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CEO Insight: The Weak Yen as a Plus Alpha on Real Estate Yields in Japan

The current depreciation of the Japanese currency against the euro and dollar will come to an end. Those who invest in Japanese real estate now can earn an attractive premium.

Do you know Eisuke Sakakibara? The ex-finance ministry official is nicknamed "Mr. Yen" in Japan because he was vice finance minister in charge of currency issues in the late 1990s and has been asked about the yen's performance ever since. His latest forecast is that the dollar will rise to over 160 yen in 2024. That would correspond to a further 16% depreciation of the yen (as of July 13). However, Sakakibara, who is now 82 years old, has often been wrong in the past, so some currency traders tend to regard his assessments as a contra-indicator. In any case, the fact is that the theme of yen weakness pervaded most of my recent conversations in Europe on Japanese residential real estate.

In my estimation, the yen's performance promises a plus alpha on residential property returns. Investors should take advantage of the current weakness through a Japan exposure. I would take out a long-term hedge for half of the capital. This creates a premium of over 1% because of the much lower interest rates in Japan. The yield for Japanese residential real estate of around 4% in yen thus becomes more than 5% in euro. For the other half of the investment, I would bet on a price correction, which in the past has often been in the double-digit percentage range (see chart).

One indicator of such a coming countermovement is Asian investors who are orienting their real estate portfolios away from the U.S. and more toward Japan. They expect a trend reversal because the yen depreciation correlated with the growing gap between the interest rates of Japanese and U.S. 10-year government bonds due to the different monetary policies in Washington and Frankfurt as well as Tokyo. Along with the dollar, the euro also appreciated against the yen.

In early 2023, the trend ended temporarily because many market participants believed that the Bank of Japan under its new governor Kazuo Ueda would tighten monetary policy and that the U.S. Federal Reserve would no longer raise or even lower interest rates out of concern about a recession. However, these expectations were not fulfilled, and the yen subsequently fell to a 15-year low against the euro. We saw a new, small countermovement last week because in May Japan registered the highest wage growth in 28 years. This led some currency traders to conclude that the Bank of Japan might tighten monetary policy at its July 27 meeting. This rather vague possibility strengthened the yen again.

The longtime Japan economist Richard Katz argues that the weak yen also reflects a lower competitiveness of Japanese companies. They would need a weaker yen to maintain their exports. But large exporters such as Toyota and Daikin are producing much more overseas nowadays. Earnings there are reflected as higher profits on their balance sheets, which are calculated in yen. Most importantly, Japan remains the world's largest net lender. In the first half of 2023 alone, Japanese investors bought 100 billion dollars in foreign bonds, the proceeds of which often flow back to Japan. The current account remains positive despite the trade deficit due to high import prices, signaling the true strength of the Japanese currency.

Japan investors should keep another important context in mind. The past shows that during periods of risk aversion, the yen weakens, boosting carry trades. This involves foreigners borrowing yen at low-interest rates and thus buying assets in a currency with a higher yield. The yen sales necessary for this further weaken the Japanese currency. But as soon as there is a crisis-related increase in risk awareness, for example during the Asian financial crisis of 1998/99 or the Great Financial Crisis of 2008/2009, the yen rapidly appreciates (see chart), partly because the carry trades are quickly unwound. Therefore, I generally advise against a yen carry trade. However, within an international portfolio, credit leverage in yen makes sense when acquiring residential real estate, as this allows the investor to take advantage of the low-interest rates in Japan.

Outlook: The yen's downtrend could end if there is a crisis in the global financial market, if the peak of the interest rate cycle in the euro and dollar becomes foreseeable, or if the Bank of Japan tightens the screws on its monetary policy. Those who, according to my recommendation, invest in Japanese residential real estate beforehand, partially hedge their yen entry rate and bet on exchange rate gains for the remaining amount, should collect a lucrative premium. I consider the risk to be manageable since a turnaround in the yen is much more likely than a further sharp depreciation.

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