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STABLE POLITICS—DYNAMIC ECONOMY—JAPAN PREMIUM

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INTRODUCTION

In the areas of politics and policy making, Japan has become the envy of the world. The snap election got "Team Abe" re-elected with a strong majority, and they will be controlling parliament with basically the same two-thirds supermajority they had before. The stability, continuity and consistency of a strong pro-growth and pro-business agenda are poised to be rewarded with a growing "Japan premium" in financial markets (i.e., Japan's equity markets deserve a higher price-to-earnings[1] [P/E] multiple), in our view.

Specifically, we see the following post-election trigger points for rising P/E multiples in the Japanese equity market and further yen depreciation.

CORPORATE SECTOR DYNAMISM AND ACCELERATING CAPEX[2] CYCLE

Political and policy stability are poised to add momentum to Japan's domestic business investment cycle. Already, leading companies such as Canon and Shiseido have announced some onshoring (i.e., building new production capacity in Japan), and the upgrade cycle for small and medium-sized companies is set to accelerate.

Here we do expect that the new opposition party, led by Tokyo Governor Koike, will put pressure on Team Abe to hasten "special economic zone" programs, particularly in Japan's largest economic region. While the new Party of Hope failed to become the largest opposition party in this election, its political future depends on holding Team Abe accountable for a concrete and visible structural reform agenda. In our view, the new configuration of Japanese parliament has reduced the risks of economic policy complacency. This is particularly so since the Liberal Democratic Party (LDP) may have to depend on the Party of Hope to support the constitutional reform agenda.

BANK OF JAPAN DECOUPLES FROM THE FED CYCLE

Japan's monetary policy[3] is poised to decouple from the Fed rate hike cycle. No matter who will be appointed as the next Bank of Japan (BOJ) governor, he or she is almost certainly going to continue the current support for "Abenomics"[4] from the central bank. The election has strengthened Team Abe's conviction that its economic policy is on the right track, precisely because of Japan's unique collaboration between fiscal and monetary authorities.

[1] Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.
[2] Capex: Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations.
[3] Monetary policy: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.
[4] Abenomics: Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012, aimed at stimulating Japan's economic growth.

Prime Minister Abe's election promise to go ahead with the 2019 consumption tax hike suggests a growing responsibility for the BOJ to ensure against recession[5]. In short, the decoupling of Japan-U.S. monetary policy cycles has become more probable.

CONSTITUTIONAL REFORM NOT AN OBSTACLE FOR ECONOMIC DYNAMISM

For the first time in history, constitutional reform was part of the ruling party's official policy platform, and there can be no doubt that Team Abe will use the two-thirds supermajority status to engage in concrete parliamentary proceedings to revise Japan's basic law. However, this does not mean economic policy comes to a stop. Parliament is not a zero-sum game. Team Abe knows full well that constitutional reform can only happen if the Japanese people support it—a national referendum has to be called within six months of parliament approval.

So it is imperative for Team Abe to remain focused on the creation of pro-growth, pro-business policies. Without a broader feel-good factor among the people, any constitutional referendum is poised to be defeated. The risk is that the pressure to deliver constitutional reform will tempt Team Abe to become more fiscally irresponsible, putting even more pressure on the BOJ, in our view.

All said, Japan's policy dynamics are poised to deliver strong upside surprises to economic growth in general, earnings growth in particular. The Japanese equity market should begin to discount this, resulting in P/E multiple expansion. Position for a Japan premium.

P.S.: The current TOPIX P/E is 16.3 times;[6] an expansion to 20–21x would push it to the top range observed during the past decade.

THE COMING BOJ PIVOT TO BANKS

In coming months, Japan's monetary policy is likely to move back to center stage. This is not just because Prime Minister Abe will have to make a decision on the next governor, but, more importantly, because the case for a change in the operational targets of the BOJ's "yield curve control" is growing stronger. Specifically, we expect a possible change in the BOJ duration[7] target: a pivot away from targeting the 10-year yield to targeting the 5-year or 7-year yield could greatly enhance BOJ reflation[8] credentials.

[5] Recession: A significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale retail sales; generally defined by the NBER (National Bureau of Economic Research) as two consecutive quarters of negative economic growth.
[6] Source: Bloomberg, 10/23/17.
[7] Duration: A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.
[8] Reflation: The term is used to describe the first phase of economic recovery after a period of contraction. This period is typically characterized by the act of stimulating the economy through accommodative central bank policies and reducing taxes to bring growth and inflation back up to the long-term trend.

