KENSHO INVESTMENT GROUP

16th of May 2022

CEO Insight: Growing interest rate gap benefits Euro investors

Japan will not experience soaring inflation or a sudden rise in interest rates. This will also benefit foreign investments in residential real estate.

Japan will not be spared from the global trend of rising prices: According to the latest forecast of the Bank of Japan, the inflation rate (excluding fresh food) will rise to 1.9% in the new fiscal year (from April 1). This would be the highest rate of the past three decades, excluding the years of sales tax increases.

However, I do not expect interest rates in Japan to rise significantly. Rather, Japan will decouple more from the US and the Eurozone in this respect, and the interest rate differential between Japan and these regions will widen even further.

Unlike the Federal Reserve Board and the European Central Bank, the Bank of Japan is maintaining its ultra-loose monetary policy with stoic calm. The key interest rate remains at the very low level of -0.10% and the target yield of 10-year government bonds at around 0%. Asset purchases are not being actively reduced and balance sheet holdings of government bonds and equities are not being trimmed.

The central bankers in Japan have a good reason for their perceived stubbornness: they do not consider current inflation to be sustainable. Rather, prices are driven by expensive imported energy and raw materials and partly by the weak yen, but not by a correspondingly strong increases in wages. Consequently, the Bank of Japan expects the inflation rate to fall to 1.1% in 2023 and 2024.

The high liquidity of large Japanese banks also works against rising interest rates. Their deposits exceed their loans by 50%. Therefore, in contrast to Europe, there is no risk in Japan of a credit crunch and higher interest rates. Commercial banks minimally raised their fixed rate for 10-year mortgage loans in May, but the lower floating rate remains unchanged.

The Bank of Japan has backed up its interest rate assessment with unlimited offers to buy 10-year government bonds at a yield of 0.25% since the end of April. This offer will only be withdrawn when there is no more demand at this price. So far, the central bank has successfully defended the unofficial upper limit of its yield corridor.

I think the Bank of Japan may allow the 10-year yield to rise to 0.35% within the next twelve months. But during the same period, interest rates in Germany may climb from currently around 1% to 1.65%. The interest rate differential between Frankfurt and Tokyo is thus likely to grow.

This means that European investors in extremely stable residential real estate assets can earn this high rate differential additionally if they invest now and hedge the exchange rate. Speaking of the exchange rate: the interest rate differential is currently causing a depreciation of the yen, which is due to the unhedged exchange into the Euro and US dollar. I will discuss the resulting further opportunities for investors from Europe in my next CEO Insight in June.

Back to residential real estate: Investment yields for high-quality residential properties in Japan continue to range between 3.5% (Tokyo city centre) and 4.3% (Greater Tokyo, Osaka, Nagoya). Hence, relative to interest rates in Japan, investors are pocketing a risk premium of 3.3% to 4.1%. The government supports higher wages. Then higher rents can also be achieved. Moreover, we continue to see pressure on investment returns due to strong demand in residential investment from large local and international players.

On May 5th, Prime Minister Fumio Kishida announced to bankers and investors at the Guildhall in London's financial district: "Sustained growth; stable markets; safe and reliable companies, products and services – that is why Japan is a 'buy'". Also with regard to residential real estate, I can only agree with his assessment.

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