

2017: Ten Surprises for Japan

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It is the time of year when economists and strategists present their forecasts and baseline scenarios for the year ahead. Quantitative forecasts are based on de-facto probability models; and qualitative scenarios are based on, well, a combination of experience and common sense. Either way, most methodologies leave little room for a discussion of true outliers and true surprises.

This list “2017: Ten Surprises for Japan” is trying to address this deficiency. They are the scenarios that I personally worry about for Japan investment implications. By definition, these 10 surprises are events or scenarios far from the consensus mean and outside one—or even two—standard deviations. Their primary purpose is to make the reader think. Improbable as they may appear, any movement toward their far-out direction may still dictate an about-face in market consensus. Enjoy, and best wishes for a successful and happy 2017.

1) Trump makes America great again—U.S. gross domestic product (GDP) grows 4.5% in 2017

For Japan, America's economy remains by far the single most important global force: almost 25% of TOPIX earnings are generated from selling to the U.S.¹ The combination of a U.S. growth surge, cuts in U.S. corporate taxes and a strong dollar would be a welcome “triple merit” boost for Japanese corporate earnings in 2017, in our view.

2) China's Communist Party gets realistic and cuts China's official GDP growth target to 5.5%

The Chinese Communist Party will hold its 19th National Congress in the fall of 2017. While a key focus will be the potential reshuffle of leadership positions, the top-down approved guidelines and goals for China's economy will also become important inputs for global economic and financial dynamics. A surprise would be if the official growth target got cut to below 6%—say, 5.5%. In our view, this would be positive for global markets, because a) it is much more in line with many private economists' estimates of the sustainable Chinese growth potential, and b) it reduces the risks of a Chinese currency devaluation: the higher the official growth target, the bigger the temptation of Chinese policy makers to use currency devaluation as a tool to achieve that target, in our view. In 2017, any reduction in Chinese devaluation risk is positive for global risk assets in general, and Japanese equities in particular, in our view.

3) Prime minister Shinzo Abe and the Bank of Japan (BOJ) introduce “J-Coin,” a blockchain-based cyber-currency designed to set the global standard

Despite broad-based consensus that blockchain-based currency and banking are an integral part of the future of finance, governments and central banks have so far shied away from sponsoring or promoting an official cyber-coin standard. Japan has the potential to take the lead here by introducing a BOJ-backed “J-Coin,” a blockchain-based cyber-currency system designed to set the Asian and global standard. Surely a surprise, but not improbable: there is huge potential in the combined forces of Japan's newfound national ambitions for true global leadership and the Tokyo governor's desire to create a true global financial center

in Tokyo, in our view. At the very least, the creation of an official, Japanese government-backed “J-Coin” would put Japanese banks and financial institutions in an undisputed global leadership position.

4) German chancellor Angela Merkel loses the German election but wins the 2017 Nobel Peace Prize

Angela Merkel has been in power since November 2005, and her leadership and success have been extraordinary in many respects. Her losing the next German federal election would still be a surprise, with potentially deep implications beyond Germany. However, her winning the Nobel Peace Prize for her steadfast promotion of a new German—and thus European—immigration policy would be a real surprise, in our view.

5) BOJ governor Haruhiko Kuroda meets a 2% inflation target, as Japan’s unemployment rate falls to 2% by end of 2017

At the start of his tenure in 2013, Governor Kuroda announced a new target for his BOJ: to hit 2% inflation. At the end of 2016, Japan’s Consumer Price Index (CPI) is up barely half a percent—still better than the negative half percent when the 2% target was announced, but still a long way off.² Over the same period, Japan’s unemployment rate has plunged from 4.3% to 3%.³ A further drop to 2% unemployment is possible and this should provide a good reason for Governor Kuroda—and financial markets—to celebrate. After all, falling unemployment and stable prices are a much better equilibrium than a real acceleration of inflation momentum, which, sooner or later, must force tighter monetary policy. The surprise may be that Governor Kuroda succeeded overall, exactly because he failed to achieve 2% inflation but did achieve world-record low unemployment.

