

# Bridgewater®

## Daily Observations

September 21, 2018

©2018 Bridgewater Associates, LP

(203) 226-3030

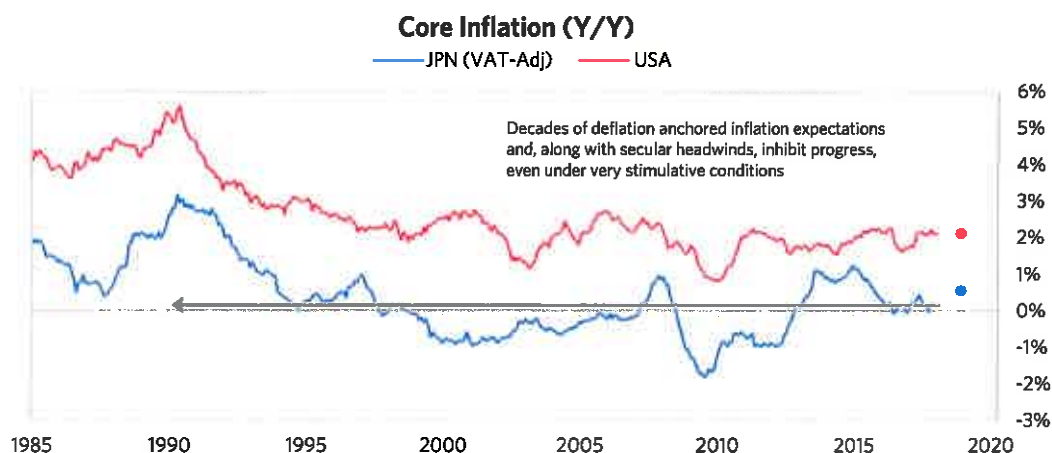
Jason Rotenberg  
Lauren Forman

### Japanese Monetary Policy Is Largely Running on Empty at a Time When Global Conditions Are Likely to Become Less Favorable

The conditions facing Japanese central bankers are a more extreme version of what many developed countries are facing: there is almost no room to ease further, and the disinflationary pressures from secular global forces and challenging demographics are keeping inflation near zero late into a cyclical recovery. It has taken an extraordinary amount of monetary easing and significant support from global growth to sustain the expansion. And still, wages and inflation have only improved marginally. The challenges facing the Bank of Japan will be even more daunting in the next downturn.

Looking ahead, we see less favorable conditions on the horizon as other central banks begin to remove global liquidity. Japan's exports are highly cyclical, and most of the swings in Japanese growth in recent decades have come from swings in global growth and trade. As it is, we expect Japanese growth to dip below 1% over the next six months. And a more material global slowdown would flow through to even weaker conditions and renewed disinflationary pressures, which the BoJ has limited ammunition to reverse: rates are already at zero, and the BoJ is already buying assets at a rapid pace. The drop in inflation in turn would itself be an additional tightening, as it would make real interest rates rise since nominal rates won't be able to adjust much because they are near zero. Given these circumstances, we see the continuation of extreme monetary easing as a sensible policy stance, even if its effectiveness is much diminished.

