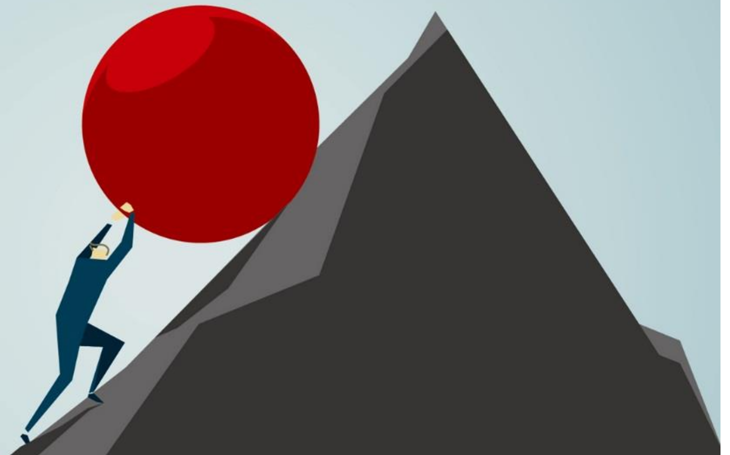
IS MIXING GOVERNMENT POLICY WITH PENSION FUNDS A GOOD IDEA?

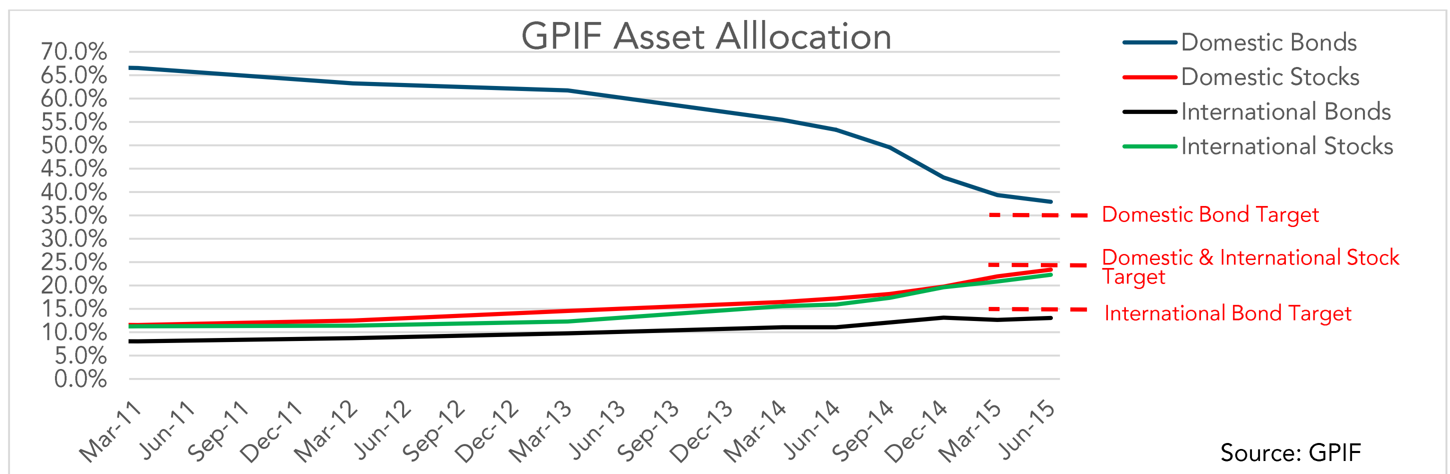
Russell Clark's
Market Views

"The Abe administration has substantially increased risk within the GPIF, potentially at a cyclical top in markets whilst the average fund member has come closer to retirement age."



