Going negative

The Bank of Japan ponders the monetary frontier

by Benjamin Cole

For monetary authorities across the developed world, a type of central bankers' Twilight Zone has become the operating reality, a topsy-turvy wonderland in which interest rates are negative and bankers balloon money supplies — but all without inflationary consequence.

While central bankers scratch their heads and ponder more-exotic options, the economics textbooks will have to be revised, and institutional property buyers may have to reassess opportunities.

Negative interest rates were once thought to be an economic near-impossibility. In Asia, nowhere is the new monetary reality more prominent than in Japan; the island nation has tried to shrug off persistent deflation and sluggish economic growth for more than two decades, with mixed success. In January, the Bank of Japan implemented a 10 basis point negative interest rate policy for new deposits from banks. Though unusual, it is a less extreme position than that of the European Central Bank, suggesting the BOJ has further room to move, if deemed necessary.

And recently, the unheard of is happening in Japan — an institutional property buyer in February managed to finance "borrowing" through interest-rate swaps and is earning interest for the effort of leveraging up. With Tokyo

office markets becoming tight, negative interest rates are certainly interesting to property buyers — but fundamentals even more so.

In addition, public-company ownership of institutional real estate is evolving, say experts, with more corporations examining whether underutilised assets should be sold. Island pubcos own US$4 trillion in real estate, and many are contemplating monetising those assets by selling to better, professional managers. A solid stretch of buying and selling might unfold in coming years.

Haruhiko Kuroda is the governor of the Bank of Japan in these rare times, and under his leadership the Japanese central bank has implemented a relatively-aggressive quantitative easing programme, in concert since January with negative interest rates. In the QE effort, the BOJ has been buying about 6.66 trillion yen (about US$60 billion) every month of securities, including not only Japanese government bonds, but also exchange-traded funds and J-REITs. This US$60 billion in monthly QE from the BOJ takes place in an economy roughly one-third the size of the US economy.

Governor Kuroda's monetary expansion is one shaft of Abenomics — Prime Minister Shinzo Abe's "three arrows", the tripartite plan of structural reforms, fiscal stimulus and a deflation-fighting monetary policy.

Abenomics is drawing praise in some institutional property investor circles, and Kuroda's efforts have seemed nearly heroic. Yet in March, Japan's core consumer price inflation rate (excluding fresh food) was again negative, at –0.3 percent year-over-year. Japan's growth rate in the first quarter was, however, better than expected — at 1.7 percent in nominal terms, quarter-over-quarter — despite the uncertain outlook with major trading partner China.

There are critics of global monetary authorities, and in some quarters there is speculation "central banks are out of ammunition" — an inconceivable notion only a few years back, when the nearly-constant refrain of monetary authority observers and pundits was that eternal vigilance was the only bulwark against runaway inflation.

What to do, BOJ?

"There is no question that the ammunition available to central banks, including the Bank of Japan, is narrowing," says Harry Tan, Singapore-based head of Asia Pacific research at TH Real Estate.

In part, this is due to the market for Japanese government bonds being stretched thin by constant BOJ buying.

Still, Tan thinks the BOJ has little recourse but to maintain positive monetary pressure, including deeper negative rate cuts and quantitative easing. Tan also ponders if the arrow of structural reforms in Abe's quiver has been shot. In Japan, as in every democracy, interest groups are organised

Exotic policies: helicopter drops, perma-bonds

With Japan's deflation and sluggish growth episodically resistant to hitherto unconventional policies such as quantitative easing and negative interest rates, even more exotic options are being proffered — and by serious observers.

Lord Adair Turner is former chairman of the UK Financial Services Authority, a former member of the UK Financial Policy Committee, and has also had extensive private-sector experience, including a stint with consultancy McKinsey & Co.

For Japan, Turner advocates "helicopter drops on a leash", akin to what former US Federal Reserve Board Chair Ben Bernanke has called "money-financed fiscal programmes".

