

JAPAN POLICY UPDATE: POLITICS NOW, ECONOMICS LATER

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I recently visited the Japanese prime minister's (PM) offices and met with several senior decision makers to get a firsthand update on what lies ahead now that Prime Minister Abe's popularity has dropped to 35%–40% (from 50%–60% six months ago).¹ As far as I'm concerned, the key takeaway for investors is that the [structural bull case](#) for Japan remains intact, with a relentless pro-growth policy bias poised to return center stage starting in September/October, when the basic debate on next year's budget and economic policy initiatives will start. However, from a tactical perspective, several unpopular political hurdles will have to be cleared between now and then, and everyone in the PM's office expects some further slippage in opinion polls. **Domestic Agenda in Focus** Specifically, the immediate domestic Japanese agenda looks like this: **Week of July 27:** Upper House to start deliberations on the defense law and security bill revisions. These unpopular bills did already pass the Lower House by a two-thirds majority and will automatically become law by mid-August. However, Prime Minister Abe will have to navigate continued media coverage on this unpopular topic. **August 3–5:** Likely decision on the Trans-Pacific Partnership (TPP) free trade zone. Here, Prime Minister Abe and the vast majority of the ruling Liberal Democratic Party (LDP) are firmly committed to tariff cuts and agricultural deregulation. However, a small minority of old-style protectionist politicians are sure to raise their voice. The deal is done, but the media spin is poised to put some additional pressure on Abe's popularity. **August 10:** Possible restart of the first nuclear reactor (all reactors are currently shut down due to post-Fukushima safety concerns). Similar to the defense and security law revisions, nuclear restart remains unpopular, and the PM's office expects large-scale demonstrations, should the restart proceed as scheduled. **August 15:** The 70th anniversary of the end of the Pacific War. The focus here is on Prime Minister Abe's speech and the reaction from neighboring countries to the degree of the apology presented. **Mid-September:** LDP presidential election. The LDP presidency is a three-year term, limited to two terms. Abe became president in September 2012, winning a race against five contenders. For the upcoming election, those I spoke to consider it very unlikely that Abe will be challenged. It goes without saying that Abe's unanimous reelection by his party would be a powerful symbol for investors to extend their trust in Japan's policy stability and consistency. From an investor perspective, the immediate outlook for Japan's agenda suggests a somewhat asymmetric short-term [risk](#) profile: until late August/mid-September, politics will dominate, while economic policy initiatives are unlikely to make headlines again until late September or early October. **Pro-Growth Agenda Remains Intact** After my meetings, I remain very confident that there is absolutely no lack of commitment for or focus on Abe's pro-growth policies. Specifically, all decision makers acknowledged that the recent drop in Japanese stocks² was not just due to an external Greece and China "[risk off](#)" but that the sell-off was caused in part by the slip in Abe's popularity. This candor is very encouraging. More fundamentally, Abe's policy team knows that positive [wealth effects](#) from both the stock market and the real estate market are a necessary condition for a true Japan revival. I believe the start of the 2016/17 fiscal and tax debate should reassert the pro-investment, [pro-risk-asset policy](#). Here, concrete proposals should come in late September or early October, and concrete steps could come through special tax measures with, possibly, a renewed focus on speeding up the intergenerational transfer of household assets from old to young, from pensioner to spender, in my personal view. ¹Source: Robin Harding, "Shinzo Abe's Approval Ratings Fall to New Low," Financial Times, 6/15/15. ²Japanese stocks: Refers to the low the Tokyo Stock Price Index (TOPIX) hit on 7/8/15. Source: Bloomberg

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Structural bull case : Reasons to believe that an equity market is maintaining drivers of long-term appreciation.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

Wealth effect : When individuals see their investment portfolio increasing in value; even if they don't sell and take profits, they tend to feel better about their potential consumption due to these gains.