Research Blast

Asia Pacific Real Estate Market, May 2016 Update

Japan's negative interest rate policy: Impact on real estate

The Bank of Japan (BoJ) joined the negative interest rate club earlier this year, following in the footsteps of central banks in Europe – including the ECB, Swiss National Bank, Riksbank and Danish National Bank – which have pushed deposit rates on bank reserves below the zero threshold, albeit to varying degrees.

Digging deep

While the motivation and implementation of the negative interest rate policy (NIRP) differs across markets and regions, the BoJ has signaled its commitment to achieve its 2% core inflationary target by offsetting recent domestic demand weakness and stimulating household and corporate spending. In Japan's case, NIRP is not applied to the total outstanding deposits that financial institutions hold at the BoJ. Instead, interest rates will be applied on multi-tiered basis where only the excess slice beyond the basic balance and macro add-on balance[1] is 'taxed' at a -0.1% rate. This is to minimize the pressure on bank earnings and to ensure that reserve increases that are the direct consequence of the BoJ's quantitative easing program are not subject to negative rates. The framework also provides flexibility for the BoJ to push rates further into negative territory in the future.

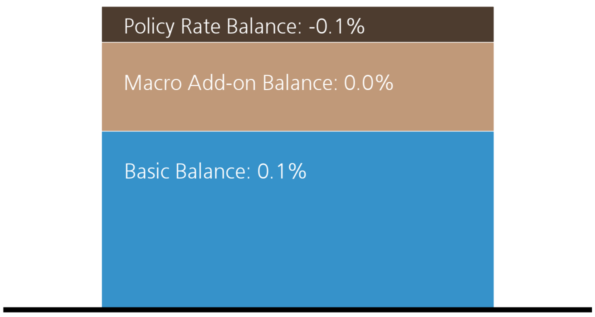
The underlying premise appears straightforward enough; that is to supplement existing quantitative easing measures of Abenomics. For one, the NIRP will lower the returns that the banking sector earns on their aggregate excess reserves held at the BoJ. This may incentivize banks and other financial institutions to lend more to corporates and households where the absolute returns are higher, so as to encourage spending and investment.

The BoJ's combined quantitative easing program and NIRP is generally positive for real estate pricing and capital flows

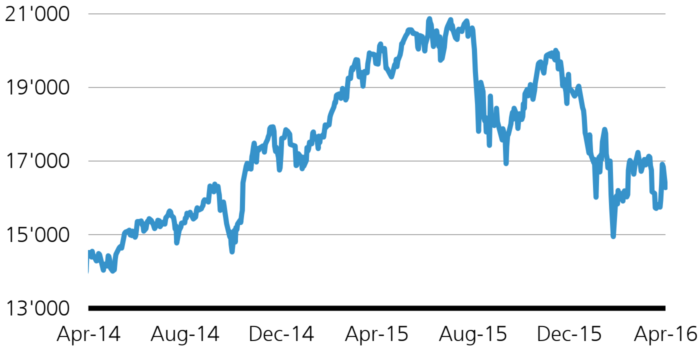
Moreover, the combined impact of the quantitative easing program, NIRP and further expected monetary easing in the coming months may reinforce the BoJ's commitment to achieve its inflationary targets. Such credible goals would have knock on impacts to household and corporate inflationary expectations, and importantly, wage inflation. In turn, this would help to stimulate the economy as households and corporates bring forward their spending plans ahead of any expected price hikes.

Note: 1 Basic Balance refers to the existing level of reserves held at the BoJ (average current balance last year). Macro Add-on Balance refers to required reserves and funds borrowed from the BoJ under the various lending programs Policy Rate Balance refers to new excess reserves created by the BOJ asset purchase program and any reserves not included in the first two tier of balances

Multiple Tier System of NIRP



Tokyo: Index: Nikkei: 225 (Japan)



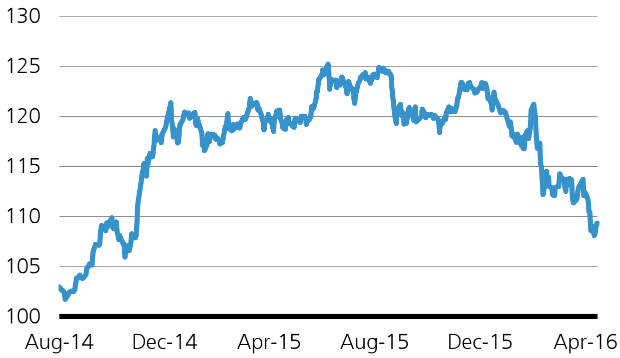
Source: BoJ, as at January 29, 2016 & CEIC, as at April 18, 2016