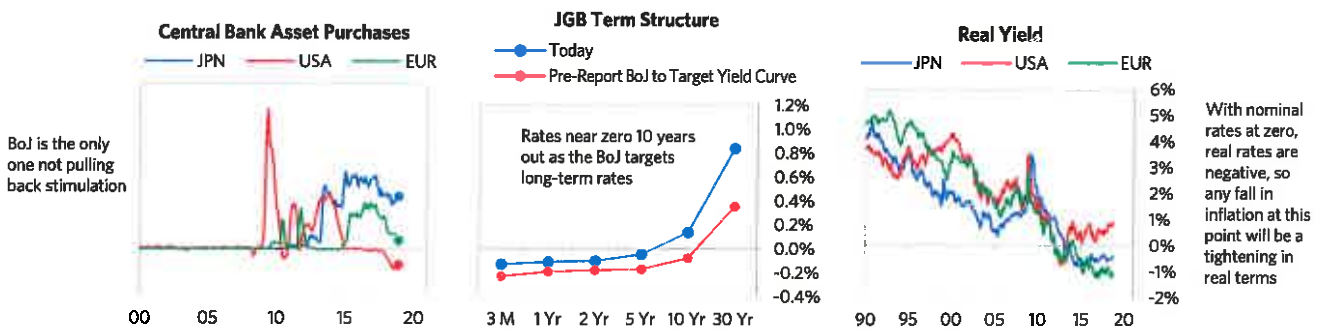
The chart below shows how deeply entrenched Japan's deflation is, and how little progress has been made toward sustainably rising prices, even in the recent period when conditions were as supportive as they have been in decades. It also shows that although the level is lower, the swings in Japanese inflation are similar to those in the US, as global growth and more secular disinflationary forces have had similar effects over the past few decades.



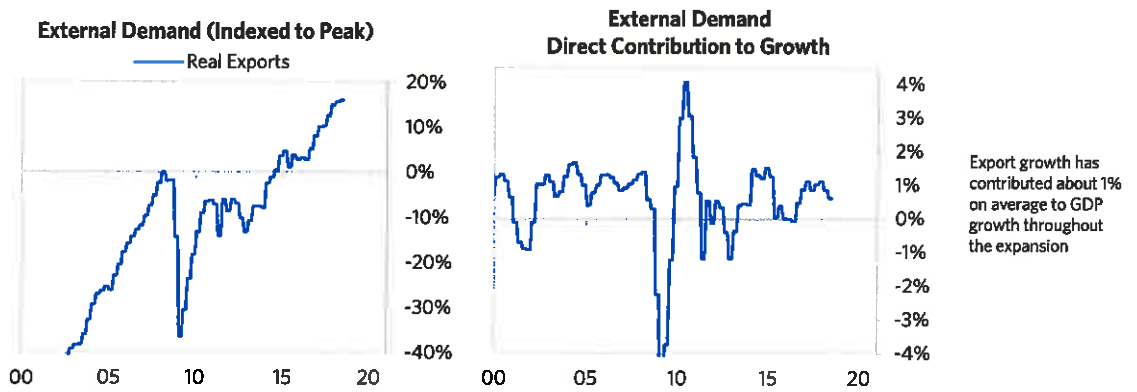
© 2018 Bridgewater® Associates, LP. By receiving or reviewing this Bridgewater Daily Observations™, you agree that this material is confidential intellectual property of Bridgewater® Associates, LP and that you will not directly or indirectly copy, modify, recast, publish or redistribute this material and the information therein, in whole or in part, or otherwise make any commercial use of this material without Bridgewater's prior written consent. All rights reserved.

