Third Arrow” micro reforms that have helped to (somewhat) raise the country’s productive potential. Not enough to allow Japan to grow its way out of its government debt morass for sure – not that anyone in their right minds thinks that this is really possible – but enough to restore some decent, underlying vitality to a hitherto moribund economy.

Steady if unspectacular “Third Arrow” micro reforms have helped to (somewhat) raise Japan’s productive potential

Notwithstanding these improvements, I have remained highly sceptical that the Bank of Japan would have very much success in hitting its 2% core (excluding fresh food) CPI target. 2% can be breached, transiently, during episodes of elevated global commodity prices but the structural backdrop has continued to argue for minimal increases in generalised inflation.

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For a range of cyclical reasons – slowing money and credit growth, burgeoning trade headwinds and lower oil prices – the trajectory of the CPI seems likely to weaken again over the coming months. The only significant counterargument would be the signals emanating from a tightening labour market (albeit one that, I have long argued, has rather greater slack in aggregate than the headline unemployment numbers might suggest). Nevertheless, improved household income growth has, hitherto, largely been accompanied by a desire to rebuild savings rather than any major acceleration in consumption.

Indeed, the trajectory of the CPI seems likely to weaken again over the coming months

Furthermore, another structural headwind is steaming down the line which threatens to further undermine the central bank’s ability to generate higher inflation. E-commerce penetration in Japan has significantly lagged behind many other countries but should this gather speed over the coming years as seems likely, it will inject an additional dose of competition and transparency in what has been hitherto an extremely cossetted retail sector. This “Amazon Effect” will be the principal focus of today’s article.

And here comes the “Amazon Effect”

¹ With apologies to.... nah! You tell me.



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In recent years, a growing body of research has emerged which tries to determine the impact of increased on-line purchasing on patterns of inflation.² Isolating the pure influence of growing e-commerce penetration from other drivers of price trends is far from easy. Nevertheless, the provisional evidence, from mainly US-focussed studies, suggests that inflation for goods readily available online could be a couple of percentage points lower than those purchased through traditional channels. Moreover, burgeoning on-line activity – both at the retail and wholesale levels – is driving faster rates of price adjustment and national convergence.

A growing body of research has emerged which tries to determine the impact of increased on-line purchasing on patterns of inflation

Of course, not all purchases can be made online. Moreover, many parties continue to argue that less e-tradable goods and services such as education, healthcare and housing are both underreported and unrepresented in official baskets for reasons of political expediency (not a cudgel I intend to take up here). For example, housing, utilities, transport, education and medical costs, all of which have hitherto likely been more shielded from online competition, comprise 44% and 46% of Korea and Japan's CPI baskets respectively, while the equivalent share for the US is 66%. Still, this leaves a sizeable chunk of

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² Two of the more comprehensive studies I would recommend are: "Internet Rising, Prices Falling: Measuring Inflation in a World of E-Commerce", Austan D. Goolsbee & Peter J. Klenow. NBER Working Paper No. 24649, May 2018 <https://www.nber.org/papers/w24649> Abstract: *We use Adobe Analytics data on online transactions for millions of products in many different categories from 2014 to 2017 to shed light on how online inflation compares to overall inflation, and to gauge the magnitude of new product bias online. The Adobe data contain transaction prices and quantities purchased. We estimate that online inflation was about 1 percentage point lower than in the CPI for the same categories from 2014-2017. In addition, the rising variety of products sold online, implies roughly 2 percentage points lower inflation than in a matched model/CPI-style index.*

and: "More Amazon Effects: Online Competition and Pricing Behaviors", Alberto Cavallo Harvard Business School & NBER, August, 2018 <https://www.kansascityfed.org/~media/files/publicat/sympos/2018/papersandhandouts/825180810cavallopaper.pdf?la=en> Abstract: *I study how online competition, with its shrinking margins, algo-rithmic pricing technologies, and the transparency of the web, can change the pricing behavior of large retailers in the U.S. and affect aggregate inflation dynamics. In particular, I show that in the past 10 years online competition has raised both the frequency of price changes and the degree of uniform pricing across locations. These changes make retail prices more sensitive to aggregate "nationwide" shocks, increasing the pass-through of both gas prices and nominal exchange rate fluctuations.*

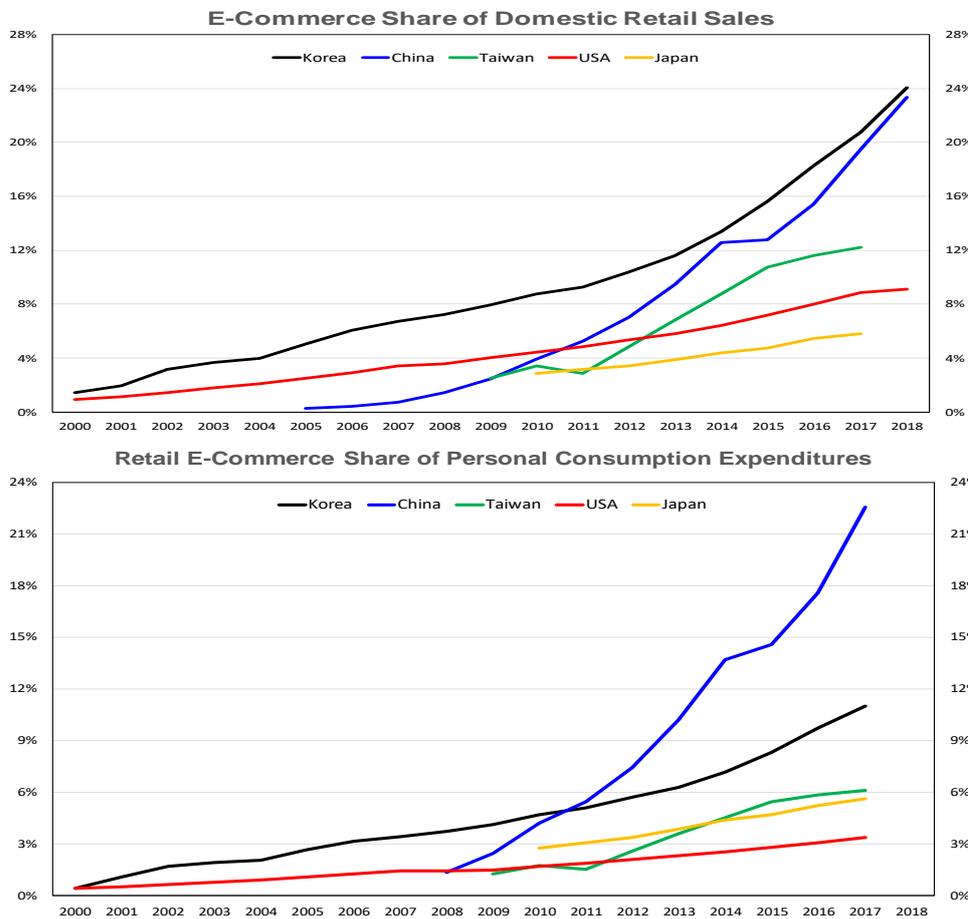


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citizens' everyday purchases subject to the potentially disinflationary impact of growing on-line penetration.

The first chart below suggests that Japan's retail e-commerce penetration significantly lags that of its Asian neighbours and, to a lesser extent, that of the USA. Care has to be taken when reading this chart since different countries include and exclude different types of goods and, in some cases, services from their retail sales statistics. However, if we consider the same numerators set against personal consumption expenditures (lower chart, which includes all services), the rankings are not materially altered.³

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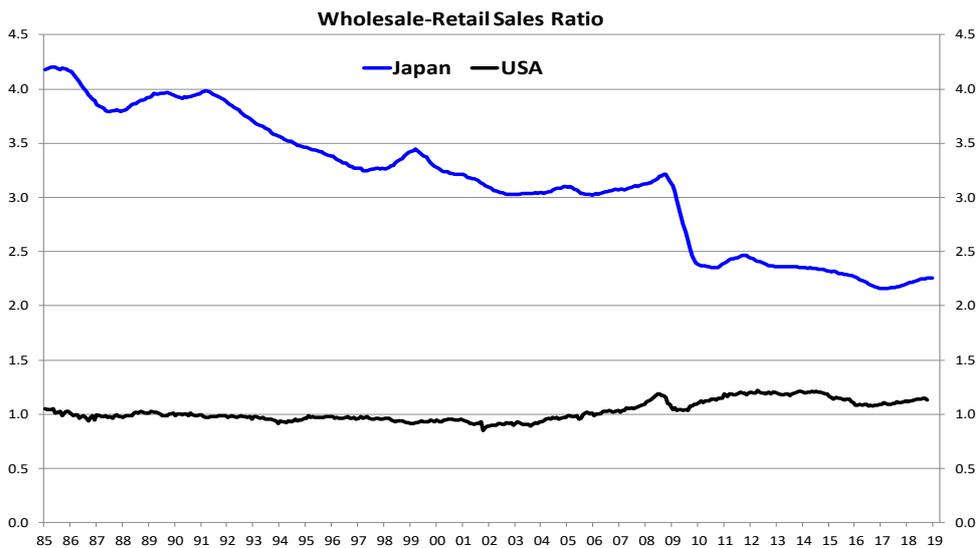
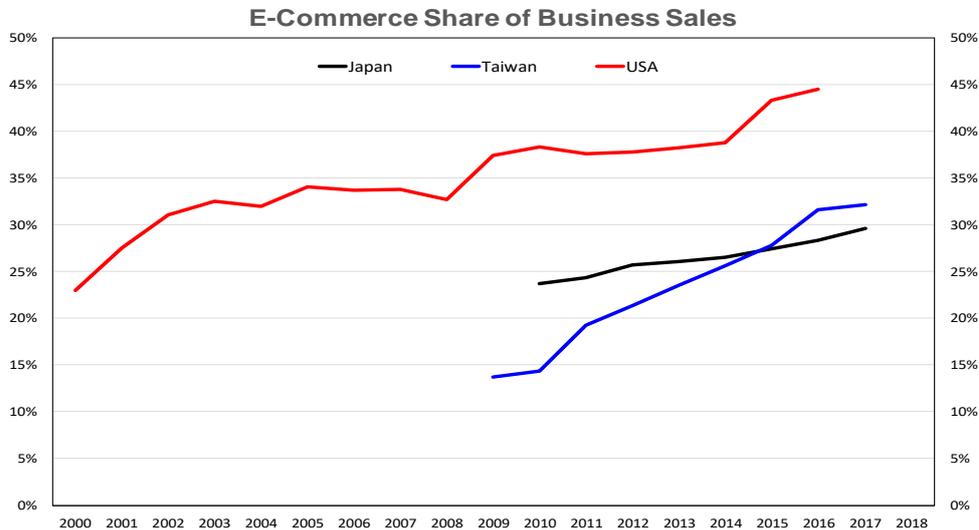
³ For example, the Korean statistics cover goods only whereas most other countries at least include restaurant and accommodation purchases. The Chinese series, idiosyncratically, also incorporate a range of government purchases. Richer countries would tend to have a higher percentage of services purchases in PCE which largely explains America's bottom ranking.