In the vernacular of the street, this means the central bank prints (digitizes) money — and does not borrow — to finance national government operations, a policy long taboo in monetary circles for the potential for runaway inflation. Usually, the "print money to finance the government" idea is abruptly dismissed with references to Weimar Republic and Zimbabwe.

Yet Turner cites a fascinating bit of Japan's history, lesser known in the West: The early 1930s Japanese Finance Minister Korekiyo Takahashi used monetary-financed fiscal expansion, or money printing, to pull Japan's economy out of depression — indeed the Great Depression visited Japan only briefly, in 1930 and 1931. The island economy grew thereafter and through World War II.

The money-pioneer Takahashi also took Japan off the gold standard and lowered interest rates. In a sad denouement, Takahashi sought in 1936 to tighten policy once economic growth and inflation had returned to Japan, but imperial militarists wanted to paper-finance war preparations and so had him assassinated. Under militarist rule, money printing led to low double-digit inflation.

Other exotic plans, however, have been touted. In April, Sean Darby, Jefferies Group's chief global equity strategist, proposed the BOJ issue perpetual bonds, with no interest payments and no principal repayments.

Darby noted the BOJ was only a year or two away from running out of Japanese government bonds to buy — the private sector has a declining supply to cough up. Financial institutions often need collateral, a function fulfilled by high-quality government bonds. Darby also suggests the new Japanese government perma-bond could finance government outlays.

Whether Japanese Prime Minister Shinzo Abe and BOJ Governor Kuroda are prepared to embrace helicopter drops and perma-bonds remains to be seen, and Japan faces elections this summer, perhaps increasing pressure for macroeconomic caution.

What is certain, though, is previously-exotic policies that were dismissed out of hand, such as negative interest rates and quantitative easing, are now conventional. The BOJ's future is being discussed by shrewd observers, who are advocating even more exotic options. What is unconventional in monetary policy today may become orthodox tomorrow.

— *Benjamin Cole*

to protect existing prerogatives, embedded in tax codes, regulations and trade laws at all levels of government. But without substantial progress on the structural reforms, "the upside of Abenomics remains restricted," notes Tan.

That being the case, the BOJ may be compelled to move to even deeper negative rates, such as –0.3 percent from the present –0.1 percent, and also to boost QE, suggests Tan. Recently there has been talk of a 25 percent increase in the central bank's QE purchases, to 8.32 trillion yen (about US$75 billion) a month, but in late April the BOJ disappointed markets with a "no action" policy meeting.

Marc-André Flageole, portfolio manager at Presima, generally echoes Tan's sentiments. "The Bank of Japan has three main options: expand the size of its QE programme; lower rates even further; and/or purchase a larger amount of risk assets such as ETFs, J-REITs or even corporate bonds."

In short, most observers do not believe retreat is on the menu for Kuroda and the BOJ.

Moreover, there is hope for some progress on structural reforms, indicates Tan, as Abe's LDP party has a dominant position in the nation's lower and upper legislative houses and might be able to risk disfavour from some interest groups in migrating toward better general, long-run policies.

Still, analysts at Bank of America Merrill Lynch are dubious Kuroda and the BOJ can emerge victorious over deflation. "We do not rule out the possibility that an exit from deflation can be achieved by further strengthening the current set of policies," the financial house stated in an April report. "It would be hard to argue that such an approach has been successful so far, however."

That lack of progress has prompted some observers to suggest the BOJ should move to even more aggressive, less orthodox alternatives, such as central bank–financed national government spending (money printing) and perma-bonds (see sidebar, above).

One takeaway: For institutional property investors, it appears the BOJ will not be "trying to cool the market off" any time soon. And in coming years, much prime property may come up for sale from Japan's public companies, making for a rare opportunity for institutional property brokers and buyers.

