JAPANESE MARKET – HEALTHY CORRECTION, NOT FUNDAMENTAL ROT

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Japanese equities dropped 5.5% last week, for their sharpest weekly loss in over 15 months. The market is still up 11.8% year-to-date[1], and in our view, last week marks a healthy—and overdue—correction. The multi-year bull market for Japanese risk assets—equities and real estate—remains intact. **Why? Four Reasons:** 1) Valuations 2) Liquidity 3) Domestic demand 4) Pro-growth policies Valuations are straightforward: Today, the TOPIX is trading on a trailing price-to-earnings (P/E) ratio of 16.3x. This is not just significantly below the more than 25x average P/E ratio reported over the past decade but also below the 17.1x average trailing P/E ratio observed during the past three years of Abenomics. To be sure, Japan's valuations are not at the bottom end of cheap: in April of last year the trailing P/E ratio briefly dropped below 14x; but in our view, Japan continues to be perfectly respectable from a valuations perspective. Liquidity parameters also point to a continued positive backdrop for Japanese equities. At the front end, the Bank of Japan remains steadfast about expanding its balance sheet by ¥80 trillion and base money is surging at a swift 33% year-over-year clip. There is no discussion of "tapering" and ending the quantitative and qualitative easing (QQE). If anything, the recent slippage of the Consumer Price Index (CPI) back toward zero is beginning to increase the pressure on the Bank of Japan (which remains committed to achieving a 2% inflation target). More importantly, evidence continues to mount that Japan's private banking system has pulled out of its "liquidity trap": private credit and lending is growing at a steady pace of just around 2.5%; and the broad liquidity money supply has actually accelerated to 4.3% growth in July, up from around 3% at the end of last year. Here, the portfolio shift toward domestic equities is one of the drivers, with domestic mutual fund flows beginning to pick up over the past three months (driven by rising wages and summer bonus payments). What about growth? There is no question that growth appears to be getting increasingly scarce in the world. Japan, in our view, has what it takes to become a source of positive growth surprises. Yes, exports are poised to stay under pressure, in line with the slowdown in China and barely noticeable offsets from a "new normal" America and a stagnating-at-best Europe. Japan's domestic demand, on the other hand, is poised for steadfast recovery and growth momentum. Why? Because Japan's labor market is tight and, for the first time in almost a generation, wages and incomes are starting to rise: employment income rose 0.7% in the recently released gross domestic product (GDP) statistics for the first positive quarter in over a year. The same GDP report also showed robust private residential investment, up 8% annualized, which in turn should feed a rising demand for durable goods in coming quarters. All said, while export growth remains stuck in its correlation to global demand, Japan's domestic demand is set for an endogenous and steadfast recovery. Small and medium-sized companies as well as the Japanese Financials and Healthcare sectors are poised to benefit as the most tangible concrete investment beneficiaries, in our view. **Yes, Abenomics; Yes, Pro-Growth** Finally, we remain convinced that the relentless pro-growth policy bias of Prime Minister Abe and his team is poised to re-assert itself in the autumn session of Parliament. Moreover, it is becoming increasingly likely that Abe's re-election as president of the Liberal Democratic Party (LDP) in September will be uncontested, i.e., Abe's grip on power is de facto strengthening. Note here that the prime minister is set to travel to New York at the end of September, not only to make a speech at the annual assembly of the United Nations but also to meet with business leaders and investors. More importantly, we expect concrete pro-growth policies to be presented at the October start of the 2015/16 budget deliberations. Among the most likely pro-growth targets are further cuts in corporate taxes, increased child allowances and additional support for elder care. Politically, next year's upper house election (slated for July) may, in our view, raise the odds of Abe's ruling party trying to buy as much feel-good-factor growth insurance as possible. The bottom line is clear: Pro-growth policy stimulus is poised to re-assert itself starting in late September/early October. Combine this with reasonable valuations, growing liquidity and rising visibility of domestic-demand growth, and you may comprehend our steadfast conviction that this week marked a healthy market correction and the structural multi-year bull market is poised to continue. **All sources are Bloomberg as of 8/21/15, unless otherwise stated.** [1]Source: Bloomberg, as of 8/21/15. “Japanese equities” refers to the Tokyo Stock Price Index (TOPIX), and returns are price change in yen terms.

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DEFINITIONS

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

TOPIX 500 Index : A capitalization-weighted index designed to measure the performance of the 500 most liquid stocks with the largest market capitalization that are members of the TOPIX.

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.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Inflation : Characterized by rising price levels.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Monetary stimulus : refers to attempts to use monetary policy like lowering interest rates or quantitative easing to stimulate the economy.

Tokyo Stock Price Index (TOPIX) : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.