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While Japan is clearly a laggard, its retail e-commerce penetration rates continue to steadily rise. This goes too for online B2B sales where, as the upper chart below illustrates, e-commerce penetration is significantly higher. (Unfortunately, only three of the five countries I survey here publish figures for business e-commerce sales.) The lower chart, meanwhile, is an old favourite I have trotted out many times over the last few decades, used to illustrate that the Japanese wholesale-retail supply chain has slowly, yet materially, become more efficient over recent decades. It can still become more efficient though as B2B and B2C commerce becomes even more influential on overall supply chain pricing.

Japan's B2B e-commerce penetration is significantly higher



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Given this backdrop, it had been surprising – to me at least – that one had not seen more e-commerce impact articles of the type cited early emanating from Japan. As a result, on my last trip there late last year, I decided to have a deeper dig around. This is clearly a sensitive subject for a central bank which has regularly had to defer the target date for attaining its inflation goals, and has now dispensed with a “mission accomplished” date altogether.⁴ However, various interrogations and triangulations led me in the direction of a paper posted on the BoJ website (only available in Japanese) whose title can roughly be translated as: “Influence of the expansion of internet mail ordering on prices.”⁵

The authorities are quietly assessing the potential disinflationary impact of increased e-commerce penetration

The paper’s conclusion seemed to be that between 2016 and 2018, the estimated impact on competing goods prices – food, clothing and other household goods which comprise around a third of the overall CPI basket – was 0.34% per annum.⁶ Simplistically and linearly extrapolating, were Japanese retail e-commerce penetration rates to trend towards Korean or Chinese levels over the coming years, a 0.1% overall annual drag on overall prices could become nearer 0.5%. This is not an insignificant figure in the context of a persistently low inflation-flirting-with-disinflation environment.

Between 2016 and 2018, the estimated impact on competing goods prices was 0.34% per annum

An increased prevalence of e-commerce seems both intuitively and statistically to have a negative influence on price rises, but as an offset, does it deliver an overall boost to total consumption, or merely cannibalise sales via traditional channels? The charts that follow seem to suggest more of the later unfortunately.

Does e-commerce deliver an overall boost to total consumption, or merely cannibalise sales via traditional channels?

⁴ Good economic practice in my opinion. Giving dates and numbers is always to be recommended; giving the two at the same time, less so. Also, forecast, but forecast often....

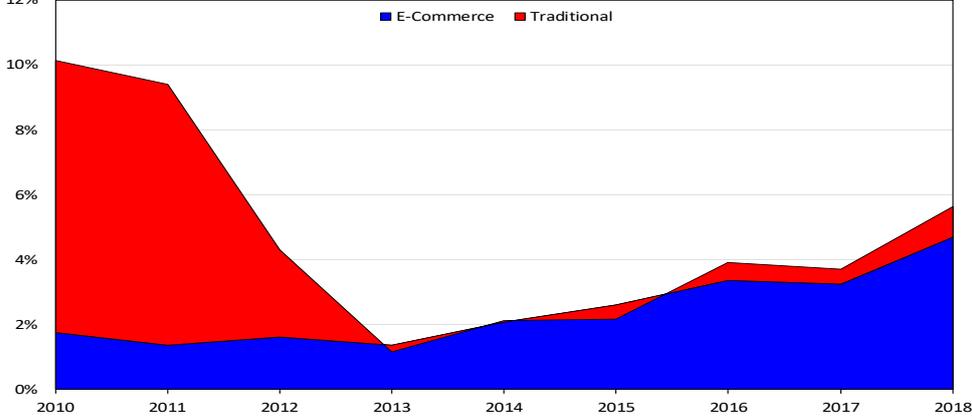
⁵ http://www.boj.or.jp/research/wps_rev/rev_2018/data/rev18j05.pdf

⁶ I would caution readers against relying overly on my own crude translation.

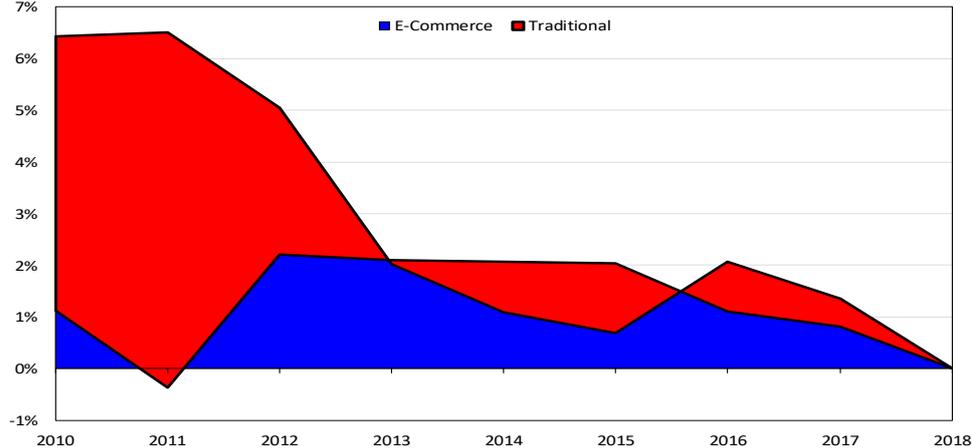


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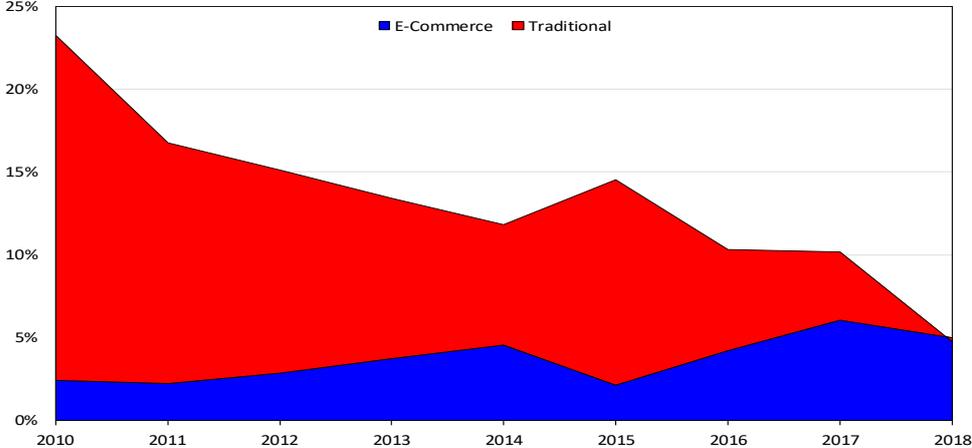
Korea: E-Commerce and Traditional Channel Contributions to Annual Nominal Retail Sales Growth