Favourable institutional property outlook

For all the uncertainty and debate surrounding Japan's central bankers and macroeconomic policies, the outlook for institutional property in Japan remains positive, especially for well-situated real estate in Tokyo. The nation is shrinking population-wise, making some regions increasingly speculative, and overall economic growth is sluggish.

But the population continues to migrate to Tokyo and other select regions, and the prospect is for historic and extraordinarily-favourable interest rates for the foreseeable future. Many rival investment options, such as Japanese bonds, offer negligible yields.

In Japan, as across the globe, institutional property took a hit in 2008, with some prime properties taking a 50 percent haircut. But since the global financial crisis, Tokyo properties have been climbing back. Tokyo grade A office towers enjoy low vacancy rates, and rents are rising, reports Savills. In fact, Tokyo's five central wards had a cumulative office vacancy rate of 1.8 percent in the first quarter, and rents are rising. By way of comparison, the average office vacancy rate in the United States was 13.2 percent, according to CBRE. Savills cites the "ultra-low" Tokyo office vacancy rates as a solid fundamental, justifying landlord optimism.

Another positive sign for Japanese real estate is the J-REIT index, up 4.6 percent year-to-date through late May, despite a general Japanese stock market decline in the same period.

With interest rate yields shrinking around the world and in Japan, and yet abundant global capital seeking a home, experts expect to see strong demand for quality commercial real estate in Japan from core investors, including domestic J-REITs.

Not only that, at least one J-REIT has been effectively *paid* to borrow money and invest in property, reports Presima's Flageole.

"In February, using interest rate swaps, a J-REIT landlord in the logistics space was able to finance at an effective rate of minus 0.009 percent, essentially being paid to borrow," says Flageole. "While this type of agreement is not yet widespread … it showcases how negative interest rates could change completely the nature of real estate financing."

If institutional buyers are able to borrow for negligible interest rates, the prospects for quality commercial real estate can only be positive. The immediate upshot is, when pencilling out a commercial property purchase, some buyers may have to *pencil in* interest rate returns. Such returns in Japan may be miniscule at present but will perhaps be larger in the future if the BOJ travels deeper into the world of negative interest rates.

And if inflation returns?

Institutional property denizens in Japan would seem to be in the catbird seat. If inflation stays dead, the BOJ can do little except double down, lower interest rates, stay aggressive on QE, and possibly consider the even more exotic options being discussed by some monetary mavens. Commercial property buyers will find financing cheaper than ever in the seasons ahead, while rival returns for fixed income turn sallow. And many markets in Japan, such as Osaka and Tokyo, are healthy.

Moreover, as previously mentioned, there may come onto market a supply of institutional real estate in the near term, as public companies monetise extraordinarily valuable yet sometimes underutilised assets. Public companies, responding to increasing shareholder pressure, may see compelling logic in offloading prime property to professional owners and managers.

There is a remote possibility of higher interest rates in the years ahead, perhaps posing a risk to property owners. But if the BOJ and the Japanese economy eventually turn the corner to higher inflation rates, then property should inflate along with prices and economic growth. If BOJ Governor Kuroda's plans work, they should result in more aggregate demand and spending, which are generally positives for property values. "Based on the likely premise that a BOJ policy decision to increase interest rates will be in reaction to either — or both — an economic recovery or rising inflation, real estate will benefit from an associated increase in market rents," explains Morgan Laughlin, head of Japan at PGIM Real Estate.

The cliché "win-win" comes to mind for institutional property owners in Japan, when the topic is future inflation, or lack of it.

The unprecedented economic circumstances of Japan, and the curious reality of persistent deflation and negative interest rates, may be unsettling at first glance.

But institutional property investors are an intrepid lot by nature, who think long term and, as they look ahead, evidently believe more opportunity than risk exists in prime Japanese property markets — and fundamentals, particularly in Tokyo, are supporting that belief.

And, getting paid to borrow money to acquire institutional-quality property in Japan may be too compelling to pass up. ❖

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