FORTEM CAPITAL

FRIDAY NIGHT 'LIGHTS

Japan

23rd September 2016

This week, we turn to Japan for our Friday Night Lights topic. The Bank of Japan stated that the economy was no longer in deflation, most likely indicating that to their eyes at least, the current programs are having the desired (if somewhat slower than expected) effect, and their policy moving forward will be simply to fine-tune. It seems therefore that it was business as usual with regard to their 2% inflationary target; case in point, the maintaining of short term rates at -0.1%. The major policy announcement to come from this speech was the introduction of QQE with yield curve control, likely resulting in their purchasing of different maturities to target some steepening of the curve. Bear in mind however, it would seem unlikely that the BoJ would buy too many long and ultra-long JGBs so as not to crowd out the larger financial institutions.

What does this mean for Japanese equities?

Well, for the majority of investors into Japan this year, most gains have been garnered through exposure to the Yen (which, being seen as a safe haven currency following disappointing statements from the FED and the surprise that was Brexit, has appreciated greatly against the Dollar and Sterling). The direct response following Wednesday's announcement was for the Nikkei to rally approx. 2% (with financials clearly outperforming). So how about longer term? Is it time to take Yen off the table? We've noted conversations for some time now re the potential for equity performance within Japan, but some uncertainty about the durability of the Yen longer term. In fact, even if you have no view on Yen, or at the very least there are no theoretical reasons why the Yen should add significantly greater returns to you the investor — why should you take on the exposure and have to deal with uncompensated, unnecessary volatility?

Now, it would be remiss of us at this point not to suggest the logic of a derivative solution to handle such an investment outlook. There are certain reasons why at this point in time using options to go long Japan are particularly effective. But first, a quick reminder of some structured product basics.

In the simplest example, you start by taking bank credit in the form of a zero coupon bond (ZCB), then sell a put on your chosen index and finally using the money left over from the ZCB and the extra cash generated from the put, you buy your upside calls. The option price is derived from the following formula, and it is with this that the advantage of the current Japanese economy comes into play:

Forward Price = Spot + Applicable Interest Rate – Expected Dividends.

What with the Bank of Japan choosing to maintain rates of -0.1% and the Topix currently yielding 2.16%, these two factors result in far cheaper upside participation than on many other equity markets – take the S&P500 as an example. Tie this in with the fact you are benefiting from UK rates on your zero coupon bond (though much maligned of late, they are at least still positive) this means you can garner quite a decent degree of participation on the upside, while still maintaining a defensive capital position on the downside. One of the defining characteristics of Structures (or so we believe at least) is that they are entirely customizable to your investment rationale; do you want capped or uncapped participation for example, or even a far more defensive product? And finally, and particularly relevant for this FNL, do you wish to be exposed to the currency?

Indicative Levels – 6yr	
Topix GBP Supertracker 65% EKIP	180.0%
Topix GBP 85/125 Booster 65% EKIP	200.0%

Rates (bps)	Current	Week Chge
GBP 1yr	46.70	-0.90
GBP 3yr	42.30	-4.10
GBP 5yr	48.80	-7.00

Equity Indices (%)		
FTSE 100	6915.86	3.06%
S&P 500	2172.20	1.54%
Nikkei 225	16754.02	1.42%
Eurostoxx 50	3032.54	3.31%

Currencies (%)		
GBPUSD	1.2948	-0.42%

5yr Credit Spreads (bps)		
Citigroup	80.10	1.22
Credit Suisse	131.56	4.86
Deutsche	223.10	10.57
GS	96.38	0.61
HSBC	67.12	-0.55
JPM	62.46	0.78
MS	92.87	-0.55

Commodities (%)		
Gold	1339.66	2.24%
Oil	46.24	6.01%

3m Implied (vol pts)		
FTSE 100	13.90%	-1.47%
S&P 500	13.45%	-1.29%
Nikkei 225	19.99%	-2.04%
Eurostoxx 50	19.88%	-1.56%

5yr Implied (vol pts)		
FTSE 100	19.29%	-0.83%
S&P 500	21.14	-2.06%
Nikkei 225	19.54%	-0.48%
Eurostoxx 50	19.82%	-0.33%

Source Bloomberg / Partner Banks
Data as at 23rd Sep, 3.00pm

Upcoming events	
26th Sep	BoJ's Koruda Speaks in Osaka
26th Sep	Draghi speaks in Brussels

