



External accounts highlight major vulnerability

Japan's balance of payments still promises a brisk tailwind for yen weakness. The trade account has deteriorated further, against most expectations of stabilization. This is overwhelmingly an oil and gas story, though lackluster external shipments and strengthening domestic demand are supplementary issues. Net FDI outflows a similar-sized drag that is only likely to get bigger even if the current account gradually improves. That reflects a massive cost-of-funding advantage spurring catch-up after Japanese corporates have been risk averse and lagged their competitors in overseas expansion over the last two decades. Overall it leaves Japan's 'narrow basic balance' in a pretty neutral state (middle chart).

Cross-border portfolio flows have also had little impact on the yen thus far. Foreign equity inflows seem to have been largely hedged and new bond outflows were limited to banks' offshore treasury activity. Henceforth, real money inflows to Japanese stocks should pick up, but will probably be balanced by growing Japanese outflows into foreign bonds and stocks – the latter encouraged by the new NISA scheme and more aggressive GPIF portfolio adjustment away from JGBS.

That would leave the financial account's short-term loans balance as largest swing factor again. It captures carry trades and foreign asset hedging activity and responds to risk aversion and investor's perception of long-term interest rate differentials. It is several orders of magnitude larger than other BoP components and seen in stock terms retains scope for several hundred billion dollars of yen-selling unwinds (lower chart).

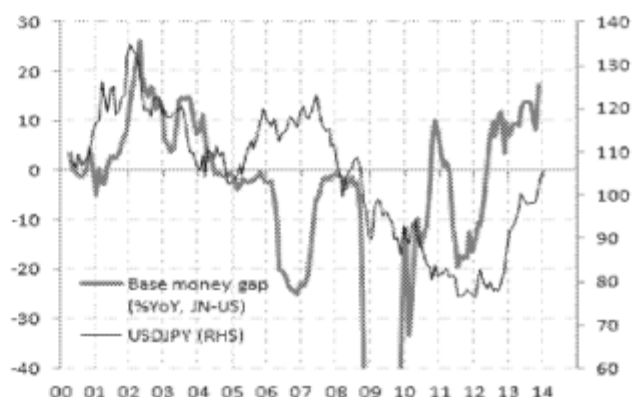
Abenomics abound

Conventional market tops are characterized by hubris in the mainstream which creates unquestioning acceptance of a 'new status quo.' By contrast, most forecasts for Japanese asset prices strike us as intensely conservative as there is tremendous skepticism that the country's long-term prospects have really been changed by the advent of Abenomics.²

Inevitably there will be bumps along the way, and nobody should expect a free lunch. But until the basic tenets of what remains a uniquely favorable backdrop of fundamentals and potential flows are challenged or overshadowed (geopolitics, anyone?), we'd encourage investors to replay last year's template as this year's basic game plan. We expect FX-equity correlations to remain extraordinarily high and volatility to stay elevated. Our end-2014 and 2015 USD/JPY forecasts of 115 and 120 are reiterated with upside risks.

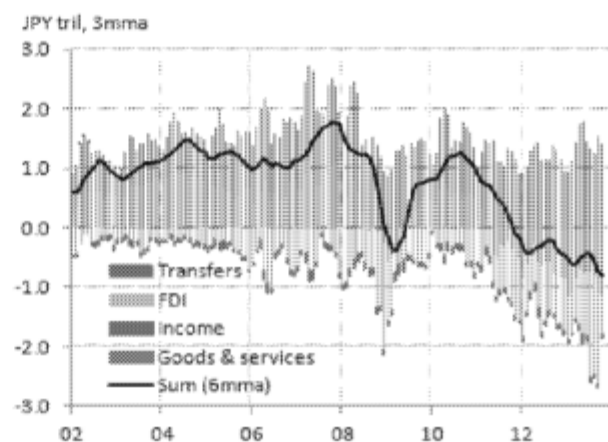
² For a convincing exposition of this assertion, see Kuroda's recent speech: https://www.boj.or.jp/en/announcements/press/koen_2013/data/ko131225a1.pdf

Relative base money growth will only point higher



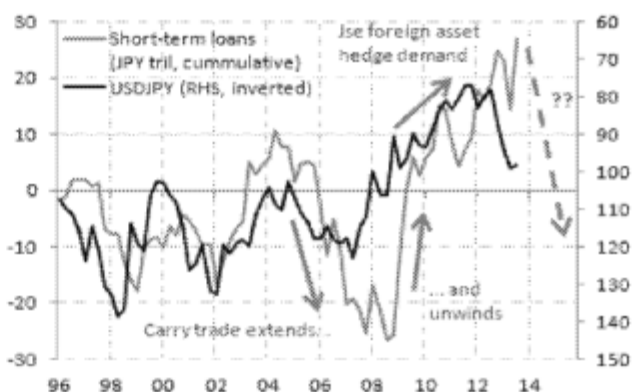
Source: Deutsche Bank, Bloomberg Finance LP

Narrow basis balance still under pressure



Source: Deutsche Bank, Bloomberg Finance LP

Financial account's 'other investment balance' is key



Source: Deutsche Bank, Bloomberg Finance LP

James Malcolm, London, (+44) 20754 50884
Taisuke Tanaka, Tokyo +81 (03) 5156 6714