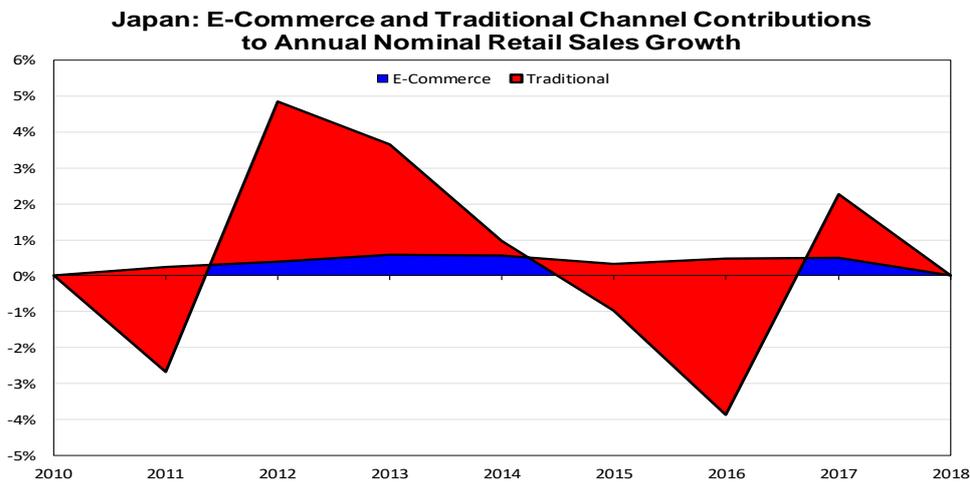
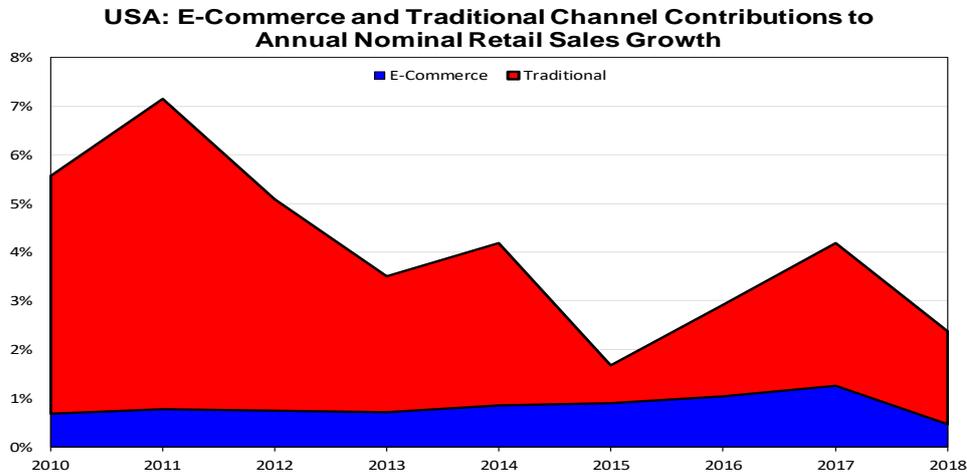
Taiwan: E-Commerce and Traditional Channel Contributions to Annual Nominal Retail Sales Growth



China: E-Commerce and Traditional Channel Contributions to Annual Nominal Retail Sales Growth



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Ostensibly Japan seems well set up for accelerated online purchasing. IT literacy and penetration rates are high; over 90% of homes have internet connectivity, smartphone penetration rates are around 80% and the country has 40% more mobile phone subscribers than people. Japan also has excellent physical infrastructure and extremely well-developed distribution networks. Moreover, high levels of societal trust mean that parcels left on the doorstep are highly unlikely to be stolen.

Ostensibly Japan seems well set up for accelerated online purchasing

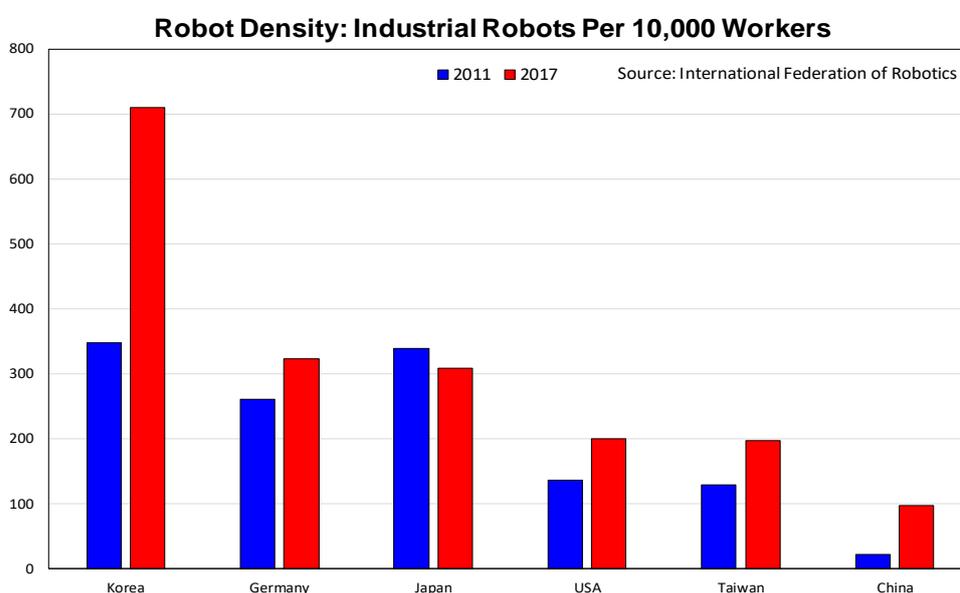
Set against this, Japan's unrivalled quality of service means that if one has to pay through the nose for one's products, one might as well pay for the best.⁷

⁷ The trite investment thesis is shop in a Japanese full-service retailer and own shares in a disrupter.



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Although Japanese consumers have had fewer non-pecuniary incentives than those in other countries to abandon their physical shopping habits, price sensitivity cannot be zero in aggregate. A more granular constraint is a dearth of labour to staff the delivery sector. Driverless vehicles, will likely provide a suitable supply side response over time⁸ as will increased adoption of robots both in the industrial sector (see chart below), but even more so in services such as health and elderly care. I also suspect that increased immigration – more on this later though always be careful not to label it as such – will also play an increasing role.



It is probably worth a short digression into Japanese attitude to robots and specifically what robot sociologist, Naho Kitano, formerly of Waseda University and founder of HiBot Corp, terms a differing ontological reality between Japanese and Western conceptions.⁹ This fundamentally stems from

“I love you (Miss Robot)”

⁸ On-demand driverless vehicles should also curtail the dangers of elderly drivers, especially in the countryside. Rural areas have been hollowed out and in many cases are bereft of youngsters who could act as potential chauffeurs. Moreover, local rural transportation links, while still reliable, can be infrequent. Hence many elderly drivers, who probably should no longer be on the roads, rightly feel they have no other choice. My own experience driving in the boondocks has been to always keep my distance and expect the worst.

⁹ See, for example, http://www.roboethics.org/atelier2006/docs/Kitano_slides.pdf as well as this more recent article by Joi Ito <https://www.wired.com/story/ideas-joi-ito-robot-overlords/>



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the Japanese belief in *kami*,¹⁰ broadly speaking, but difficult to translate with any accuracy, the spirits that are everywhere and inhabit even seemingly inanimate objects. To paraphrase Kitano, while a Japanese person interacting with a machine recognises that a robot is not human, the rapport created by the interaction allows the user to sense the robot's inner spirit leading to closer and more intimate relationships. If this assessment is indeed accurate, then this has particular importance for robots put into service in the educational and caring milieus.¹¹

(Shallow) philosophical discourses notwithstanding, a retardant, though I suspect not an ultimately binding constraint on e-commerce adoption, is Japan's ongoing attachment to cash-based transactions. Even today, many shops and restaurants refuse to accept plastic and in many outlets a card being proffered will still elicit an audible tooth-sucking. The cash-GDP ratio, after two decades (and counting) of zero interest rates has risen to 18%, a ratio only matched in the developed world by Hong Kong where the demand for HK dollars is rather less a function of purely local purchasing preferences. Switzerland, another country with heavy foreign demand for (ahem, large denomination) notes lags with a third-place 12%.

Japan has an ongoing attachment to cash-based transactions

The traditional argument set forth was that physical cash enabled business entertainment outlays and political slush funds to go undetected, but in recent times, the former at least, have become far less ubiquitous and significantly harder to disburse on a non-receipt basis. These days, one can only assume that the Japanese addiction to cash is an (understandable?) function of distrust of the banks and their government, as opposed to an atavistic aversion to electronic payment channels more generally (Japan's embrace of cryptocurrencies would not argue otherwise.) Conversely, Korea's cash-GDP ratio

Even today, many shops and restaurants refuse to accept plastic and in many outlets a card being proffered will still elicit an audible tooth-sucking

¹⁰ Shinto holds that gods or *kami* are to be found and are embedded everywhere, in the animals, in the water, in the mountains, in the trees, and in the soil. Hence whatever happens is a reflection of the natural order of things that man cannot and indeed should not seek to change.

¹¹ I obtained something of a sense of this a number of years ago when I was fortunate enough to attend a workshop where I got to interact with a couple of fascinating presenters and their robots. See, respectively: <https://www.youtube.com/watch?v=uD1CdjlRtBM> and <https://www.youtube.com/watch?v=yYFLVFniIto> The robot geriatric care-seals were easy enough to relate to but frankly, this *gaijin*, was not sure whether he was more discombobulated by Professor Hiroshi Ishiguro himself or his android twin. Probably the former.



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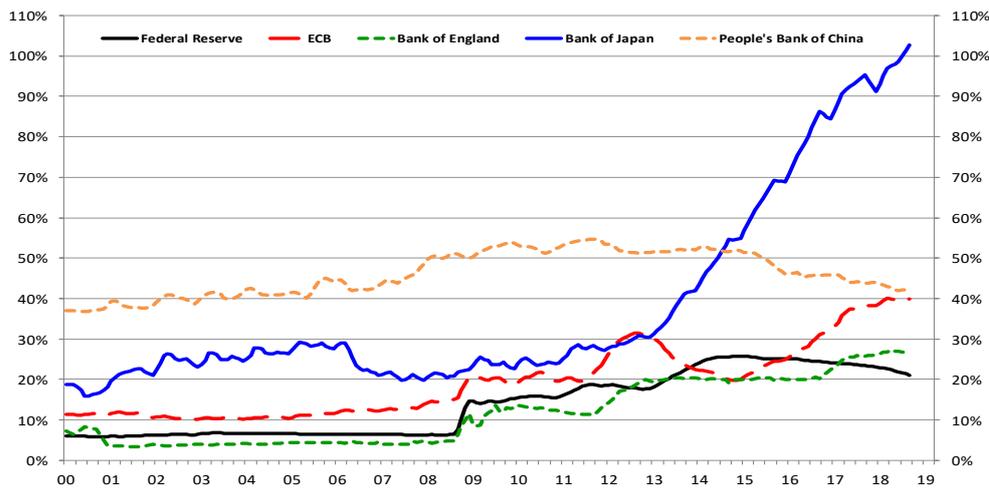
of only 6%, and China's of 8% (the PRC was at Japanese levels in the 1990s) suggest that their respective citizens are far more trusting/naïve and/or place a far lower value their privacy.

