JAPAN: WHERE DO WE GO FROM HERE?

Recent Japanese monetary and fiscal policy announcements are trying to reinvigorate Abenomics, (Prime Minister Shinzo Abe’s economic plan), but the reality is there seems to be little momentum left in the current set of policies. The government continues to struggle to get the three arrows of Abenomics — fiscal stimulus, monetary easing and structural reforms – back on course after such a promising start in 2013, and a potential shift in the administration’s focus to constitutional politics could slow what little momentum remains.

Given the importance Japanese equities play in a globally diversified equity portfolio – they represent approximately 10% of the global equity markets – how might Abe’s faltering policies affect investors? To answer this question, it is important to first understand the economic and political forces at play.

Recent developments

This past month Japanese voters gave the prime minister and his party an even stronger mandate at the country’s Upper House elections and a super majority across both houses. Both the Bank of Japan (BoJ) and the government announced additional measures, signaling a continued resolve to meet the economic targets of the program. However, the economy is still in the doldrums and the current measures fall short of shocking the economy off its low growth/low inflation path. The government has the backing of the people to do more, but it appears to be at a crossroads: will it boldly focus renewed strength on its economy? Or waste its popular mandate on re-igniting historical conflicts to gain a geopolitical advantage in the region?

In mid-July, a mere two weeks ahead of the 29 July BoJ meeting, former U.S. Federal Reserve Board Governor Ben Bernanke visited Japan and met with Prime Minister Abe. Bernanke’s continued advocacy of so-called ‘helicopter money,’ (a radical monetary policy that stimulates the economy through direct transfers to individuals funded by an increase in government deficits), contributed to mounting expectations that he may be in Japan to advise the BoJ how to implement such a policy. The Yen weakened in anticipation touching 107.38 against the US Dollar on 21 July, exciting observers that Japan may finally do something revolutionary. However this was not the case; while new measures were announced following the meeting, none were deemed significant enough to pull Japan out of its low inflation
rut. The Yen strengthened immediately and opened at 102 on 1 August; hopes of a win for Abenomics were dashed.

The government also announced a new fiscal package as the government returns to using both fiscal and monetary coordination. While this is a positive development unfortunately it proved equally disappointing in its scope. The new fiscal package totaled JPY 28.1tn but technically only JPY4.6tn or 0.9% of GDP in new money. The package included money for welfare spending, infrastructure and small and medium-sized businesses facing stress from Brexit and post-earthquake reconstruction. In the short term I can see little of this extra funding feeding immediately into the economy, while medium and long-term influence will rely on the quality and implementation of the projects selected be it through market determined projects, contributing to efficiency and job growth.

When Prime Minister Abe was first elected in December 2012, he started both a domestic campaign and global tour to sell Abenomics. His enthusiasm was unmatched and there was a sea change in beliefs around what Japan could do to reverse the multi-year slump and deflationary episodes. But that momentum has seemingly faltered and fatigue has set in over the various piecemeal announcements on new measures.

**Market Distortion**

Against this backdrop, the Japanese market is becoming increasingly distorted and the government needs to tread carefully to avoid panicking market participants in an overall fragile economy. Japanese 10-year government bonds were heavily sold off after the last BoJ meeting, with the yield increasing 23 bps in the week following the July meeting. The sell-off was triggered by concerns that the BoJ was close to giving up on its inflation target of 2% after the limited announcement from the BoJ and the smaller fiscal package from the Japanese government causing investor hesitation. According to year-end data, the BoJ held 32% of the total Japanese government bonds issuance programme in 2015, this year, the BoJ will have to buy 90% of total new issuance across maturities in order to meet their JPY 120tn target. The distortions are not contained to fixed income. BoJ data from 20 July show ETF (exchange traded fund) holdings stood at JPY8.7tn plus equity holdings totaling JPY 10tn which represents 60% of the value of all outstanding ETFs in Japan.

In an article from April 2016, Bloomberg estimates the BoJ is now in the top 10 shareholder category for approximately 90% of the Nikkei 225 Stock Average. This could be saving the bond and equity markets from a larger correction given the macro environment in Japan but the moral hazard is high. We’ve seen repeatedly in Europe that appropriate and difficult policy is delayed until market pressures come to bear on officials. However in Japan, market pressure is increasingly unlikely, as liquidity dries up leaving the government as the largest equity holder.

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1 The BoJ announced a doubling of its Exchange Traded Funds (ETF) purchases to approximately JPY 6tn, a doubling in the size of the BoJ’s lending program to support growth in USD to support Japanese firms’ overseas activities to USD 24bn and the establishment of a new facility for lending Japanese government securities (JGS) to be pledged as collateral for USD funds-supplying operations.
Political Mandate

However, now Prime Minister Abe, his Liberal Democratic Party and its coalition partner (Komeito) have a strong mandate from the July elections. Their supermajority in the dual house parliament allows them to change the constitution. There has been a focus on whether Prime Minister Abe will seek to change the pacifist constitution, one of his long-term goals. That aim is still controversial domestically and could prove provocative in the region as well. Tensions in Asia are already high around China’s South China Sea expansionary policy and the challenges facing the region around the Trans Pacific Partnership trade agreement. If Japan chooses to move forward with a constitutional change to move away from its pacifist stance, there could be even more geopolitical risk in the region – with negative implications for the future of Abenomics.

There are lots of questions for Japan at this juncture and lots of variables the government has to consider. But given the popular mandate the current government has and the recent re-opening of the door on more coordinated fiscal and monetary policy, it would seem that now is the best time to make bold changes. If Japan chooses to strengthen its economy rather than its military, we believe it is more likely to maintain its ability to shape the region – without the risks inherent in re-opening historical conflicts in the region.

Prime Minister Abe is implementing policy that he believes will help in the long-run, while trying to keep the markets and the public believing a change can happen in the short-term. However, if investor disappointment and disillusionment sinks in, achieving his long-term aims will likely prove impossible. If he chooses to complicate the already challenging economic environment with a diversion into geopolitical risk, Abenomics is likely to fail that much quicker. We believe the time is ripe for bold action that will pay off in the short term. The government has the political capital, Abe just needs to spend it on the economy, and soon.

Implications for Investors

As Abe manoeuvres around the economic and political possibilities, it is important that investors maintain perspective. Japanese equities play an important part of a global approach to equity investing, representing approximately 10% of the global equity markets. From a strategic perspective we do believe that Japanese equity exposure assists in providing the diversification we seek. For instance, in 2015, when U.S., European and emerging market equities struggled to provide positive returns, Japan was up double-digits on hopes that Abe reforms would turn into meaningful economic progress.

However, on a more tactical (one-year) basis, we are underweight Japanese equities, taking a “wait and see” approach. Japanese companies derive approximately 70% of their revenues from the Japanese economy. Until we see better traction from Abe’s initiatives and central bank accommodation, we prefer U.S. equities in the current environment.