KENSHO INVESTMENT GROUP

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CEO Insight: Cost of capital in Japan to remain low in 2023

The normalization of monetary policy that has begun in Japan will cause interest rates to rise only slightly - the Japanese real estate market will retain its attractiveness.

"The Year of the Rabbit is a Year of Leaping" - This is the proverbial forecast in the Kabutocho stock exchange district, Japan's counterpart to Wall Street, for the new year 2023, which is a Year of the Rabbit in the local zodiac calendar. Some market participants believe this "big jump" will happen in monetary policy after the Bank of Japan loosened its control over the yield curve just before Christmas.

Since then, the central bank has allowed the yield on government bonds with a remaining maturity of 10 years to rise to as much as 0.5%, twice as much as before. De facto, it thus raised interest rates. But at the same time, Japan's central bank increased its monthly bond purchases by nearly a quarter. In doing so, it demonstrated its determination to defend the 0.5% limit.

To be sure, the five largest commercial banks raised rates on new 10-year mortgage loans by 0.1 to 0.34 points - Mitsubishi UFJ, for example, now charges 1.05% and Mizuho 1.4%. But these adjustments do not start a general trend of rising interest rates in Japan. The big picture has not changed; Japan's monetary policy remains loose. The cost of capital will remain low and investments in real estate continue to promise attractive returns.

The central bank is likely to put its strategy to the test again in the coming months, though. One reason is the change at its top: In April, a new governor will take over the baton from incumbent Haruhiko Kuroda. The successor could further normalize the monetary strategy. But that that does not mean that interest rate hikes will move onto the agenda.

Rather, the review of monetary policy is likely to result in only minor adjustments. This is because the interest rate cycle abroad is generally expected to peak this year. This will strengthen the Japanese yen and reduce imported inflation. And in case the global economy slows down, higher interest rates would be counterproductive because they would increase the financing costs of the government and companies and burden home builders with flexible-rate mortgage loans.

The debate about a possible monetary change of course will continue for some time. This is because, according to press reports, the government does not intend to nominate the successor to 78-year-old Kuroda, who is retiring after ten years in office, until mid to late February. No clear favorite has emerged among the floated candidates. Even after the selection of the new governor - almost certainly a man - and his confirmation by the parliament, the financial market will weigh every statement he makes.

After all, Kuroda's name is associated with all three core pieces of current monetary policy - large government bond and stock index fund purchase programs, the negative policy rate, and the yield curve control. A successor could make changes relatively easily, as Kuroda himself seems to have prepared for a possible course correction. The government will certainly also have a say in any adjustment.

Ultimately, the economic conditions will decide. In the new fiscal year, which starts on April 1, company profits are likely to grow at a slower pace because the positive base effect of the yen devaluation will be eliminated. If this bonus is factored out, the pre-tax profits of large companies will shrink by just under 2% already in the current fiscal year ending March 31, according to the investment bank Nomura.

These circumstances also speak against rising interest rates, as does the development of wages. In November, real incomes shrank by 3.8% year-on-year. In nominal terms, incomes rose by only 0.5%, significantly weaker than the 3% annual wage growth deemed necessary by the central bank to achieve its 2% price target on a sustainable basis. Even if the wage negotiations in the spring result in agreements of 3%, the Bank of Japan will wait to see how things develop.

Long story short: Under new central bank leadership, we will likely see a cautious normalization of monetary policy in Japan in 2023 without any leaps. It will be a gradual process that is likely to take several years. Japan's cost of capital will therefore remain favorable in the medium term and will continue to offer investors good opportunities to earn money from Japanese real estate.

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