6) Japan introduces “use it or lose it” policy to force companies to put their record retained earnings cash balances to work

Japan is very asset rich. The corporate sector holds retained earnings—cash deposits and short-term securities—valued at 125% of GDP.⁴ Relative to the size of GDP, Japan holds the world record. For example, the U.S. corporate sector retained earnings are estimated to be worth a mere 32% of U.S. GDP.⁵ Moreover, Japan’s corporate cash riches have grown by basically 1-times of GDP over the past decade. 125% of GDP in zero-interest-earning cash holdings are clearly an underutilized asset—a fact that has not gone unnoticed by “Team Abe.” Creative policies designed to penalize corporate cash hoarding could be a real surprise. “Use it or lose it” tax policies to unlock corporate cash balances for the national interest are not uncommon in Asia. Whether the corporate cash gets spent on human capital, productive capital or shareholder capital should be up to corporate management’s discretion, in our view. However, given the world-record level of Japan’s underutilized corporate balance sheet, the progressive changes in corporate governance and investor stewardship may need further reinforcement through big-stick intervention via tax penalties on excessive holdings. Policies to force the unlocking of Japan’s corporate cash would be a welcome boost to the national economy and investor returns (higher dividends and buybacks), in our view.

7) The bull market in Japanese equities prompts the government to privatize the next tranche of both Japan Post and Tokyo Metro

Japan’s government is eager to step up the privatization of national assets. Upcoming candidates for privatization are plentiful, with the next tranche of Japan Post and Tokyo Metro expected to be in pole position. So far, the Ministry of Finance has never attempted more than one privatization project per

year. However, a sustained bull market in Japanese equities might tempt the Treasury to become less conservative. Aiming to conduct two big successful privatization projects over a 12-month period would be a surprise and may well turn into an important inflection point for confidence in the Japanese market. The more the government does to reliquefy Japan's private asset markets, the better market transparency and efficiency become, in our view.

8) A Japanese artificial intelligence (AI) machine beats Google's AlphaGo in a Go match competition

Last year, an AI machine beat a human grand master at the game Go.⁶ The machine, called AlphaGo, was built in the UK by a company owned by Google. The game Go was invented in China and, in many respects, perfected by Japanese grand masters. More importantly, Go remains an important game for Japanese elites. If a made-in-Japan machine could become the undisputed Go world champion, Japan would get a huge boost in confidence, in our view. Japan's reputation for true leadership in artificial intelligence and machine learning would rise—and surprise many who think Japan has fallen behind technologically.

9) A Chinese bank buys a major stake in Deutsche Bank

The end game for the European banking crisis may have been delayed by aggressive European Central Bank (ECB) action; however, worries about capital shortages and weakened bank franchise values could well resurface in 2017, in our view. A real surprise would be if a Chinese private bank were to become a significant equity partner in one of the major European banks. In addition to the obvious boost to confidence and business prospects from a China–Europe bank partnership, such a move would also provide a welcome counter to those forecasting the end of the globalization of finance, in our view.

10) The U.S. Federal Reserve (Fed) hikes rates five times, to 2.5%, by the end of 2017, but the BOJ holds on to the zero-rate Japanese government bond (JGB) target

The final surprise follows from the first one: if U.S. GDP accelerates toward 4.5% in 2017, it follows that the Federal Reserve will likely hike policy rates much faster and more aggressively than currently anticipated. With 4.5% average GDP growth, a Fed Funds Rate of around 2.5% would be justified, in my personal view. The real surprise, however, could come from Japan if the BOJ holds steadfast to the current “zero upper bound” target rate policy for 10-year JGBs.⁷ The delinking of U.S.–Japan monetary policy—Fed hikes more than expected but BOJ stays “zero for longer”—could well become a key dynamic for 2017 global capital flow dynamics. Welcome to a strong dollar, and “sayonara” to the strong yen.

¹Source: Bloomberg, based on most recent available earnings data as of 12/7/16.

²Source: Bloomberg, as of most current reading for 12/7/16.

³Source: Bloomberg, as of most current reading for 12/7/16.

⁴Source: Bank of Japan data, most current reading as of 12/7/16.

⁵Source: Federal Reserve data, most current reading as of 12/7/16.

⁶Source: Cade Metz, “Google's AI Wins Fifth and Final Game against Go Genius Lee Sedol,” *Wired Business*, 3/15/16.

7Source: “New Framework for Strengthening Monetary Easing: Quantitative and Qualitative Monetary Easing with Yield Curve Control,” Bank of Japan, 9/21/16.

Important Risks Related to this Article

Investments focused in Japan increase the impact of events and developments associated with the region, which can adversely affect performance.