OBSERVATIONS FROM TOKYO: WHAT'S NEXT FOR JAPAN?

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Last week, Professor Jeremy Siegel and I visited Tokyo and had extended conversations with Jesper Koll, CEO of WisdomTree Japan. We discussed the extraordinary monetary policy easing that the Bank of Japan (BOJ) undertook recently, Koll's thoughts on the sectors that might benefit and general progress on Abenomics. **Outlook for Japan—Economy and Equity Market Highlights** The key issue for Japan is that there are two strong pillars arguing for a structural and longer-term bull market in risky assets. First, the Japanese government is relentlessly pro-growth and pro-inflation after more than two decades of zero growth and disinflation. The BOJ's negative rates policy—a new tool at the BOJ's disposal—underscores Prime Minister Shinzo Abe's ability to coordinate with the BOJ to ensure that Japan does not slip back into deflation, reinforcing the "one dream, one team". This announcement came on the back of weak consumer and business expenditure data. Governor Haruhiko Kuroda is effectively quashing all expectations that the BOJ is behind the curve. The investor community needs to understand that the BOJ wants to provide a tailwind for corporations. Japan is also managing a revolution in corporate governance by encouraging better shareholder returns through a focus on corporate buybacks and dividend growth. This year, Japan will be one of the only countries to cut corporate taxes, taking the rate down from 31% to 29%, despite the government's large fiscal deficit. Companies can free up cash flow for returns to shareholders and private investment. **Rationale of Negative Interest Rates** The BOJ enhanced its tool kit beyond quantitative and qualitative easing (QQE) in which it is buying ¥80 trillion per year—twice the net annual issuance of Japan's Treasury. The BOJ is effectively running out of options in terms of what it can buy. Thus, it has introduced negative interest rates of 10 basis points (bps), which applies to new reserves banks accumulate. The goal is to encourage banks to provide loans instead of keeping money piled up as reserves at the BOJ. Koll believes with this policy, the BOJ creatively found a new way to surprise the markets. **Sector Beneficiaries—Real Estate and Financials** Koll discussed the real estate market in Japan, which has been through a consistent bear market since the bubble peak in 1989–1990. Back then, it cost 22 years of average income to buy the average apartment within a one-hour commute to Tokyo. Over the past 25 years, the rate fell to about 4x average annual income. But today's Japanese real estate market is one of the most attractive sectors in the world, according to Koll. Since the BOJ announcement in January, the real estate sector has been reignited. Japanese mortgage companies are bringing down mortgage rates. You can borrow about 85% of the value of your property with a 15-year fixed-rate mortgage of just 65 bps. Further, Koll believes the construction industry could benefit greatly from negative rates, as there are lower-hurdle rates for capital expenditure . While Japanese Financials, especially banks, sold off in light of negative rates, Koll believes this was a wrong, knee-jerk reaction. He expects the negative rate will hit bank earnings by less than 200 to 300 bps annually. In addition, fee-based income at Financials is improving. For instance, consumer finance has been growing dramatically, with consumer lending growing at a pace of 3.5% to 4% annually. Koll also expects industry consolidation, and he believes the sell-off in Financials offers a good entry point. **Third Arrow Progressing Nicely** Structural reforms do not happen overnight. A plethora of rules, regulations and legal recourse needs to be addressed. As Koll highlighted, if you look at energy policy, Japan used to have a monopoly on power generation and distribution that was granted to nine companies. As of April this year, private suppliers of power will be allowed to feed into the grid, effectively deregulating energy. A second example is health care deregulation. Use of generic drugs is way behind most countries, with a less than 20% generics usage. This is likely to move to 50% over the next 1.5 years. Third, with labor market reform, the government set a target stating that 20% of senior managers have to be women, and Japan's female participation surpassed that of the U.S. in 2015. **Amari Out, Ishihara In** Akira Amari, Japan's economic revitalization minister, resigned from his position and took full responsibility in light of a bribery scandal. Shortly after, Nobuteru Ishihara was appointed to the post. Koll explained that Ishihara is a younger minister and has great clout with younger entrepreneurs that he hopes to bring to the table in pushing through industry deregulation. He is also very close with Abe. Investors should keep in mind that at the end of May, Japan is hosting the G7 summit, where, Koll believes, Ishihara will likely announce a new batch of proposals for third arrow and structural reforms. Read Conversations with Professor Siegel Series.

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DEFINITIONS

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

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.

Bullish : a position that benefits when asset prices rise.

Inflation : Characterized by rising price levels.

Negative interest rates : Usually borrowers make regular interest payments to their lenders for the money they owe. Under a system of negative interest rates this relationship would be reversed and the lender would pay the borrower for the privilege of lending.

Deflation : The opposite of inflation, characterized by falling price levels.

Buyback : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

Dividend : A portion of corporate profits paid out to shareholders.

Fiscal deficit : Situation where government spending exceeds government revenue.

Quantitative and qualitative monetary easing (QQE) : A central bank monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Basis point : 1/100th of 1 percent.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Bubble : when market participants drive stock prices above their "fair value" in relation to some system of stock valuation.

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

Third arrow policies : The part of Japan's Abenomics process of reform that is focused on structural changes intended to promote economic growth.