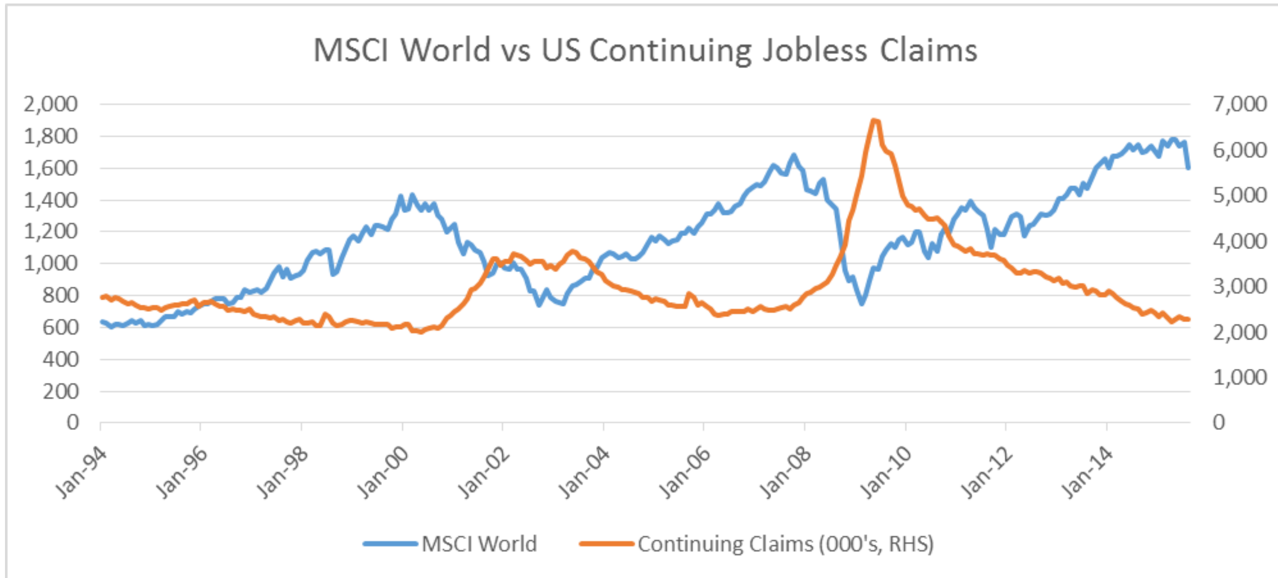
This note is written in conjunction with Shannon McConaghy.

Japan under Prime Minister Abe is seeking to end deflation. So far its main methods have been to engage in massive Quantitative Easing as well as to force the Government pension funds to sell Japanese Government Bonds (JGBs) and buy more risk assets. The Government Pension Investment Fund (GPIF) with 1.5 trillion USD in assets is the world's largest pension fund. As the chart below shows the GPIF has duly shifted its asset allocation with significant gusto and by June this year had almost reached its new targets.

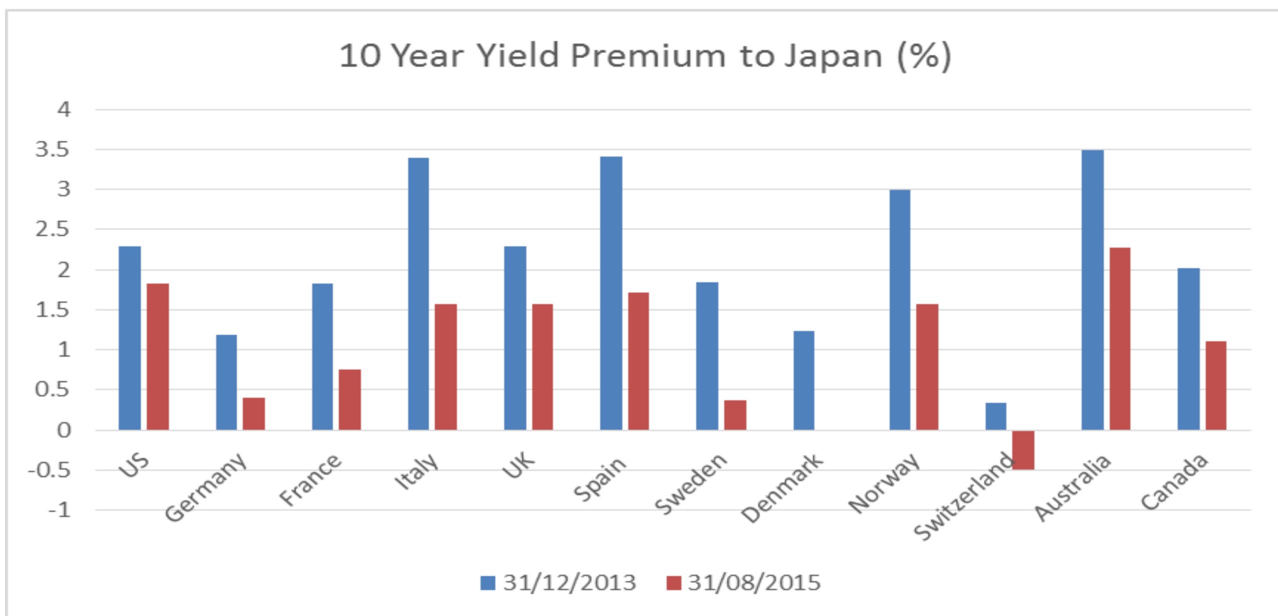


The GPIF has essentially been selling JGBs and moving the money into domestic stocks, foreign stocks and foreign bonds.

It is easy to argue that the shift into domestic and foreign stocks has come at a time when equities are at a cyclical high. The recent sell off in global equity markets has coincided with levels of US continuing jobless claims last seen just prior to the financial crisis and before that seen just prior to the tech crash.

