AEW

The BoJ and Japan's Property Markets

Farewell to Negative Rates

Japan - renowned as the final stronghold for negative interest rates, officially ended its 8-year negative interest rate policy on March 19, 2024, setting a new rate range of between 0% and 0.1%. The overall tone of policy makers remains dovish and accommodative policy is expected to be maintained.

This was an expected outcome as some BoJ policy makers had hinted to the press/media that a change was imminent. The precursor to this was corporate giants had announced average salary increments of up to 5.3% for FY 2024, larger than what the trade unions petitioned for last year. In policy discussions, the BoJ had emphasized the importance of wage growth to stimulate consumer spending and achieve sustainable inflation, despite core inflation already exceeding their 2% target for the whole of 2023.

Yield curve control (YCC) was also officially scrapped, although it had been informally discontinued in October 2023 by allowing the 10-year JGBs to float above the 1% reference rate. The BoJ has been buying 10-year JGBs at a rate of JPY6 trillion per month and is largely expected to maintain this pace and magnitude of bond purchases over the next few months. Consequently, AEW believes a rise in 10-year JGBs is likely to be gradual rather than a sudden spike.

Going forward, the BoJ have reiterated a commitment to accommodative financial conditions and managing a gradual tightening process, a commitment likely to be strictly adhered to given policy missteps in the past and the still fragile state of the Japanese economy. Acknowledging data and information available as of time of this note, the door is probably still open for another rate hike in 2024.

The yen's rise was expected following the March 19 announcement, but the BoJ's accommodating language pushed the USDJPY beyond the 150 mark. Additionally, the yen had slightly softened in the week leading up to the BoJ decision, influenced by the strength of the US dollar and expectations of reduced rate cuts from the Fed. Forward curve expectations have tapered since the start of 2024, with the yen's appreciation to end 2024 expected to be between 4 to 5% from spot.

Sources: AEW Research, AEW Asia Pac Securities, Bloomberg.

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Considering these developments, AEW examined what may be the biggest risks and advantages to the current and potential investments and property markets going forward:

Cost of Debt to Stay Attractive and Lender Appetite Healthy

- Lenders, especially big banks, remain eager to lend (alongside the prospect of higher net interest margins); there has been no change in LTVs or margins to-date.
- Higher debt costs are inevitable, but the increases are very slight- the floating rate (3M TIBOR) has increased by 12 bps since end Dec 2023. The five-year fixed rate (against the 3M TIBOR float) commonly used by core investors has also increased by 8.6 bps. Investors are expected to opt for more fixed-debt arrangements, given market perceptions today and to seek protection from rising interest rates.

Currency Impact Likely to be More Influential Over Debt Costs in the Near-Term

- Leveraged cash-on-cash returns are anticipated to marginally decrease in the near-term, especially for assets with floating debt exposure. As an example, a projected 20 bps rise in the debt costs (assuming 40% LTV) would likely lead to a 10 bps decline in cash returns.
- However, investors in USD and EUR denominated funds with unhedged positions could probably see greater influence from currency impact. According to AEW's estimations, a 5% increase in JPY could result in a positive FX impact of around 300 to 350 bps for USD asset-level returns, assuming all other factors remain unchanged.

Inflation Should Support Rent Growth

- Inflation's silver lining should not be ignored, as it will likely prompt more regular rent increases, especially in shorter-lease property types like residential. While locals have historically been resistant to rental increases, landlords and asset owners are likely to push through cost increases more frequently than before.

Further Cap Rate Compression Unlikely

- In a rising interest rate environment, the potential for cap rate compression is limited. Any compression that does occur going forward will likely be due to specific asset features, value created through asset management, or investment in niche property types that are still maturing.
- Traditional sectors with longer lease term sectors such as office and logistics are more at risk to cap rate expansion versus the shorter lease term residential sector, for which rents are likely to benefit from an inflationary environment.
- AEW believes the weight of capital into the market will likely keep yields largely flat for 2024. Investor interest in Japan remains strong, with CBRE highlighting the market as a top-tier destination for investing for 2024. Already in the first two months of the year, Japan has made up around 45% of all transactions across our target markets.

Public Market Implications

- With chatters of an earlier-than-expected normalization of monetary policy since mid-March, the market had reacted by a marginal pullback of 3.6%. Japan equities had been a global outperformer globally year-to-date so the profit taking on any reason was hardly surprising. Post the announcement and a more dovish than expected tone, real estate stocks rallied 4.5% and JREITs 3.2% respectively.
- While BoJ is continuing its JGB purchase program, ETF and JREIT purchase program will be terminated. There is little market impact on the absence of buying by BoJ, as the central bank made no purchase in 2023 and miniscule buying in 2022 of JPY631bn and JPY3.6bn in ETF and JREIT respectively.
- However, the halt brings on the question of exit, which BoJ is probably not ready to address in the short-term. We are particularly concerned about JREITs, as BoJ owns close to 10% of major JREITs.
- The increase in base rate will have an impact on JREITs dividend, but we feel the impact will be limited. The average debt duration is longer than 4 years and more than 70% of the debt is fixed. But the increase in cost of debt provides greater pressure on JREIT management to focus on growth to offset the downward pressure on dividend.

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