In conclusion, while there are various retardants which might limit the rate of Japanese adoption of e-commerce in comparison to say Korea and China, penetration rates seem surely set to rise further providing the authorities, *ceteris paribus*, with an additional disinflationary headache. To this needs to be added various cyclical headwinds to which I now turn.

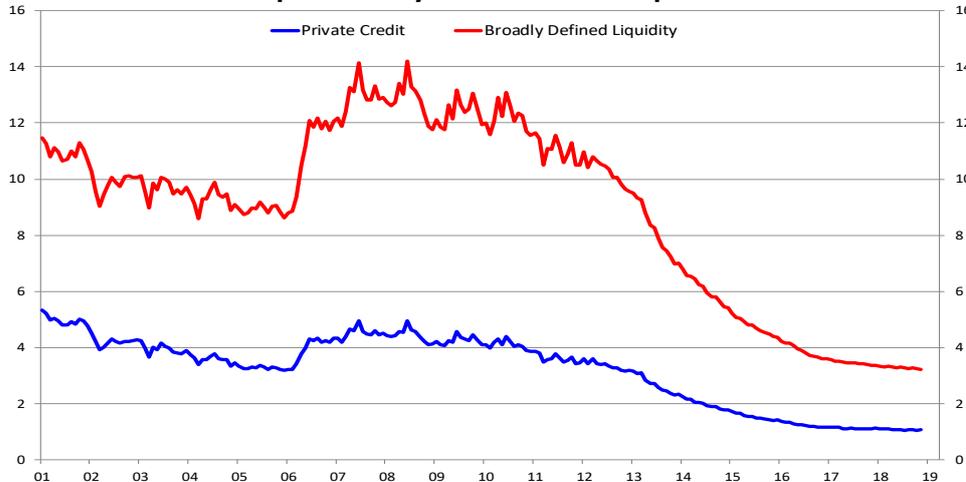
No central bank has been trying to reflate a collapsed soufflé as aggressively and for as long as the Bank of Japan. Yet for all the BoJ's (metaphorical) huffing and puffing, the multipliers have stubbornly failed to respond.

Irrespective, penetration rates seem surely set to rise further providing the authorities, *ceteris paribus*, with an additional disinflationary headache

Central Bank Balance Sheets as a Percentage of GDP



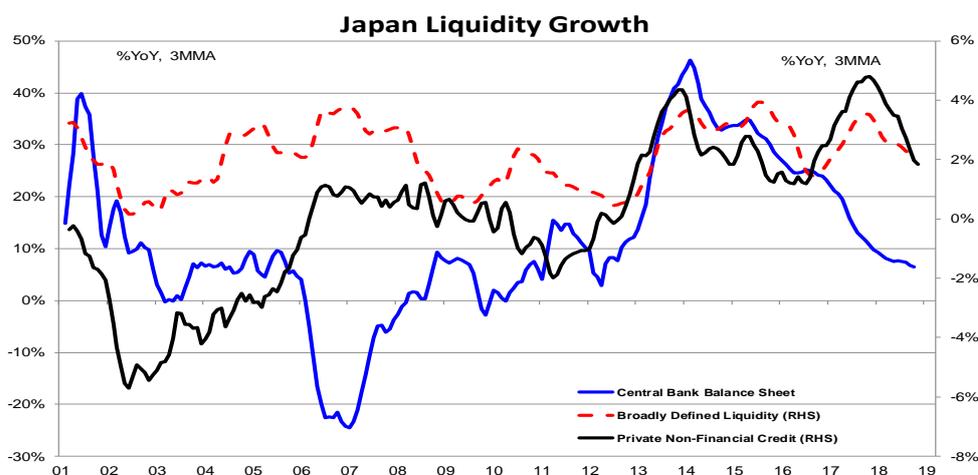
Japan Money and Credit Multipliers



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To be fair, over the past half-decade, broader money and credit aggregates have returned to respectable growth rates though whether this is attributable to active monetary policy decisions or other factors – incremental supply side reforms, the coincidental ending of the private sector’s structural deleveraging cycle,¹² better external demands conditions, and the like – it is hard to prove either way. Irrespective, the recent decelerations seen would not seem to bode particularly well.

Recent money and credit decelerations would not seem to bode particularly well for higher inflation prospects



The deceleration in the growth rate of the central bank’s balance sheet has had some commentators ruminating over whether or not the BoJ has been attempting a stealth tapering. My strong retort continues to be that it has not been, but given the regularity of client questions received, I can only conclude that the central bank’s market communication strategy has been somewhat flawed.

The BoJ has *not* been attempting a stealth tapering

Personally, whenever I have visited the BoJ in recent years, the same two messages have been consistently and clearly imparted, to wit:

- a) you can in effect forget the quantity purchase target, it is the yield anchor target that matters; and
- b) do not expect any significant moves away from the current policy stance until there is far greater evidence of *sustainable* inflation and wage growth.

¹² Japanese household and corporate balance sheets, in aggregate, look pretty strong in an international context. The government balance sheets rather less so....



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Nevertheless, others still need convincing it seems, since the public messaging has been – deliberately or inadvertently – somewhat ambiguous. The BoJ shifted in its monetary policy framework in September 2016 to anchoring 10-year government bond yields around zero (subsequently tweaked to a 0.2% fluctuation either side) while simultaneously targeting purchases of JGBs at an annualised rate of JPY80 trillion. This was an effective move to a price rather than a quantity target for JGB purchases, and in my read, subsequent and regular quantity undershoots, have been the natural consequence of not wanting 10-year yields to drop sustainably below zero.

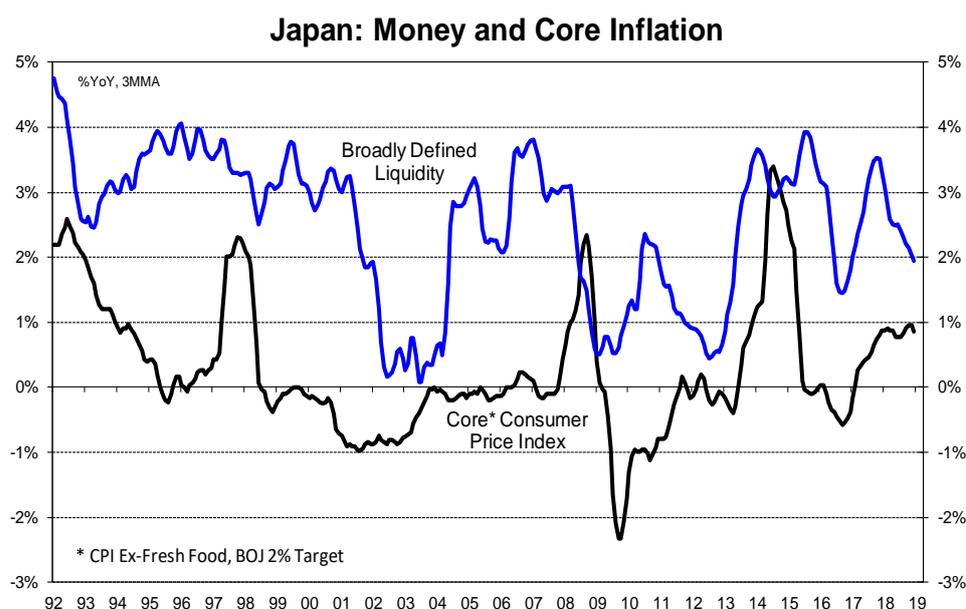
Nevertheless, the public messaging has been – deliberately or inadvertently – somewhat ambiguous

So why not communicate this seemingly obvious point more forcefully? One reason might be a desire not to spook markets which might misconstrue the dropping of an explicit target for quantity purchases. Alternatively, and this may sound rather unconvincing, it has been my understanding that a lively debate amongst the board members has continued to rage with some members still believing that quantity targets remain more important. Hence these have been retained as an optic for face reasons as much as anything else. Neither of these are, I know, particularly edifying explanations for those more used to more openly confrontational Western ways. But Japan often works very differently....

Forget the quantity purchase target, it is the yield anchor target that matters

Deliberate tightening, benign neglect, or otherwise, monetary trends do not imply an imminent inflation acceleration from here.

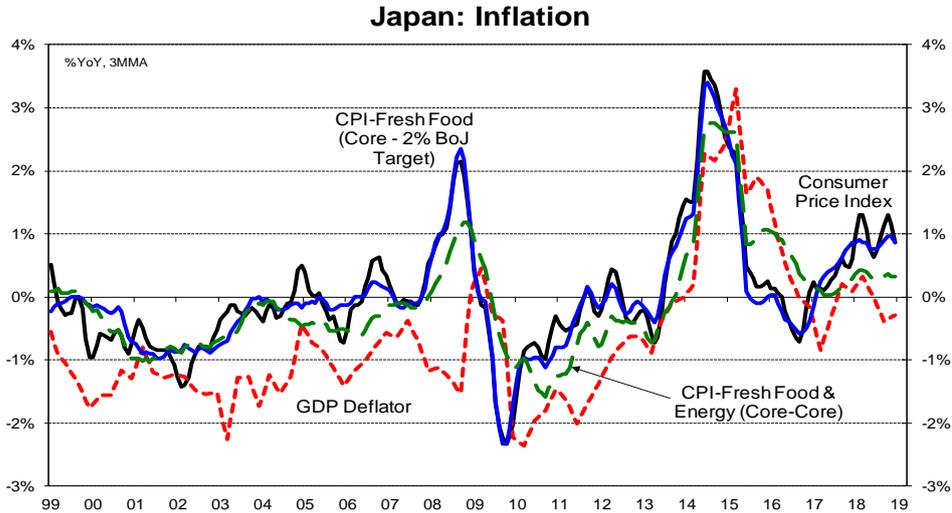
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Indeed, strip out energy prices, or focus on the broad GDP deflator, and the inflation quest looks all the more quixotic.