The benefit of such an operational shift—which is possible without abandoning the 2% inflation target—could be threefold:

First, it would further reliquify private banks' activity in the bond market, effectively "crowding in" private investors' bond investments. Of course, a BOJ pivot away from the 10-year sector may result in higher 10-year bond yields, but private asset managers currently starved of longer-maturity quality assets are likely to welcome this transition.

Second, the steepening[9] of the curve past the new pivot point will raise profit margins and carry trade[10] arbitrage opportunities. Banks and insurance companies would see their profit margins begin to expand, while short- and medium-term yen funding costs would still be capped at zero up to the new pivot point. A "hockey stick" steeper yield curve should boost private banks' profits.

Third, the impact on Japanese equities would likely be very positive, thus adding to the reflationary momentum. This is because Japan's banking sector has been a huge drag on Japanese equities—while TOPIX has surpassed its Abenomics 2015 high, the Banks Index is trading about 40% below it.[11] Make no mistake, this huge underperformance is due to the BOJ's negative rate policy compounded by the 10-year zero yield control. An inward pivot to capping 5-year or 7-year bonds should trigger a positive inflection for banks' future earnings and thus allow a positive rerating of Japanese financials in general, banks in particular.

In addition, an inward pivot should not have significant impact on global carry trades and the exchange rate. By anchoring short- and medium-term yen funding costs at zero, the rising interest differential between Japan and the U.S. should still push up the U.S. dollar, in our view.

At this stage, the first trial balloons on a possible change in the operational target of the BOJ's yield curve control appear to be floated with, for example, Deputy Governor Nakaso hinting at flexible scenarios that might be considered. In our view, Team Abe is likely to look favorably on a BOJ operational shift that raises the profitability of banks and thus furthers the reflation agenda.

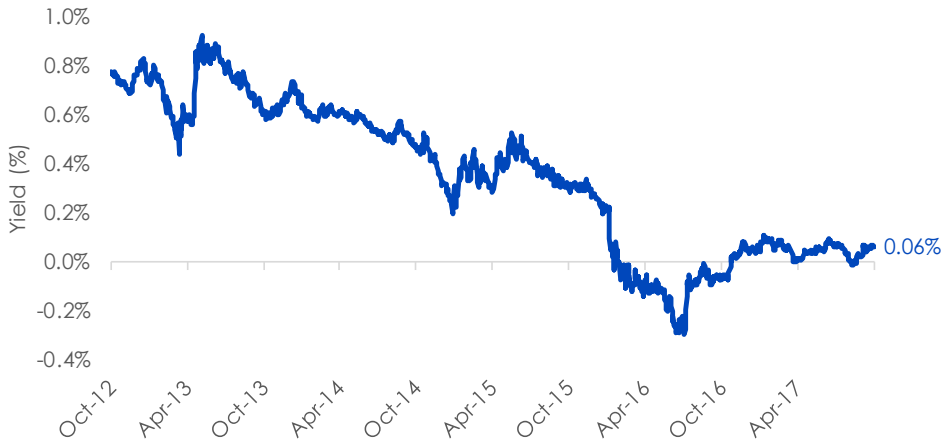
In our view, the time has come to raise allocations to Japanese financials in general, banks in particular. If we are right on the coming pivot, the next BOJ move will be reflationary—precisely because it allows a turning point in banks' profitability prospects.

[9] Steepen: An increase in the spread between short-term interest rates and longer-term rates.
[10] Carry: The amount of return that accrues from investing in fixed income or currency forward contracts.
[11] Source: Bloomberg, 10/23/17.

FIGURE 1: Japanese TOPIX and TOPIX Banks—Sharp Underperformance by Banks because of 10-Year Yield Control since September 2016

Sources: WisdomTree, Bloomberg, 10/24/12–10/23/17. Past performance is not indicative of future results. You cannot invest directly in an index.

FIGURE 2: BOJ Has Anchored the 10-Year JGB Yield into a Tight Box—Zero to 10bps; No Room for Bank Profits to Grow



Sources: WisdomTree, Bloomberg, 10/24/12–10/23/17. Past performance is not indicative of future results. You cannot invest directly in an index.

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