Homegrown strength: Japan's CAPEX cycle accelerates

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Our structural bull-thesis for Japan calls for an endogenous, self-sustaining domestic demand up-cycle that is driven by Japan's private sector. Demographics is the key force for households, the structural shortage of labour will be pushing up incomes and improving job security, thus creating purchasing power for a "new middle class"; and for companies, the scarcity of human capital will force a shift towards more capital-intensive business models, i.e. a structural up-turn in business investment to improve the quality of the domestic capital stock. Also, M&A activity is poised to pick-up, with the scarcity of human capital forcing fundamental industrial reorganisation. Clear-speak—Japan's productivity is ready for a positive super-cycle, which should translate into a structural up-turn in capital returns.

From Thesis to Reality—Yes, A New Japan CAPEX Boom

Good news: the latest forward-looking surveys suggest a sharp pick-up 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 smart recovery from the 12.7% contraction reported last fiscal year[1]. Make no mistake—Japan Inc has re-discovered 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 poised to accelerate which, before long, is poised to bring upward revisions to industrial sector profit forecasts. Small & mid cap companies are poised to benefit the most. However, given that the sharp rebound in Japan's overseas investment appears to be coinciding with an accelerating US capex-cycle, large-cap machinery makers and capital goods companies are also poised for positive profit surprises. Clear-speak—Japan's capital goods sector is poised for both domestic- and export-led growth.

Second, Japan's financials in general, banks in particular are poised for 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 re-leveraging. 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). If, as we suspect, the visibility of the re-leveraging cycle begins to rise in the next three to four months, Japanese banks and financials are poised for relative outperformance, in our view. DXJ gives excellent exposure here, with three of the top five holdings now banks.

Note here that net interest margins are now past their worst compression—they were crushed after the 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 new-found Japan investment cycle will, before long, begin to bring upward revisions to the potential growth rate. Of course, this is a highly complex and almost ideological debate amongst academics and central bankers, the implications for market practitioners are relatively straightforward—the stronger Japan's CAPEX boom, the lower the risk of a pre-mature 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 amongst real-world investors is poised to pick-up from here, in our view. Markets live on the debate 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. Japans' financial market metabolism is poised to rise.

Figure 1: Japan Bank Lending

Source: Bloomberg

[1]"Japan Capex Growth Rebounds to Post-Crisis High," Nikkei Asian Review, 27/05/17.

[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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