KENSHO INVESTMENT GROUP

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CEO Insight: Weak Yen offers profit opportunities

Euro investors should take advantage of the current depreciation of the yen to gain exposure to Japan. The economic circumstances suggest that the trend will not last.

The weakness of the yen is currently dominating the headlines of economic news from Japan. For 1 euro, you now get around 143 yen (as of June 10), about 9% more than at the beginning of the year. Against the dollar, the Japanese currency lost as much as 14% value in the same period. How should foreign parties that are planning to invest in Japanese residential real estate react to this apparently strong downward trend?

In my view, this development offers opportunities. Planned investments in Japan should get materialized now. For half of the capital, I would take out a long-term hedge. The investor can take the resulting premium of 0.75% to 1% at maturity. For the other half of the investment, I suggest to wait for a correction, which logically has to be expected.

This forecast may sound bold. However, the currency market is not witnessing a yen weakness, but a strength of the U.S. dollar. Japanese capital is moving to the U.S. because 10-year U.S. Treasuries yield 3.0%, but 10-year Japanese Government Bonds (JGBs) yield only 0.25%. For the same reason, yen carry trades have come back into fashion: Investors borrow in yen at low interest rates and use the capital to buy assets in a currency with a higher rate.

The global interest rate differentials relative to Japan are likely to widen further for the time being. The U.S. Federal Reserve as well as the European Central Bank are planning more interest rate steps, while the Bank of Japan is actively resisting rising rates. Its governor Haruhiko Kuroda rightly points out that Japan differs from the U.S. and Europe in terms of inflation and economic activity.

Although Japanese core inflation climbed to 2.1% in April, the highest level since October 2014, price gains remained far below those in the U.S. and EU. There is also no wage pressure in Japan – incomes rose by only 1.7% in April. As long as wages do not grow sustainably, the central bank intends to keep interest rates low.

Nevertheless, investors should be prepared for a potentially drastic reversal in the currency market. After all, the Japanese yen is - fundamentally and historically - a strong currency. The macroeconomic data speak for themselves. Japanese companies and residents together hold the world's largest net foreign assets of any nation, most recently 411.2 quadrillion yen (3.9 trillion euros), around 30% more than Germany. The returns on these assets will provide a positive current account balance in the long run, even though the trade balance recently turned negative.

Moreover, the current yen devaluation makes Japan more attractive for foreign direct investment. Take wages and salaries as an example: According to OECD data, net income per capita in Japan is $28,872, about 26% below Germany and 44% less than in the USA. Given the low personnel costs, high level of education, and superior service quality, foreign companies will increasingly invest in Japan or purchase services there.

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Moreover, the weak currency will revive tourism; before the pandemic, foreign visitors spent $46.1 billion annually in Japan. Capital investors will also increase their Japan exposure, supported by the favorable valuations and high payouts of listed companies. The Japanese benchmark index Nikkei 225 has lost only 3.4% since the beginning of the year, while the U.S. S&P 500 has lost 18.2% (as of June 10). Residential real estate is already very much in the focus of foreign investors. These assets still offer solid returns while prices continue to rise.

Given this overall situation, an upwards movement of the yen can be expected, for instance once the U.S. interest rate cycle peaks. As the past has shown, such a correction can be rapid, partly because carry trades are quickly unwound. Thus, euro investors who are now investing in yen-denominated assets could reap lucrative gains as a bonus in the medium term. To limit the residual risk, I recommend hedging half of the invested capital and earning the premium of 0.75 to 1% paid in the process.

Dr. Leonard Meyer zu Brickwedde
President & CEO

Leonard Meyer zu Brickwedde

Kensho Investment Corporation
Sanno Park Tower 3F
2-11-1 Nagata-cho,
Chiyoda-ku, Tokyo 100-6162

Tel: +81(0)3-6205-3039
contact@ken-sho-investment.com