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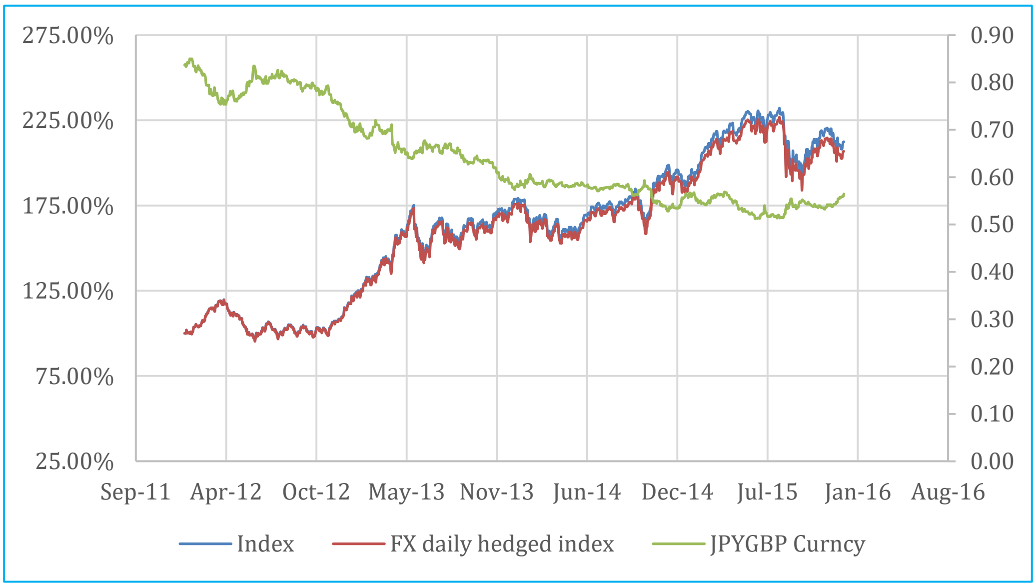
Were the answer no, there are two means in which to mitigate currency risk. The first is a Quanto – which is perfectly hedged against the Yen from the day you buy the product to the day it matures (or you decide to sell) for the full notional amount; the other is a somewhat Quasi-hedge. Each day the structure enters into a one day FX forward, whereby JPY is sold one day forward in exchange for GBP, for a JPY amount equivalent to the JPY value of the equity for that day. Hence any change in the value of your JPY equity investment over that day is exposed to JPY|GBP currency movements. This is very similar to the FX hedging strategy many funds utilise, albeit they tend to operate a monthly hedging policy.

The Quanto sounds better, and is a more effective hedge – but we believe it can also result in you paying far more than is necessary out of your upfront participation; the more volatile the currency and equity market, the more expensive it is to perfectly hedge such an exposure. We have found that the pricing difference between the Daily-Hedged versions and the Quanto is potentially very attractive given certain market scenarios. The below analysis uses current pricing from our banks for the structure listed and takes the view that the Yen will weaken against the Pound, while the Topix will appreciate in value.

Citigroup Topix Supertracker

6-year maturity	**180% Participation** (Quanto: 125% participation)
Topix underlying (with daily FX hedge)	
65% European Knock-In Put	
Uncapped Participation	



	Participation	Index Final	Index Performance	Payoff
Daily Hedge	180.0%	204.4%	104.4%	287.8%
Quanto	125.0%	206.8%	106.8%	233.5%

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The below is an alternative product were you to hold a slightly less bullish outlook.

Citigroup Topix Booster

<table>
<tr><td>6-year maturity</td><td rowspan="4">200% Participation</td></tr>
<tr><td>Topix underlying (with daily FX hedge)</td></tr>
<tr><td>65% European Knock-In Put</td></tr>
<tr><td>Capped Participation from 85%-125%</td></tr>
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So there you have it. The long Japan play, without exposing yourself to the yen. This is potentially of real interest going forward, especially given the outlook for Japanese equities in the next few years. Of late Japan has been unique in looking at the quality of a company's balance sheet and not at its size; meaning that company directors are attempting to build high quality businesses with very low operating margins, running on stable profits so as to avoid the potential "loss of face" were their company to fall out of the "moral indices". As such, when paired with, what will hopefully be successful long term QE to devalue the currency, you are left in a position where a fall in the value of the JPY will immediately drive up operating margins, leading directly to increased profits. In a world with global economic growth of circa 2.5%, and worldwide company profits averaging no more than 3%, were Japan to be successful in building quality businesses and devaluing their currency, you will likely see a situation similar to that of the US stock market over the last few years; increased investor momentum moving into corporate profit, resulting in the growth of Japanese equities.

Disclaimer

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