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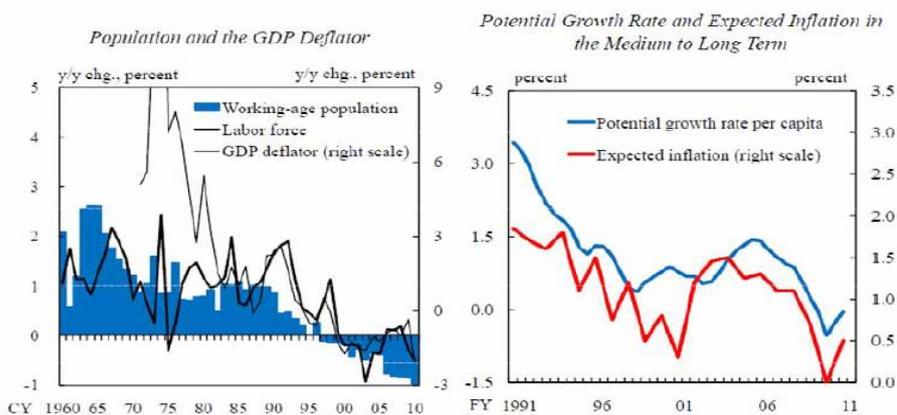
Former BoJ Governor Masaaki Shirakawa, both while in office and since, has often argued that the disinflationary impact of Japanese demographics will be hard to defeat with monetary policy alone. I have always been sympathetic to such arguments but having started my working career as a trainee actuary, I probably would say that.

The disinflationary impact of Japanese demographics will be hard to defeat with monetary policy alone

Chart 16



Population Growth and Inflation in Japan



Note: Lagged values are used for population growth because they precede inflation by a year. Expected inflation is the inflation outlook for CPI in the next 6 to 10 years by the Consensus Forecast (average of the April and October surveys in each year). The potential growth rate is calculated by the Bank of Japan.
Sources: Bank of Japan; Consensus Forecast; Ministry of Internal Affairs and Communications.

Source: <https://www.bis.org/review/r120531e.pdf>

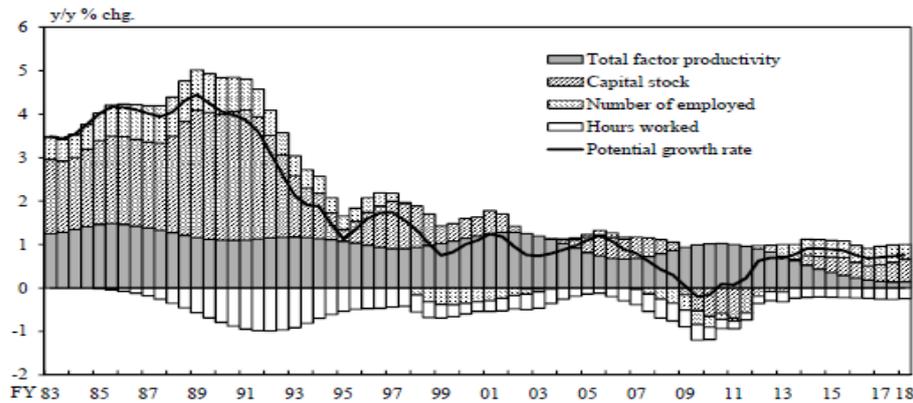


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The good news on this front is that potential growth has started to edge up again, largely due to improved labour supply prospects.

Potential growth has started to edge up again, largely due to improved labour supply prospects

(2) Potential Growth Rate



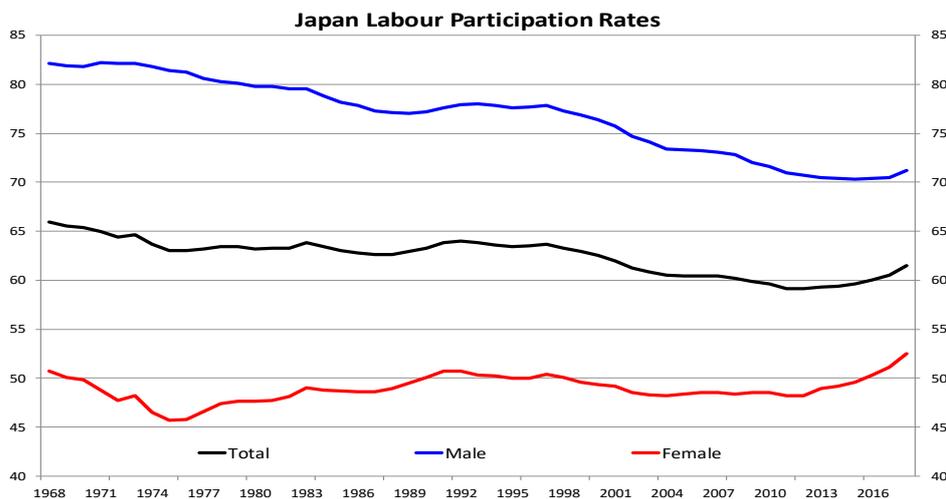
Notes: 1. The output gap and the potential growth rate are estimated by the Research and Statistics Department, Bank of Japan.
2. The Tankan factor utilization index is calculated as the weighted average of the production capacity DI and the employment conditions DI for all enterprises. The capital and labor shares in the "National Accounts" are used as weights. There is a discontinuity in the data in December 2003 due to a change in the survey framework.

Sources: Cabinet Office; Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Ministry of Economy, Trade and Industry.

Source: https://www.boj.or.jp/en/research/research_data/gap/gap.pdf

Whether or not Prime Minister Abe is a true feminist, or whether he has just had his ear bent by Akie, Japan *has* become somewhat less misogynist in recent years.

Japan has become somewhat less misogynist in recent years

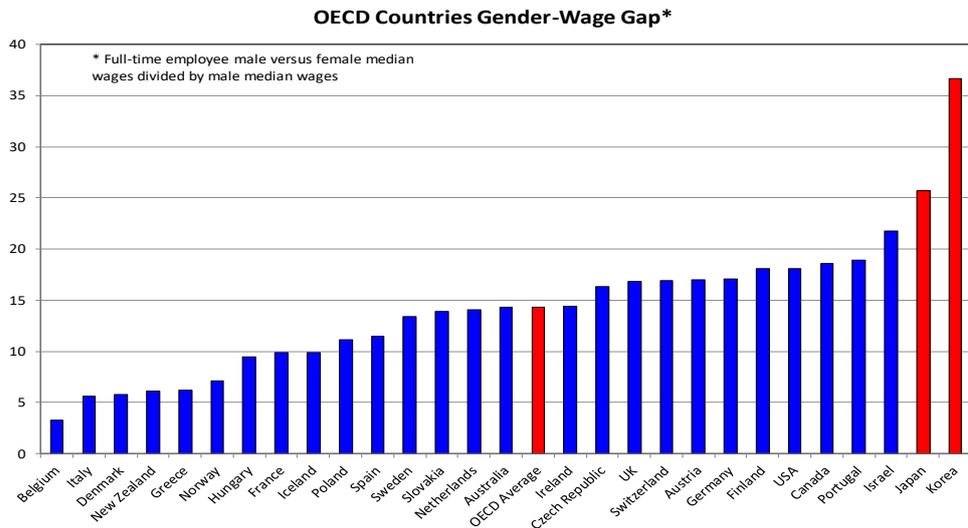


Japanese women are some of the world's most highly educated, yet have hitherto been woefully underutilised. This seems to be changing thanks to a combination of demographic necessity and policies to improve workplace flexibility and greater provision of child and elderly care. There is still plenty



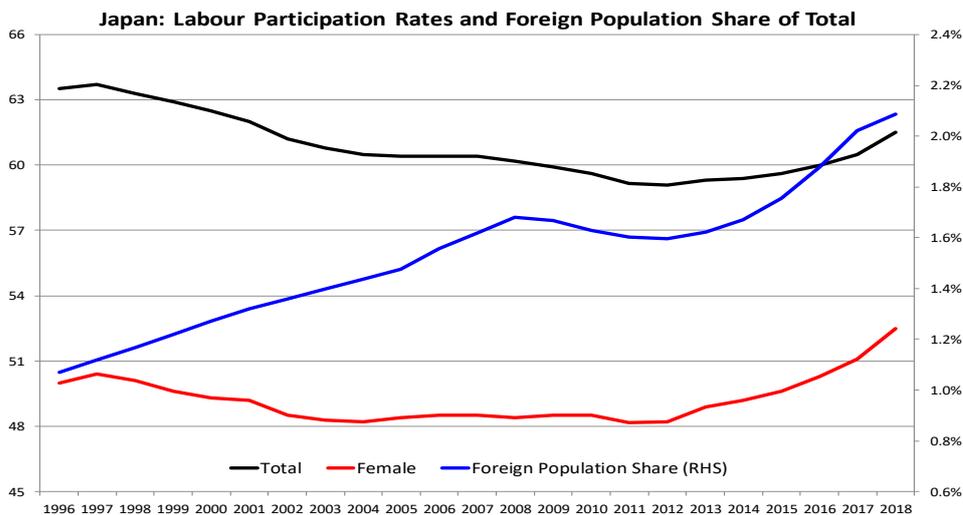
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of scope to pay the ladies more equally, though in Japan's defence, the gender-wage gap has narrowed in recent years. And it is a lot better than in Korea, a country facing many similar challenges.



