

Japan's positive surprises -- policy & earnings

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Today's re-confirmation that Prime Minister Shinzo Abe will continue to be Japan's Prime Minister for another three years bodes well for Japan's economy in general, Japanese risk assets in particular. From here, two specific forces should combine to allow a NIKKEI stock market index rally towards the 30,000 level over the next six months:

- pro-growth policy surprises
- sharp upturn in positive earnings revisions momentum

While the re-election of Prime Minister Abe was not widely anticipated, expectations for new pro-active policy initiatives are extremely low. Against this, positive surprises are poised to be delivered relatively soon. Specifically, we look for :

1) A new supplementary budget, adding as much as 5 trillion yen - about 0.9% of Gross Domestic Product (GDP) to domestic demand.

The need for this stems from the various natural disasters that hit Japan over the past six months. About half of the funds should be go to direct regional reconstruction, but the other half is poised to be earmarked for nationwide disaster prevention measures. There appears to be broad based consensus for the need of added spending within the ruling coalition and projects are basically "shovel ready". Expected timeline: mid-October at the latest.

2) Cabinet re-shuffle, breakup of government bureaucracies, and streamlining of advisory councils.

Although most key cabinet positions – Ministry of Finance, Foreign Affairs, Defence and Chief Cabinet Spokesman - are unlikely to be changed, key domestic portfolios like agriculture, labour/welfare, and economic & fiscal policy are possibly ready for new leadership. A key positive surprise would be the re-appointment of Amari Akita. Amari is a trusted Abe inner circle member who was the key architect of the deregulation and growth strategy in Abe's first "Abenomics" cabinet (December 2012 to January 2016). He had to resign over a minor scandal but has been very active on leading the Liberal Democratic Party and private sector consensus towards the need for greater government efficiency and administrative reform.

Specifically, proposals to break-up and streamline the Ministry of Health, Labour, and Welfare are on the agenda, and Amari is a strong advocate for ensuring possible privatization and new private sector investment opportunities as a target for the next round of administrative reforms. A cabinet reshuffle that includes Amari (or one of his protégées), would send a clear signal that the privatization drive is back on the agenda. Such reshuffle is likely with the re-start of Parliament by mid-October.

In addition to a cabinet reshuffle and restart of concrete administrative reform agenda, we expect concrete proposals to streamline the multitude of advisory councils that have been set up since Abe assumed power in December 2012. Here, a re-shuffle of the private sector participants – mostly unchanged in six years -- is expected and should be a catalyst for new ideas and a more active policy debate, led by private sector entrepreneurs and leaders.

3) Pro-active trade policy with US

The biggest threat to Japan's national prosperity comes from the Trump Administration threat of a 25% tariff on Japanese car/car parts exports. This could cut GDP by as much as half a percent, and force Tokyo Stock Price Index (TOPIX) profit to drop by as much as 15%. Here, "Team Abe" has been working overtime and a three-pronged strategy to make President Trump look like a winner appears to be in place: first, raise Japanese imports of agriculture products, soybeans and beef in particular; second, raise Japan's defence spending, hard and software procurement from US defence makers in particular; and third, a possible "America One Belt, One Road" Japan-funded, US targeted infrastructure investment fund.

Obviously, the tactical manoeuvrings in trade negotiations are highly unpredictable, but given the highly transactional focus of Trump's deal making, "Team Abe" does have a substantial and diversified war chest to deliver something that makes the President look good. In our view, the risks of an actual implementation of the 25% tariffs against Japan is low.

All said, we expect very positive, pro-active and pro-growth policy initiatives to become a hallmark for Prime Minister Abe rule over the next six-nine months.

And what about earnings? Against current consensus expectations of 5% Earnings Per Share (EPS) growth in FY3/2019, we maintain our call for 18% EPS growth, primarily driven by top-line sales growth exceeding conservative estimates. The next trigger should come during the next earnings results season, dues to start mid to end October, right at the same time as "Team Abe's" new pro-growth, pro-deregulation and privatization agenda becomes clear.

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