Global Bond Market and Japan

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In the past ten years, the Japanese bond market has changed drastically in the course of overcoming deflation and financial crisis. At the same time, Japan has also been significantly influenced by events in overseas markets, such as the Asian currency crisis, the collapse of the IT bubble, and the deterioration of credit quality for GM and Ford. In hindsight, if we look at developments in credit spreads by region, we can say that the Japanese market has shown a linkage with global markets (Figure 1). Many people believe that the Japanese bond market centers on its own logic, but in fact it is closely linked with global markets and I believe the linkage will grow stronger. Thus, we run the risk of failing to see the forest for the trees if we only look at the Japanese market in isolation. In this paper, I would like to examine the links between Japanese and global markets, and then consider the significance of global bond market’s influence over the Japanese market.

Spread Comparison by Region

When I refer to “global bond market”, it might seem that I am making a sweeping generalization and I am not addressing the diversity of respective regions (US, Europe, emerging markets) and products (investment-grade bonds, high-yield bonds, emerging market bonds). However, compared to the Japanese corporate bond market, the links between other respective markets seems to be already widely acknowledged, and
investors usually formulate their strategies based on overall market developments. Thus, here I would like to define “global bond market” in a broad sense, mainly referring to the investment-grade markets of the US, Europe and other regions.

The Global Bond Market’s Influence over Japanese Markets
There are three main ways in which the global bond market influences the Japanese market. The first is through the direct impact of Samurai bonds, which are yen-denominated debt issued by non-Japan corporations. It is still fresh in our memories that several Samurai bonds which had been widely held by Japanese investors eventually came under strong selling pressure due to defaults and downgrades (for example, Xerox in 2000, Enron in 2001, Worldcom in 2002 and GM/Ford in 2005). Moreover, the Samurai market was influenced substantially by the vicious circle of selling causing further selling, triggered by investors’ need to secure liquidity. The second mechanism of global influence on Japan’s bond market is the attitude of foreign investors toward the Japanese stock market. The volatility of stock prices indirectly impacts bond markets through changes in investors’ risk tolerance and market sentiment. The third element of influence is the impact that the performance of global bond markets has on Japanese investors’ appetite for domestic bonds. For Japan’s domestic bond market, the supply and demand dynamic, and thus prices and yields, will change if Japanese investors shift their asset allocations to increase or decrease foreign bond investment. The globalization of asset allocation is progressing at a very rapid pace not only among institutional investors but also among individual investors, and it is widely acknowledged that its influence on foreign exchange rates is substantial. Moreover, a reduction in returns of foreign bonds does not necessarily lead to a simultaneous increase in allocations toward domestic bonds. Indeed, if foreign bond markets are suffering, that can reduce the overall risk tolerance of investors, which negatively impacts the domestic market as well.

How to Address Special Factors of the Japanese Markets
Figure 1, illustrates some of the major developments for credit spreads over the past decade, consisting mainly of two large cycles. The first cycle (1997-2000) started with the financial crisis in 1997. After the capital injection to banks in 1999, the cycle ended with the short-term economic recovery and shrinking of risk premiums in 2000. Meanwhile, in the global market, major events such as the Asian currency crisis (1997), the Russian debt crisis (1998) and the IT bubble (1999-2000), took place at similar times as the events in Japanese market. As a result, credit spreads in most regions followed similar patterns and the difference in the level of spreads in these regions had narrowed.

