HOMEGROWN STRENGTH: JAPAN'S CAPEX CYCLE ACCELERATES

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Our structural bull thesis for Japan predicts an endogenous, self-sustaining domestic demand up-cycle that is driven by Japan's private sector. The country's demographics are the key force—for households, the structural shortage of labor will push up incomes and improve job security, thus creating purchasing power for a "new middle class"; and for companies, the scarcity of human capital will force a shift toward more capital-intensive business models, i.e., a structural upturn in capital expenditures, or capex, to improve the quality of the domestic capital stock. Also, mergers and acquisitions activity is likely to pick up, because the scarcity of human capital will force fundamental industrial reorganization. In short, Japan's productivity is ready for a positive supercycle, which should translate into a structural upturn in capital returns.

From Thesis to Reality—Yes, a New Japan Capex Boom

Good news: the latest forward-looking surveys suggest a sharp pickup in domestic business investment, set to rise 13.7% in the new fiscal year that ends in March 2018 (after a 3.8% drop in the year that ended March 2016). The 13.7% rise in domestic capex is the first double-digit growth in over four years. At the same time, overseas investment is set to rise 26.5%, a big recovery from the 12.7% contraction reported in the last fiscal year.[1] Make no mistake: "Japan Inc." has rediscovered its "animal spirits."[2]

From Capex to Leverage to Bank Profits

For investors, the coming upturn in for-growth capital spending has several implications.

First, Japan's domestic demand cycle is likely to accelerate, which, before long, could boost industrial sector profit forecasts. Small- and mid-cap companies are likely to benefit most. However, given that the sharp rebound in Japan's overseas investment appears to be coinciding with an accelerating U.S. capex cycle, large-cap machinery makers and capital goods companies could also be in for positive profit surprises. In a nutshell, Japan's capital goods sector could show both domestic- and export-led growth.

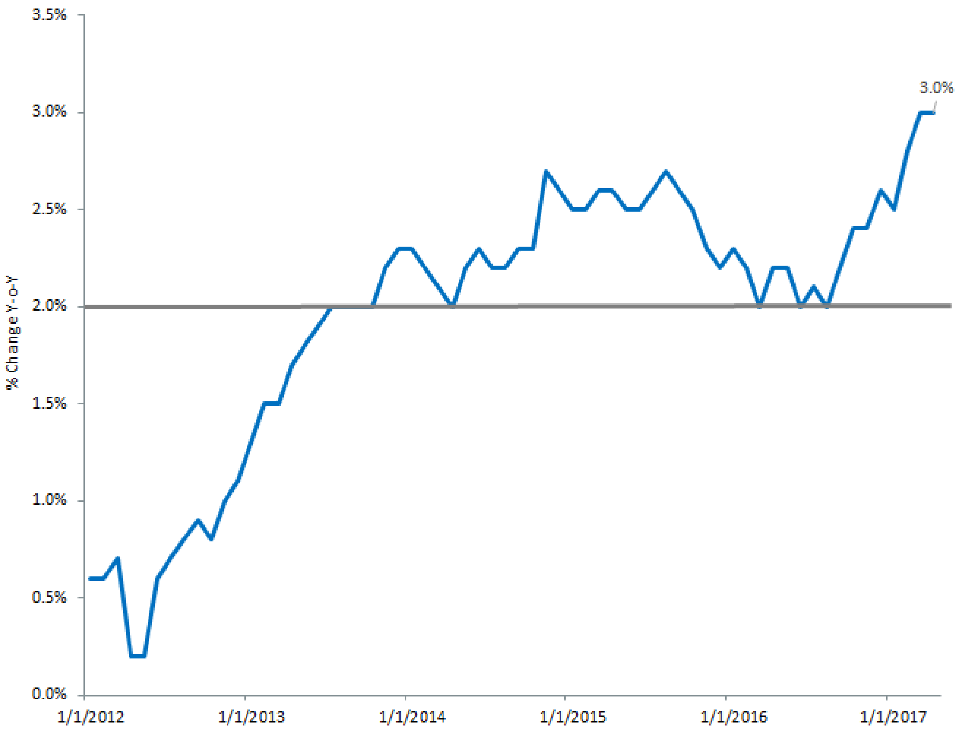
Second, Japan's financials in general, and banks in particular, are likely to experience positive earnings surprises because of rising demand for loans. As corporate demand for productive capital rises, so should demand for financial capital. The bullish capex intentions imply a likely releveraging. Note that loan growth has already begun to recover, rising 3% in April 2017 after a cyclical downturn throughout most of last year (see chart below). If, as we suspect, the visibility of the releveraging cycle begins to rise in the next three to four months, Japanese banks and financials could experience relative outperformance, in our view.

Note here that net interest margins are now past their worst compression—they were crushed after the Bank of Japan (BoJ) introduced negative rates in January 2016 but, from here, rates will not be declining further, particularly as the visibility of the domestic capex cycle raises BoJ confidence.

Third, the newfound Japan investment cycle will, before long, begin to bring upward revisions to the potential growth rate. Though this is a highly complex and almost ideological debate among academics and central bankers, the implications for market practitioners are relatively straightforward: the stronger Japan's capex boom, the lower the risk of a premature monetary tightening from the BoJ. If, as we suspect, Japanese domestic service providers begin to deepen their capital stock and upgrade to the latest technologies, it is perfectly possible to see both a rise in service sector profitability and lower prices. For example, if Japanese banks can translate their current big investments in blockchain technology into streamlined back- and mid-offices, they should be able to offer better and lower-cost services to their customers while at the same time seeing higher margins.

For analysts and economists, it will take time to verify or falsify this "Goldilocks"[3] thesis of Japan's coming productivity boom. Debate and positioning among real-world investors is likely to pick up from here, in our view. Markets live on the debate of whether capex is return-enhancing or not. The good news in Japan is that, yes, the new capex cycle marks the starting gun for a livelier debate coming, in our view. Japan's financial market metabolism is ready to rise.

Japan Bank Lending (1/1/12–4/30/17)



Source: Bloomberg, 1/1/12– 4/30/17.

[1]Source: "Japan Capex Growth Rebounds to Post-Crisis High," Nikkei Asian Review, 5/27/17.

[2]Japan Inc.: A term referring to Japan's highly centralized economic model where there is a close relationship between business and government interests. Animal spirits: A term coined by renowned economist John Maynard Keynes to explain why economic choices are made in part on emotional instincts rather than purely rational calculations

[3]Refers to an economy that is not too hot, as to cause inflation and therefore central bank monetary tightening, or too cold, as to cause a recession. A "Goldilocks economy" of moderate economic growth and low inflation allows for market-friendly monetary policy.

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DEFINITIONS

Bullish : a position that benefits when asset prices rise.

Capital expenditures : Spending by a company typically made to enhance longer-term productive capacity.

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.

Capital stock : Measure of investment available in a particular economy that represents the ownership interest in its businesses.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Monetary tightening : A course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fas.