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As mentioned in the last issue of The Fortnighter, I'm just back from a 10-day visit to Beijing and Tokyo (with a large group of my colleagues from RBC). In addition to visiting a few of the traditional tourist attractions, we also had the good fortune of speaking with a number of local money managers about the outlook for the two respective economies.

Aside from the air quality in Beijing (which is appalling), I think the topic most discussed was "Abenomics" – Japanese Prime Minister Shinzo Abe's bold plan to jump-start his country's stagnant economy.

Japan has been in the doldrums for the past 20 years. What's also well-known is that most Japanese investors shun the stock markets in favor of bank deposits – which typically pay on the order of 0.1% interest.

What I didn't appreciate, however, was that because of deflation, Japanese bank depositors actually earn more than we do in Canada (!!) – i.e. after 2.5% inflation, a Canadian investor's "real" return on a 2% GIC is -0.5% (and in a 50% tax bracket it's -1.5%). In Japan, inflation has been negative, so a bank deposit earning 0% is actually growing each year in real terms!

The second surprise was that a deflationary economy can actually attract foreign money (especially bond investors) which can drive UP the value of the currency. And herein lies one of Japan's main problems – a strong Yen has been killing their (largely) manufacturing-based economy.

Most people think a strong currency is good (i.e. a "$1.05" Canadian dollar means more $ for that Vegas vacation or eBay purchase). And it certainly helps keep inflation down. But a strong currency makes manufactured goods more expensive to foreign buyers, reducing a country's competitiveness.

So, the first target of "Abenomics" is to drive down the Yen. Print money, increase the money supply, buy foreign currencies or assets….So what if inflation goes up a bit? (Abe's target is to increase it to 2%).

It seems to be working. The Yen is tanking and the stock markets are soaring. Japanese manufacturers are elated. Keep it up and consumers might also be encouraged to start injecting some of their savings back into the economy (and stock markets) rather than see it eroded away by inflation.

But….Third surprise: As expected, Japanese bond prices are falling, but 10-year bonds are still yielding below 1%! (Inflation erodes the future value of bond payments, so if I owned long-term bonds and thought inflation was increasing to 2%, I'd be demanding significantly higher yields). So, while the stock and currency markets seem to believe that Mr. Abe's reforms will be successful, bond investors remain skeptical. Interestingly, so too were the money managers we spoke with.