Japan is also becoming gradually, albeit grudgingly, more open to foreign workers; at least as long as they do not expect to stay permanently and become citizens. Recent foreign visa reforms¹³ should see the foreign-born population share rise further though compared to UK or US levels of 13-15%, it remains early days.

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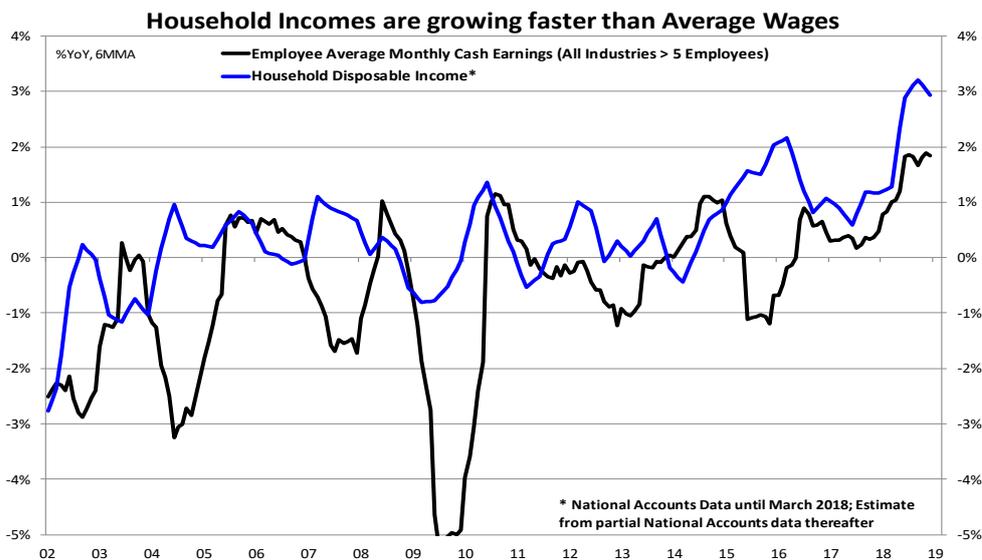
¹³ See, for example: <https://www.ft.com/content/6f47f576-de8c-11e8-9f04-38d397e6661c>



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It has long been my contention that a focus on the authorities' preferred average monthly cash earnings series would tend to understate overall labour incomes. My argument has been that greater numbers of lower-paid women and foreign workers entering the labour force would pull down the average even as overall household incomes rose. A further statistical drag has been provided by increasing numbers of 60-year-old male permanent employees retiring and then being hired back on new contracts paying significantly less. 700-800,000 male workers will reach the age of 60 each year, on average, over the next ten years, while only 500,000 or so youngsters will enter the work force over the same period. Average wage growth has indeed been rather more subdued¹⁴ than that of household disposable income (chart below) which has underpinned my relatively sanguine view of underlying domestic economic vitality.

Household incomes have been growing rather faster than average wages

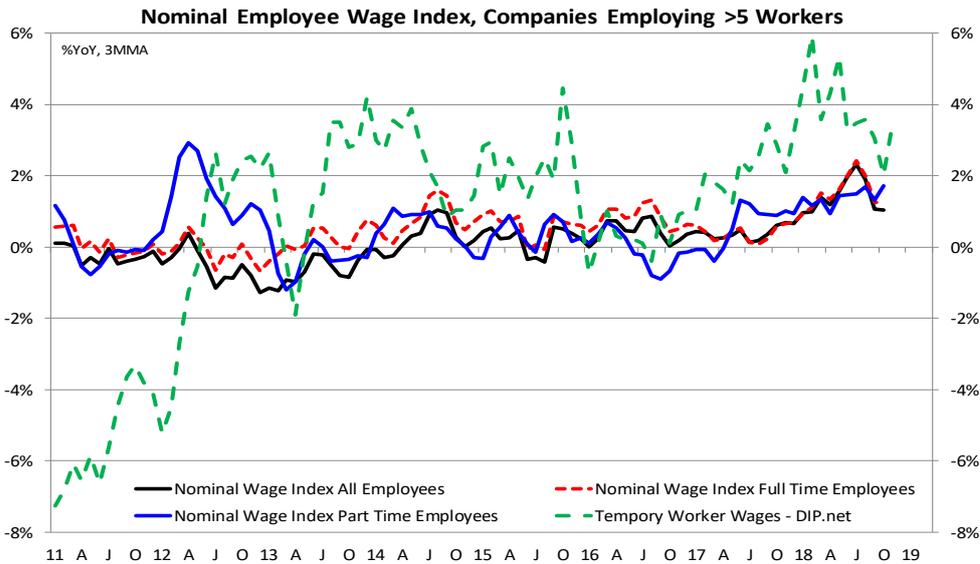


¹⁴ So subdued in fact, that the Abe administration apparently lent on the Ministry of Health, Labor and Welfare to quietly change its sampling methodology to deliver accelerating wage readings from early 2018. Having been rumbled, some (partial?) revisions were belatedly released last month which somewhat pulled down the headline numbers. Further revisions may well transpire but irrespective of statistical shenanigans, some gentle progress has clearly been achieved.

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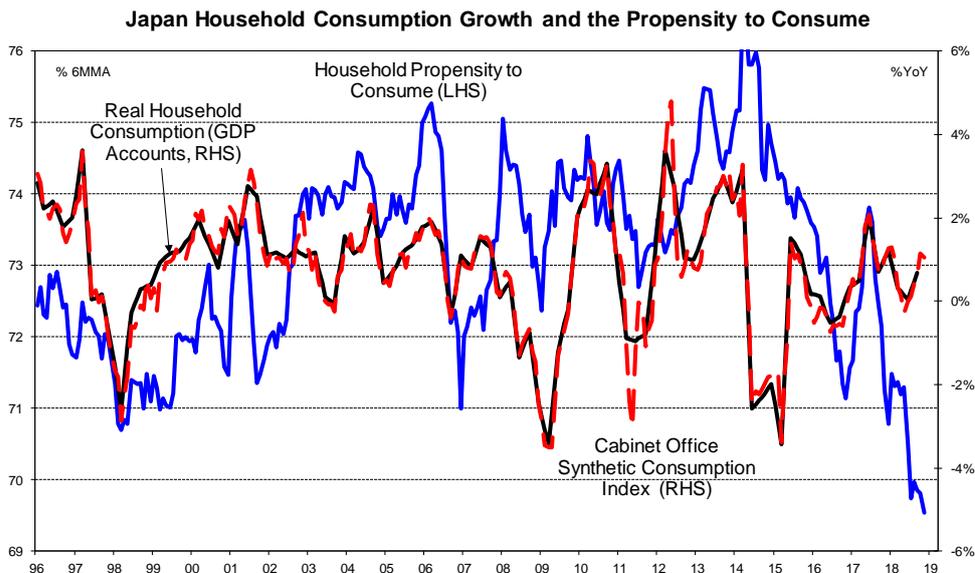
The fastest, and most volatile wage growth has been seen across the temporary workers category reflecting corporate unwillingness to enter into longer-term, more difficult to exit contracts.

The fastest, and most volatile wage growth has been seen across the temporary workers category



The precarious nature of such employment has arguably exacerbated the household sector's desire to rebuild savings. Hence consumption growth has not been as strong as improved labour income prospects might have argued for.

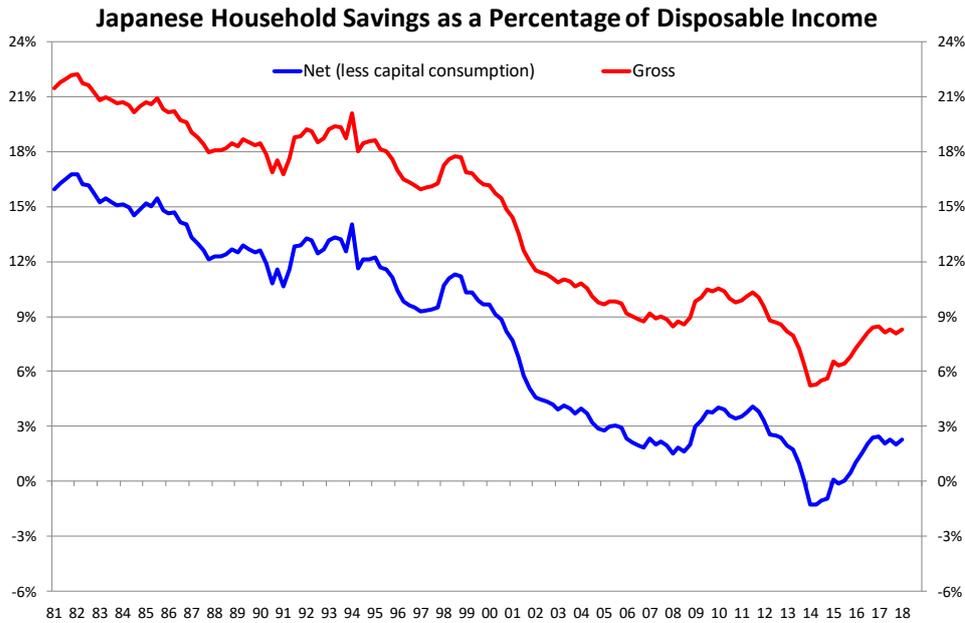
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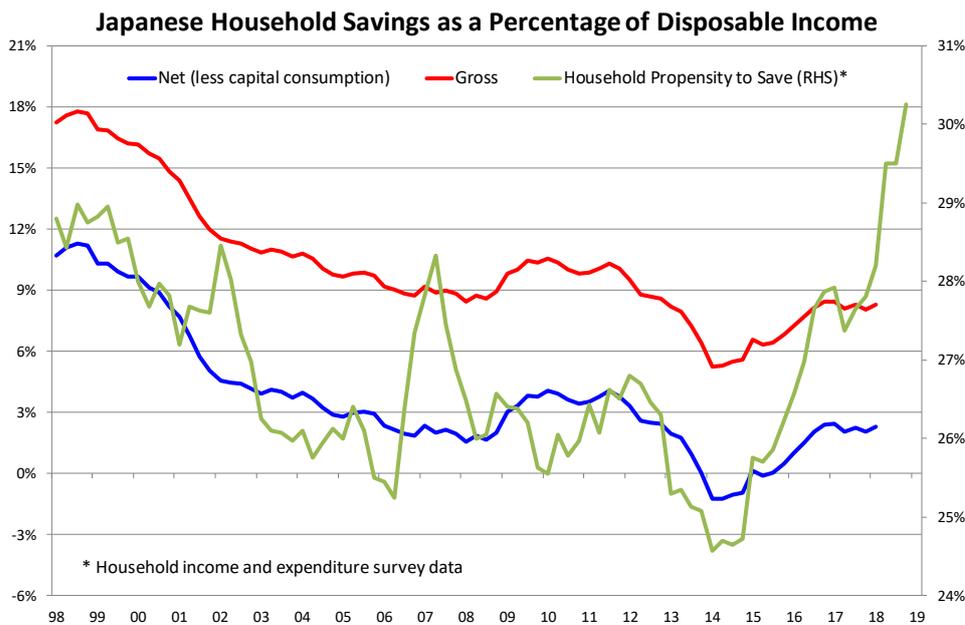
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The partial household savings rebuild is clearly evident in the next chart below. Unfortunately, the full national income accounts are only available with a significant lag with the last release being for March 2018.