UBS

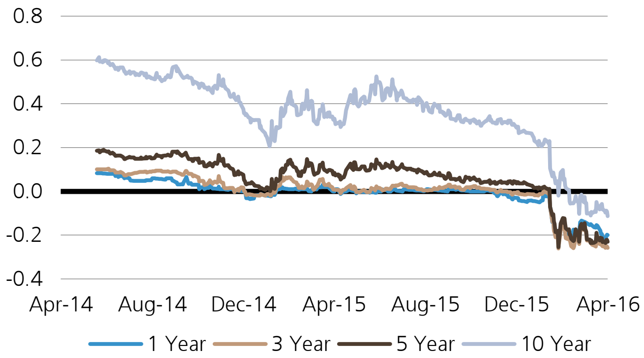
Risk aversion trumps NIRP
The immediate reaction of financial markets to the BoJ's NIRP announcement was unexpected with both the currency and risk assets moving against broad consensus views. In a flexible exchange rate regime, economic theory suggests that lower interest rates and return expectations relative to other markets should lead to a weakening of the currency, all else equal. However, other factors have been clearly at play over the year to date, with heightened risk aversion and uncertainty over the BoJ's monetary resolve leading to an unexpected strengthening of the Yen. Moreover, while the Nikkei 225 index initially appreciated in the days following the NIRP announcement those gains have been short-lived.

In contrast, NIRP and increased risk aversion have both worked in the same direction for the pricing of safe haven assets with investors increasing their exposure to defensive assets and markets during a period of heightened macro uncertainty and financial market volatility. The combined impact has pushed yields on Japanese Government Bonds (JGBs) into negative territory. JGBs with maturities of up to ten years are now being issued and traded with negative yields. Yields on longer dated JGBs have seen even sharper downward shifts, which has flattened the yield curve relative to its position at the start of the year. The flattening of the yield curve is positive for real estate pricing.

JPY USD



JGB Yields (% pa)



Source: CEIC, as at April 18, 2016

Generally, the impact on real estate is positive
The impact of the NIRP on real estate pricing, fundamentals and capital flows will generally take place via three related channels: interest rates, credit availability and currency impacts.

- **Pricing.** Despite elevated financial market volatility and the pullback in investment transactions in 1Q16, prime property yields across all sectors were broadly stable in Tokyo. In part, the stability of pricing was supported by the decline in yields on risk free assets and lower debt servicing costs over the quarter, both of which are the direct result of the BoJ's quantitative easing program and the introduction of NIRP.
- **Risk free returns.** The NIRP environment reinforces commercial real estate's attractiveness compared to the returns available on government bonds and high quality corporate debt, particularly if these assets are held to maturity. With the decline in yields on 10 year government bonds more than offsetting the compression of commercial real estate yields, property spreads actually rose in 1Q16. The same also applies in the listed space, where dividend yield spreads for Japanese Real Estate Investment Trusts (J-REITs) rose over the quarter. Elevated yield spreads for both unlisted and listed real estate exposure will continue to attract strong interest in the asset class.
- **Credit availability.** An overall decline in interest rates reduces the interest burden on leveraged investors, particularly if lending margins remain flat or fall as result of increased competition from lenders. This is likely the case for core exposure as Japanese lenders compete for the best assets and investors which should continue to pressure lending margins. Moreover, with the banking sector's earnings under pressure as a result falling returns on excess central bank balances and government bonds lenders are likely to increase their overall lending to the sector.
- **Cross border flows.** The combination of quantitative easing and NIRP is pushing returns lower in Japan and reinforcing the case for domestic investors to increase their global real estate exposure. Exposure to global markets would help institutional investors meet current and future obligations that continue to climb as dependent numbers swell. To date, however, the risk adverse nature of institutional investors - which reflects the preference for defensive strategies of older aged cohorts - has meant that RCA has only tracked USD 2 billion of capital from Japan into direct global real estate (excluding funds) over the past 12 months and USD 15 billion over the past five years. Equivalent cross-border capital flows for other countries that have large pension fund markets are considerably higher. A stronger Yen should help support the exposure to global markets.

Japan's global real estate investments (excludes funds, USD billions)

Past 12 months		Past five years	
Market	**Total**	**Market**	**Total**
Manhattan	1.4	Hawaii	2.3
Singapore	0.5	London	2.0
London	0.4	Manhattan	1.6
Sydney	0.3	Singapore	0.9
Washington DC	0.3	Washington DC	0.8
Boston	0.1	San Francisco	0.6
Seoul	0.1	Nantong	0.5
Jacksonville	0.1	Boston	0.5
Manila	0.1	Shanghai	0.3
Other	1.1	Other	5.4
Total	**4.5**	**Total**	**14.9**

Source: RCA, as at 1Q16;

Conclusion

Of course, there are numerous drivers of cross-border capital flows including the size of the domestic real estate market, appetite for higher risk strategies and regulation. But with macro growth weak, downside deflationary risks building and structural reforms aimed at boosting the labor force and productivity growth conspicuously absent, it will be again left to the BoJ to stimulate demand. Further monetary easing measures will bring forward the point at which global return expectations more than offsets currency risk for Japan's institutional investors. Under the alternative scenario in which the BoJ has already exhausted its monetary levers investors may be better off bringing forward their global investments rather than being exposed to a rudderless ship.

Real Estate Research & Strategy – APAC

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