The second cycle (2001-2005) started with the collapse of the IT bubble and reoccurrence of the financial crisis. After the launch of the reform project for Japan’s financial system in 2003, the cycle ended with the shrinkage of risk premiums caused by economic recovery. In this cycle, the movements in credit spreads in the global markets and Japanese markets were similar again, but the level of Japan’s risk premium was kept significantly lower compared to the US and Europe. Even if we consider the fact that businesses with low credit ratings curtailed bond issuance at the time, lowering supply relative to demand, it is rather surprising to see such low risk premiums under the triple burden of an increase in bankruptcies, defaults of corporate bonds, and drop in stock prices. It is worth noting that corporate bond spreads continued to shrink even when the stock market dropped during 2002 to 2003 (Figure 2).
The First Special Factor: Public Support

Needless to say, one of the contributing factors behind the low level of credit spreads has been the government’s full-fledged support for credit enhancement, such as capital injections to banks, enhancement of credit guarantees to small and middle sized companies, extension of credit lines by governmental financial institutions and an accommodative monetary policy by the Bank of Japan. Here, we need to understand “public support” in a broad sense, not in a narrow sense that only includes support to financial institutions or implicit support towards governmental agencies. The effect of zero interest rates and quantitative easing policies have been salient in swap spreads, which form the basis of credit spreads (Figure 3). This shows that monetary policy has contributed significantly to the shrinking of credit spreads.
Now that the financial crisis is over and the self-sustaining economic recovery is secured, the need for “public support” in the broad sense is likely to recede gradually, as symbolized by the ending of the zero interest rate policy. Although it is understandable to believe that the implicit support to banks and governmental financial institutions will continue for some time, it is natural for the risk premium, which was kept low artificially, to gradually “normalize.” It is difficult to define what a “normal” level is, but I believe it is inevitable that risk premiums will gradually approach those of the global markets through arbitrage transactions in the near future.

The Second Special Factor:
The Role of the Banking Sector
Another salient characteristic of the Japanese market is the presence of banks in debt markets. The ratios of bank lending and corporate bond issuance to GDP, in the US for example, are 46% and 22% respectively. But in Japan, they are 106% and 16%, respectively, showing the overwhelming presence of Japanese banks in the debt market.

Some claim that banks are keen to expand their lending, even with low interest rates, leading to low credit risk premiums in general. Even though the need to adopt an appropriate level of interest rate that reflects a counterparty’s credit risk has been acknowledged for some time, the lending by banks that regained their financial strength seems excessive in the last two to three years, and it is understandable that some people are worried that banks could repeat past mistakes. However, advancement in financial technology, particularly “market-based financial intermediation” through syndicated loans, is facilitating the transfer of risk. That is gradually causing credit risk to be sold to a wider range of investors (Figure 4). Looking at these developments, I believe that the most basic of market mechanisms – investor risk tolerances – will be a force that will gradually lead to increased credit risk premiums.

Japanese Banking System and Corporate Bond Market, History Repeats Itself?

Risk concentrating on direct financing

Increasing in Burden to Bank Capitals

Financial Crisis

Expansion of Corp. Bonds Spread

Instability of Funds Procurement

Shrinking Indirect Finance and Expanding Corp. Bonds Market

Liquidation (Securitazation) of Bank Assets

Reinforcement of bank Capital Expanding Lending Assets

Figure 4
The Third Special Factor:
Credit Cycles

In the early portions of the past decade, Japanese companies’ financial strength dropped significantly due to the so-called “three excesses” (excess capacity, excess labor, excess corporate debt). However, with individual companies’ efforts and industrial reorganizations, the financial strength of corporations has recovered prominently, especially in the past five years. Figures such as debt ratio have rebounded back to levels similar to that of the major companies in the US and Europe (Figure 5). Moreover, even with Japan’s economic recovery, companies are cautious in increasing their leverage, and they are making business investment only within the limits of their cash flow. This tendency can also be seen in other countries, and it might be a key factor in maintaining globally sustainable economic growth. Until the 1990’s, companies’ basic financial strategy was to determine their leverage based on the economic cycle, and the difference in respective countries’ economic cycles was reflected in their domestic companies’ credit quality. However since 2000, the financial strength of companies worldwide has been lining up. This is due to the corporate sector deploying prudent and conservative financial strategies despite differences in the economic cycles of the US, Europe, and Japan. With progress in globalization of the Japanese stock market and the increase in foreign stock holders, Japanese companies need to constantly be aware of such trends in global financing. As Japanese corporate bond issuers take these prevailing global trends into consideration, their behavior is likely to converge with the global standard.