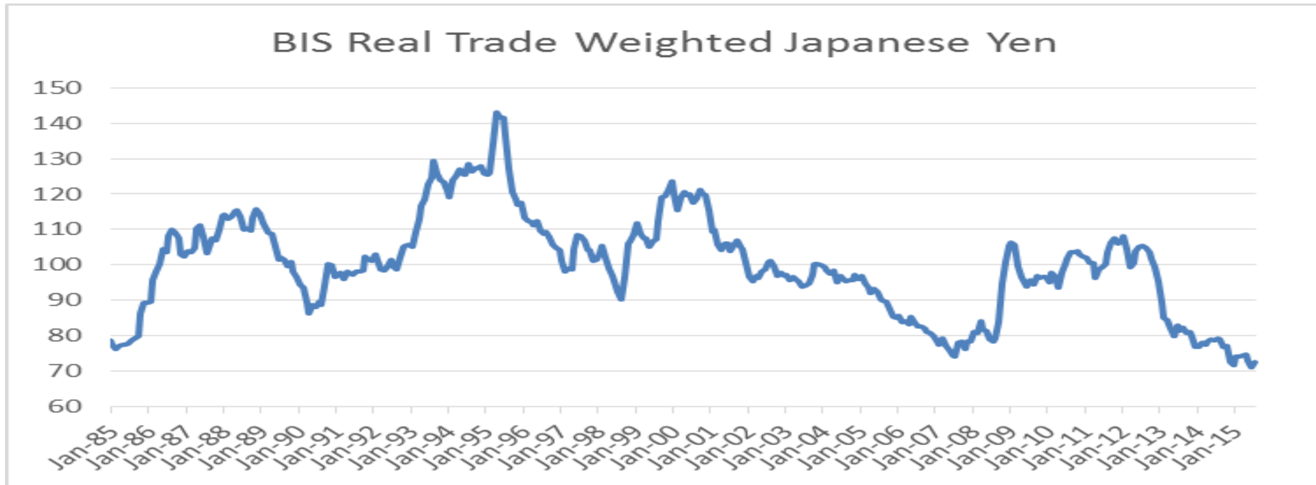


The yield premiums on offer from shifting into foreign bonds have also dramatically declined since the initial proposals were made for a shift in GPIF assets in 2013.



The GPIF outflows into overseas equities and bonds were a significant driver for Yen weakness in the last financial year, as we have previously demonstrated in The Fierce Yen Seesaw. With such a rapid move from the world's largest pension fund it is likely that the purchases increased the value of both the assets being purchased and the value of the currency the assets were denominated in, against the Yen. The size of the asset flows from the GPIF would make hedging difficult, and many articles suggest that the GPIF foreign investments are indeed not currency hedged.

The problem with this in my mind, is that the Yen is already trading at a very low level. On a real trade weighted basis it is trading nearly 30% below its long term average of around 100. The question is what would happen to the GPIF portfolio should some economic shock force the Yen back to its long term average of 100.



Looking at the GPIF performance in 2008 provides an indication of what to expect if a substantial economic shock were to hit equity prices and force the Yen to appreciate as a safe haven currency - or rather force the unwind of the Yen carry trade. During 2008 domestic bonds returned 1.35%, domestic stocks fell 35%, international stocks fell 43% and international bonds declined 7%. While the underlying foreign bond values actually rose, as they usually do in a crisis, the unhedged currency risk meant they generated losses like a risk assets. Under the old allocation, this led to a 10% fall in assets for the GPIF. If we use the new target allocation, assets would fall by around 20%. Furthermore with global bond yields now substantially lower there is less room for bonds to rally to offset equity losses, implying that losses would be greater than 20%.

The Abe administration has substantially increased risk within the GPIF, potentially at a cyclical top in markets whilst the average fund member has come closer to retirement age. This is at odds to conventional pension policy that advocates lower risk as the underlying investor ages. A substantial drawdown of the fund amidst any economic shock would likely generate a great deal of public ire towards the Abe administration, particularly as the GPIF is already experiencing a shortfall of pension contributions against pension payments. Since 2010 the GPIF has been selling down assets to pay for this shortfall, the rate of the sell down will increase and include selling all of the equities it has recently purchased (for more details see GPIF Will Soon Start Selling Equities And Buying Yen).

As we have previously written, Japanese equities tend to fall more than other markets during economics shocks. The conditions for this to happen are again in place with the Yen weakened by substantial carry trades during "risk-on" and record levels of foreign investor holdings emboldened by Abenomics (link: Japan An Excellent Hedge As Asset Imbalances Return). If one of the key policies of Abenomics were to now backfire creating added political risk as markets start to decline this would add further to Japan's attractiveness as a short that could provide magnified returns on an economic shock.

INFORMATION

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