### It's Taken Global Strength and Massive Easing to Produce a Moderate Cyclical Upswing

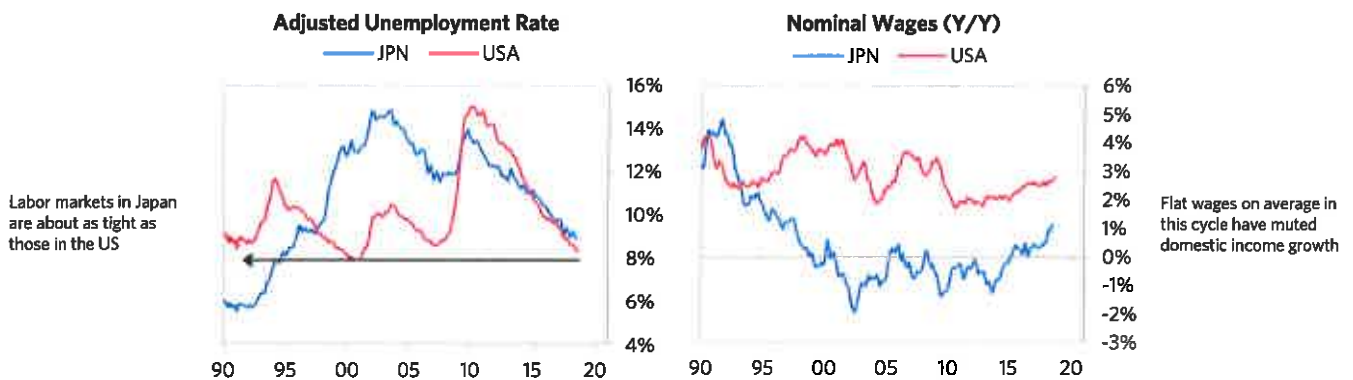
This lack of inflation is all the more striking because of the unprecedented degree of monetary easing from the BoJ and (except for the lack of price pressures) the tightness of domestic cyclical conditions. The BoJ's asset purchase program and yield curve targeting policy have maintained very easy domestic conditions even as other central banks have moved toward tightening. This easing has finally pushed real rates negative, but the ability to get them even lower is limited by the fact that nominal rates are already around zero. More importantly, if Japan were to experience another wave of deflation, real rates would rise, which would represent a tightening of monetary policy.



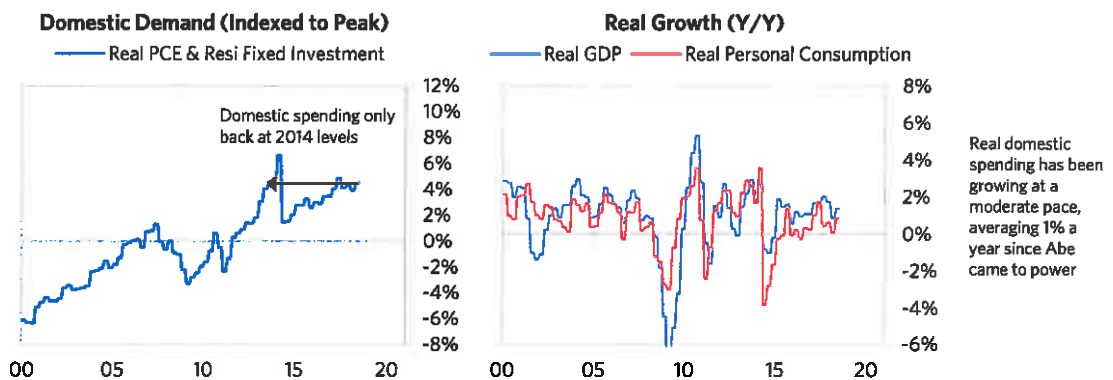
Much of the healthy performance of the Japanese economy in recent years has also come about because of strong external demand. Real exports have been growing at around 4% a year in recent years, adding a bit less than 1% to real GDP growth over that period.



The combination of strong external demand and ultra-accommodative domestic monetary policy has flowed through to some measure of cyclical recovery in Japan—but it looks pretty modest relative to the firepower necessary to achieve it. The labor market in Japan is now about as tight as in the US based on our adjusted measure, which accounts for differences in how unemployment is measured across countries. Even so, on average Japanese wages have barely grown throughout the expansion, muting domestic income growth.



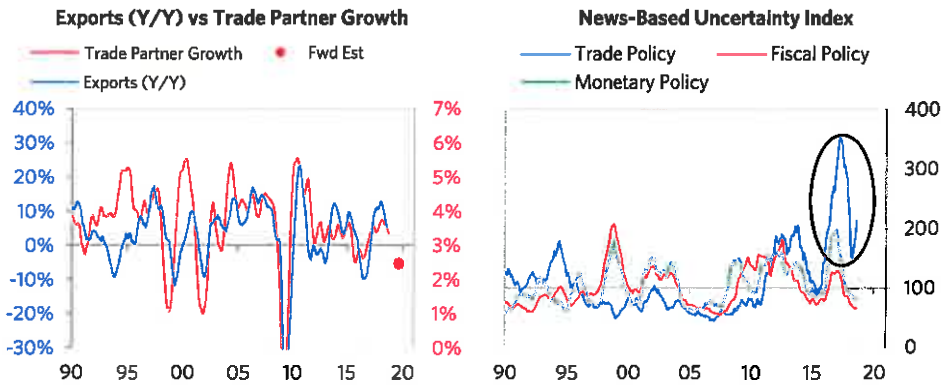
Domestic consumption has grown more slowly than overall economic growth, and would likely be even weaker without the support from rising exports and the resulting employment gains.