The savings rebuild process remains intact



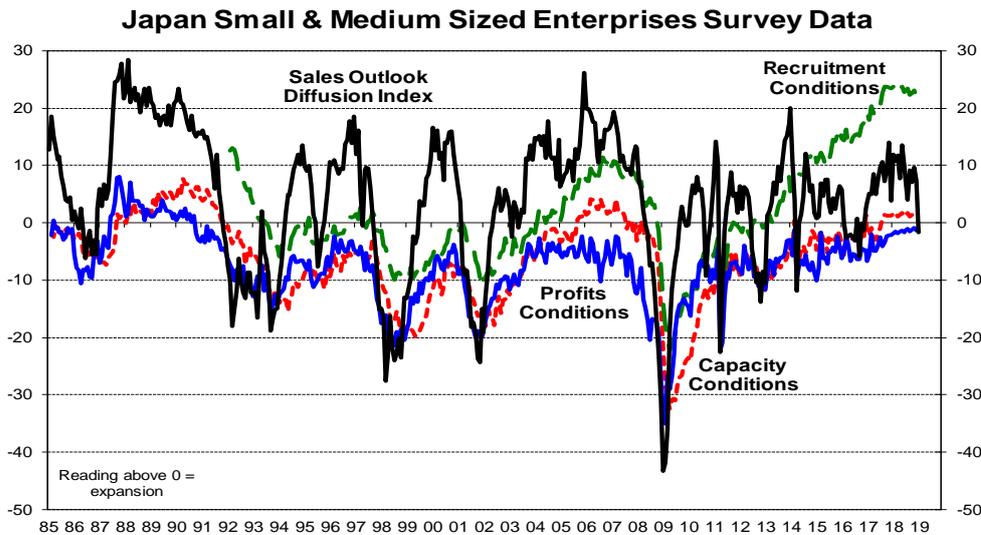
Nevertheless, a rather crude proxy suggests that the rebuilding process has subsequently continued.



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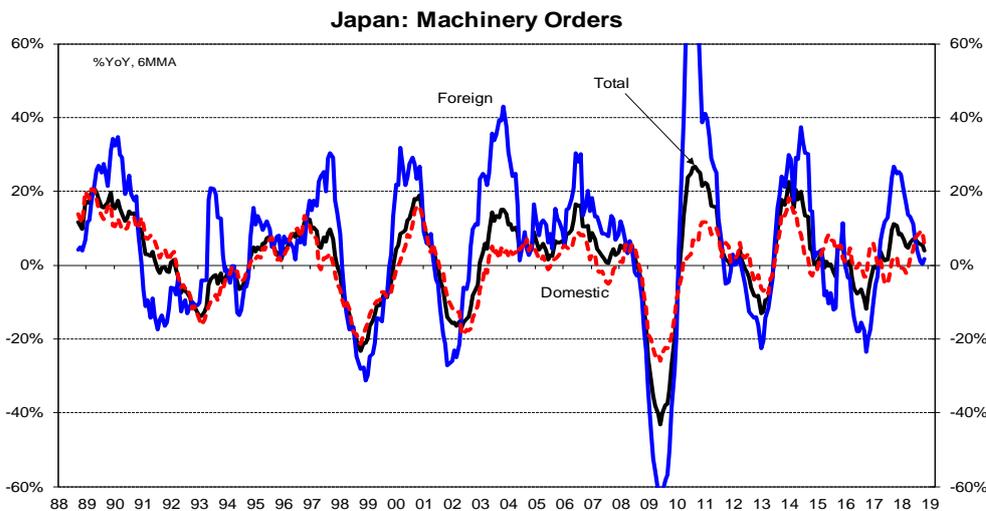
As in most countries, small and medium sized enterprises dominate employment, in Japan's case accounting for about 70% of the total. For a number of years, SMEs have been complaining about their difficulties in finding labour, though not enough to hire more full-timers and pay everyone significantly better it would seem. Recent months have seen conditions ostensible soften.

Recent months have seen SME conditions ostensible soften



Although Japan's domestic underpinnings have improved somewhat in recent times, this remains a highly export-dependent economy. For example, machinery orders have similarly lost momentum pulled down by sharply weakening overseas demand conditions.

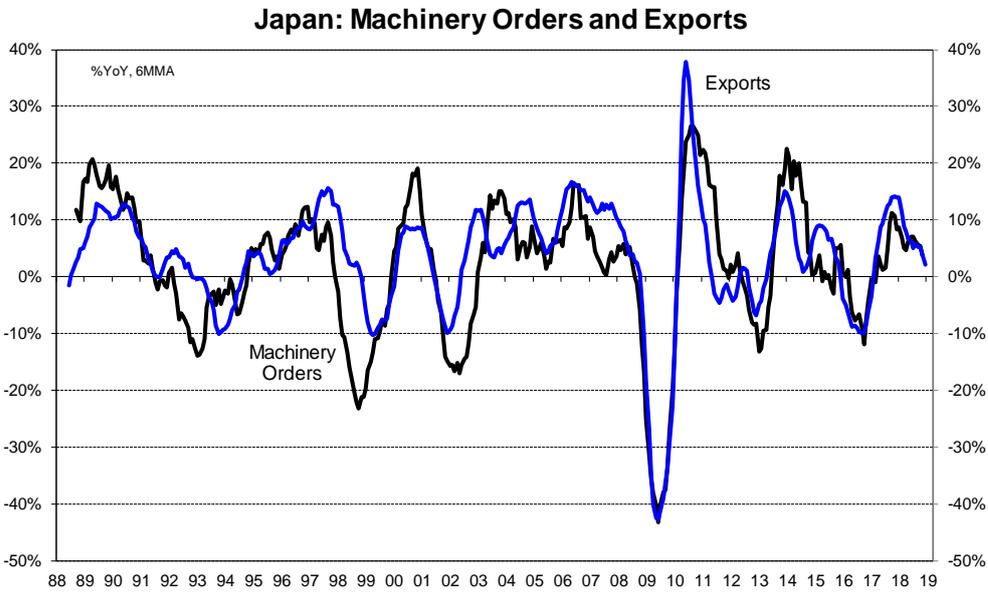
Although Japan's domestic underpinnings have improved somewhat in recent times, this remains a highly export-dependent economy



An elusive inflation target becoming ever more e-lusive

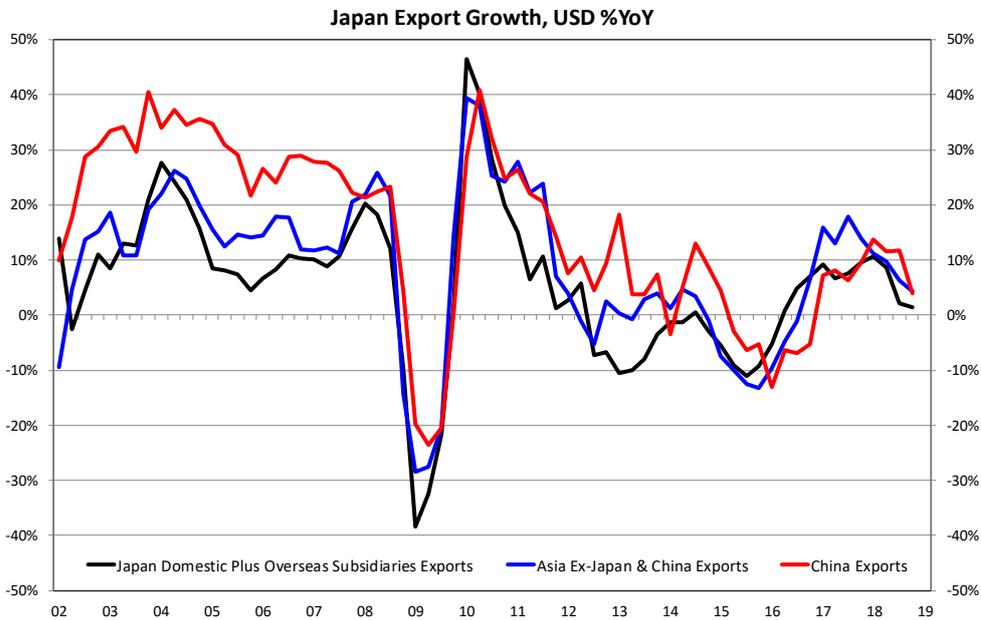
The external drivers are even more apparent here.