**Trends in Japanese Corporate Leverage**
- large-scale enterprises -

Source: Ministry of Finance

Figure 5
Having considered all these factors, I believe that the influence of special factors in Japanese corporate bond market is gradually receding, and even though we can not accurately state how long it will take for such influences to disappear completely, the linkage between the Japanese bond market and the global market is likely to become even stronger.

**Prospects for Risk Premiums in the Global Market**

Let us turn to the issue of risk premiums in the global market. Since 2003, credit risk premiums have decreased in the global corporate bond market. Spreads have also been contracting in high-yield bonds (Figure 6) and emerging market bonds, which have high beta value.

Underlying this shrinkage in risk premium, there have been changes in the global flow of funds. In particular there have been changes in the macro structure of the market, reflected in increased liquidity and risk tolerance among global investors. The risk premium was reduced due to a decrease in economic volatility, as the sectors that were the fund raisers became the fund lenders. This was achieved because of the improved private sector financial positions attained through restructuring efforts, and through emerging countries’ economic reforms and commodity price windfalls.

However, there seem to be signs that a shift in paradigm is taking place. There is an increasing possibility of changes in the global flow of funds and investment environment, triggered by the global rise in interest rates and a slowdown in the US economy. There are some movements in the market that signal an increase in spreads, such as increased issuance of lower rated bonds in the high-yield market. Also, in June, there was a drop in stock prices across the world caused by investors’ risk aversion. From a broad perspective, I believe that global corporate bond markets have reached the stage where there will be a shift from a phase of spread contraction to a phase of spread expansion.

**Position of the Japanese Market and its Future Orientation**

Having examined the position of the Japanese market after taking all the aforementioned factors into consideration, I receive a sharp image of Japan
passing the end point in the zero interest rate policy and entering the early stage for the normalization of credit risk premium. In fact, in the past three months, spreads in the interest rate sensitive high-rated sectors have increased in line with the increase in JGB rates. Even though the market environment has become slightly more favorable recently due to the improved short-term supply and demand conditions, for the mid- to long-term perspective the trend will be for a gradual increase in spreads as interest rates rise. The pace of the rise in risk premiums is likely to be slow, given that there is a low possibility that spreads in the overall corporate bond market will increase suddenly in an environment where there has been no significant increase in defaults. However, the fact that risk premiums are likely to expand means that it will be increasingly difficult for corporate bonds to outperform JGBs.

**How Does This Impact Our Investment Strategy?**

Under these conditions in which credit risk premiums are normalizing, what do we need to do to improve the returns on our corporate bond investment? The answer is not easy, but it is important not to “fail to see the forest for the trees”. It will become important to select profitable investment opportunities from the global markets while striking the right balance between the bottom up approach (i.e. selection of individual bonds) and top down approach (i.e. projection of the market’s movement from a macro point of view). PIMCO is focused on attaining higher returns through global comparison of relative values. In particular, this involves conducting arbitrage transactions that compare the relative value of the same bond in different markets, such as the yen denominated bonds vs euro denominated bonds. We also intend to seek the best return opportunities by comparing the investment values of respective global bond markets, such as Japanese corporations vs. US or European corporations. Furthermore, we will pay close attention to the product’s inherent “structural alpha” (e.g. premium offered for a bank’s subordinated bonds), thereby preparing a sufficient buffer for the downside risk of the market (Figure 7). Needless to say, in order to improve investment returns by making use of the “structural alpha” of the respective products, we need to fully understand their respective risks and conduct an efficient risk management such as portfolio diversification.

Currently, bond investors could face a period of time in which their endurance will be tested if they truly invest with a long time perspective. Yet, it is all the more important for investors to maintain a broad perspective and explore the complete framework for investment opportunities rather than making investments based on a simple elimination method.
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