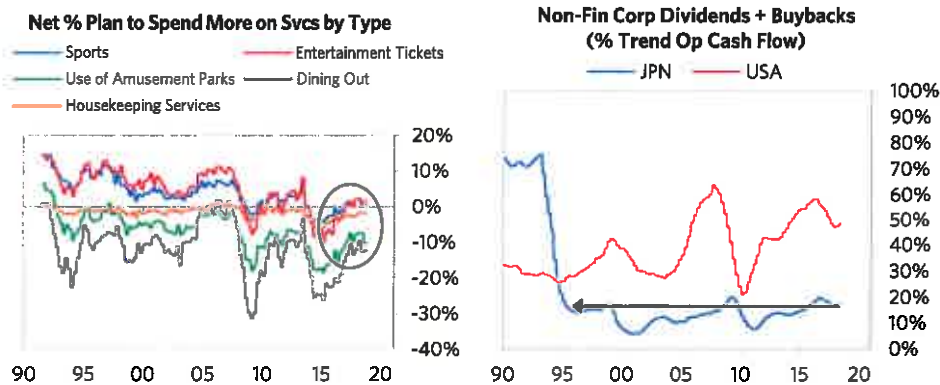
**Going Forward, Near-Term Risks to Japanese Growth Look Tilted to the Downside, While Secular Headwinds Are as Strong as Ever**

The global expansion that provided significant support to Japanese conditions has largely come from strong trading partner growth, especially in China and emerging market Asian economies linked to China. Given expectations that growth will moderate in those places and more broadly across Japan’s major trading partners, we expect this to become a drag on Japanese conditions.

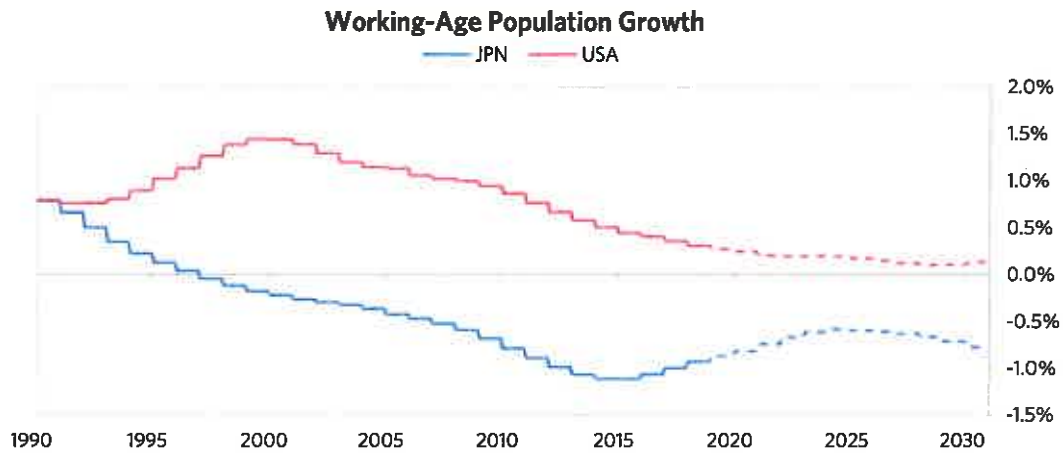
Japan's exposure to trade also means that it faces risks from being caught in the crosshairs of trade tensions. An escalation on that front would be very painful, and trade-related uncertainty in Japan, approximated by the news-based estimates of policy uncertainty shown in the right-hand chart below, has already risen significantly.