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Burgeoning export weakness is far more than just a Japanese problem.

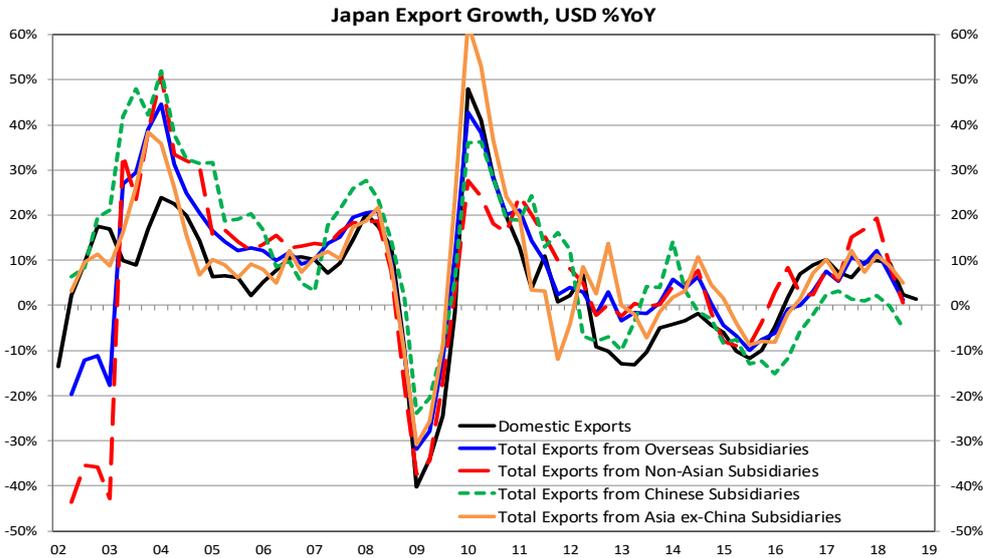
Burgeoning export weakness is far more than just a Japanese problem



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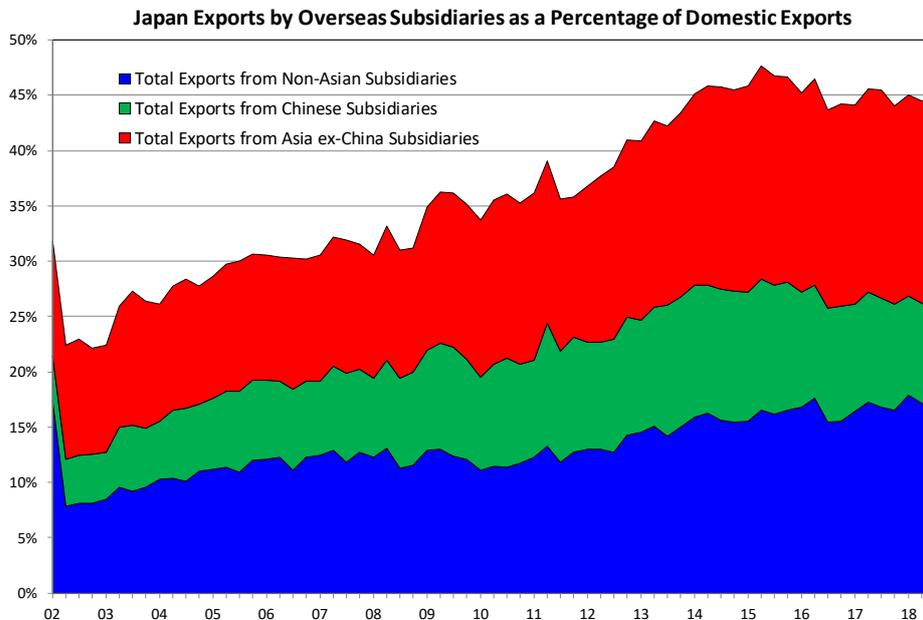
It is also reflected across the board in Japanese-owned operations both at home and abroad.

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Even before US-China trade tensions kicked off, Japanese companies had been scaling back on their China exposures. As per my November 14th 2018 article, is this “ASEAN’s chance to get back in the game?”

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Korea and Taiwan are talking up their chances of encouraging capacity looking to exit from China to come back home (though I suspect they will be largely disappointed). Japan is being rather more circumspect since Tokyo realises it could well be next in the line of fire after Beijing – especially with its old friend and nemesis, Robert Lighthizer playing a key role in negotiations. No world leader – with the possible exception of Kim Jong-un – has invested more time in trying to curry favour with President Trump than Shinzo Abe.

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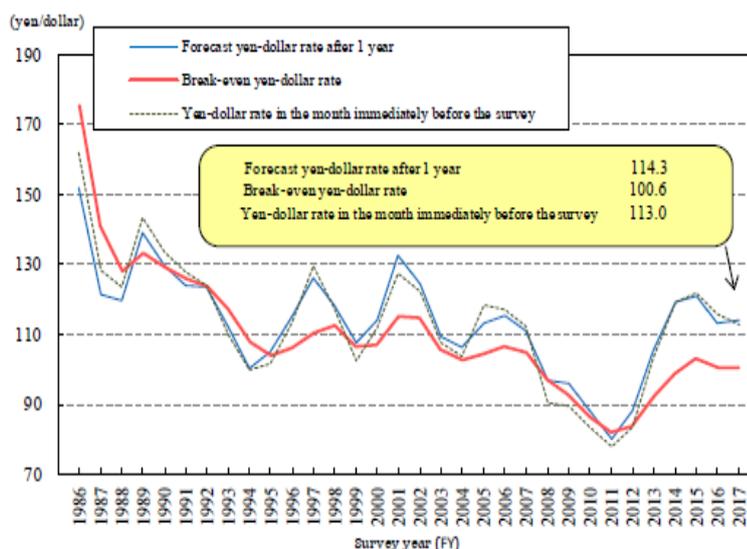
Japan's bilateral trade surplus against the US has averaged a relatively stable USD60 billion per annum over the last five years. This compares favourably to China's USD270 billion five-year average but given Trump's highly reductive trade views, nobody in Tokyo is taking any chances. Sotto, Japan would rather see its consolidated effective bilateral surplus expand via its overseas subsidiaries, including those in America itself, rather than being booked via Japan. ASEAN and India would seem to be prime potential beneficiaries.

ASEAN (and India's) chance to get back in the game?

Tokyo could also live with a somewhat stronger currency if this were the price required to keep the Americans quiet. The Yen seems pretty inexpensive here. Japanese companies reported a USD/JPY100 breakeven in the previous fiscal year; my own calculations suggest a bilateral undervaluation of nearer 20%.

The Yen seems cheap

[Fig. 1-3-1] Trend of the forecast yen-dollar rate after 1 year and the break-even yen-dollar rate (all industries basis)



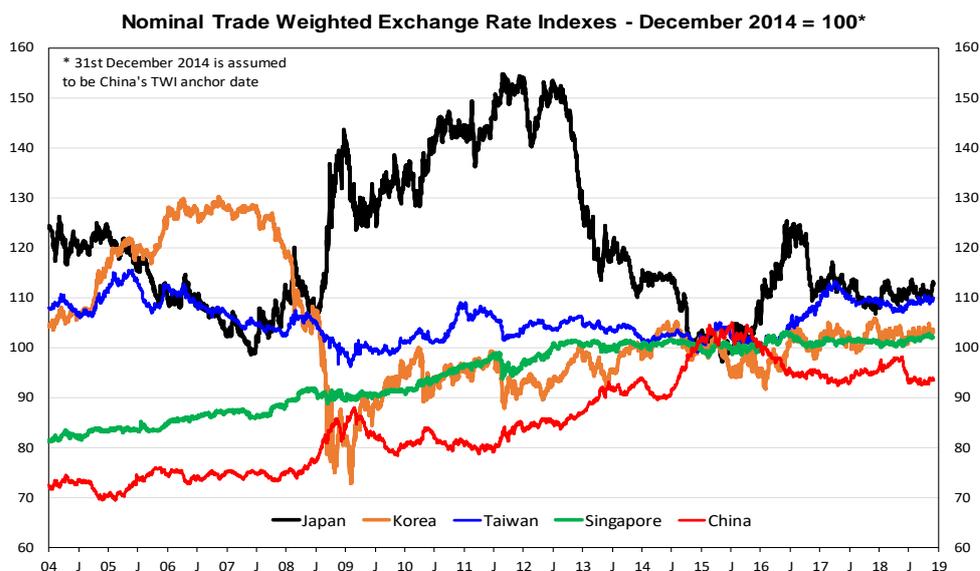
Source: https://www.esri.cao.go.jp/en/stat/ank/h29ank/h29ank_press_listed_companies.pdf



An elusive inflation target becoming ever more e-lusive

Tokyo is increasingly keeping a closer eye on its exchange rate against the Chinese Yuan and other Asian competitors. Nevertheless, some marginal TWI strength, while not necessarily great for translation effects on reported listed profits, could well be politically expedient.

Tokyo could therefore live with a somewhat stronger currency if this were the price required to keep the Americans quiet



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