Stepping back to consider the longer-term risks, it looks as though the BoJ's stimulus and strong global conditions have not been sufficient to overcome the combination of secular disinflationary forces weighing on prices across the global economy and Japan's particular deflationary funk. Japanese consumers now report they plan to spend the same or less across many categories of services, which provides a sense of how hard it has been (and continues to be) to both stimulate domestic spending and unstick expectations for deflation, which are two sides of the same coin. Corporations aren't changing their behavior around parting with cash either; despite Abe's attempts to reform governance, the cash that Japanese firms return to shareholders is still a small share of the amount they generate doing business—and has not changed much over 25 years.



Lastly, the Japanese economy continues to face an ongoing headwind from a shrinking and aging labor force. This impacts the economy in many ways, including reducing the demand for investment, keeping growth down at a time when debt levels are high, and creating disinflation in some areas, like housing.



When we look at Japan, much like for the rest of the developed world, we are more worried about what the next downturn will look like than what conditions are likely to be like in six months. Japanese policy makers have done a lot to stimulate the economy and have had only mild success in producing inflation under very favorable conditions. Japan has even less monetary fuel in the tank than other developed economies and, as a result, will likely need to resort to other tools (including fiscal policy) the next time the economy turns down.

Bridgewater Daily Observations is prepared by and is the property of Bridgewater Associates, LP and is circulated for informational and educational purposes only. There is no consideration given to the specific investment needs, objectives or tolerances of any of the recipients. Additionally, Bridgewater's actual investment positions may, and often will, vary from its conclusions discussed herein based on any number of factors, such as client investment restrictions, portfolio rebalancing and transactions costs, among others. Recipients should consult their own advisors, including tax advisors, before making any investment decision. This report is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned.

Bridgewater research utilizes data and information from public, private and internal sources, including data from actual Bridgewater trades. Sources include, the Australian Bureau of Statistics, Asset International, Inc., Barclays Capital Inc., Bloomberg Finance L.P., CBRE, Inc., CEIC Data Company Ltd., Consensus Economics Inc., Corelogic, Inc., CoStar Realty Information, Inc., CreditSights, Inc., Credit Market Analysis Ltd., Dealogic LLC, DTCC Data Repository (U.S.), LLC, Ecoanalitica, EPFR Global, Eurasia Group Ltd., European Money Markets Institute - EMMI, Factset Research Systems, Inc., The Financial Times Limited, GaveKal Research Ltd., Global Financial Data, Inc., Guidepoint Global, LLC, Harvard Business Review, Haver Analytics, Inc., The Investment Funds Institute of Canada, Intercontinental Exchange (ICE), Investment Company Institute, International Energy Agency, Lombard Street Research, Markit Economics Limited, Mergent, Inc., Metals Focus Ltd, Moody's Analytics, Inc., MSCI, Inc., National Bureau of Economic Research, Organisation for Economic Cooperation and Development, Pensions & Investments Research Center, RealtyTrac, Inc., RP Data Ltd, Rystad Energy, Inc., S&P Global Market Intelligence Inc., Sentix GmbH, Shanghai Wind Information Co., Ltd., Spears & Associates, Inc., State Street Bank and Trust Company, Sun Hung Kai Financial (UK), Thomson Reuters, Tokyo Stock Exchange, United Nations, US Department of Commerce, Wood Mackenzie Limited, World Bureau of Metal Statistics, and World Economic Forum.

The views expressed herein are solely those of Bridgewater as of the date of this report and are subject to change without notice. Bridgewater may have a significant financial interest in one or more of the positions and/or securities or derivatives discussed. Those responsible for preparing this report receive compensation based upon various factors, including, among other things, the quality of their work and firm revenues.