

Will Japanese Investors Buy More Equities?

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As we continue to monitor the potential for the impact of Abenomics, we note the potential intersection of two crucial ideas—ideas that may be central to the ultimate efficacy of these programs. • Bank of Japan's (BOJ) 2% inflation target, reversing the overall, entrenched deflationary expectations • Investors beginning to shift their assets from cash and savings accounts into equities In a deflationary environment, there is no incentive to spend, since the purchasing power of the money increases with the passage of time. As a result, Japan's households are flush with cash in the bank. However, as consumers start to expect higher inflation, they may increase purchases and also invest their assets to receive some type of hedge against inflation—in things that can increase in value as prices increase. Equities are one such option, as companies can often increase their prices as their costs increase. And because part of the inflation is coming from imports as a result of a weak yen, the Japanese also may look for assets in other currencies to protect themselves from a drop in the value of the yen. Both equities and foreign assets are thus two potential sources of inflation protection. **NISA Accounts** Starting January 1, 2014, Japanese citizens will be able to buy equities in new incentive accounts motivated to encourage risk taking—specifically the movement of money from savings accounts and cash into things such as equities, where there is no guarantee that its value will be maintained. Each citizen will be able to invest up to 1 million yen per year for at least five years. The capital gains and dividend payments from these equities will be tax free. These accounts were designed to encourage risk taking. Importantly, Japanese government bonds (JGBs) are not eligible to be purchased in these accounts. While we believe that taxation (or the lack thereof) is usually an effective motivator for people to change their behavior, we believe that receding deflationary expectations—in concert with the implementation of these accounts—can create a more widespread and far-reaching motivation for Japanese investors to buy equities. An additional motivation for Japanese households to get invested is that the income stream offered from equities is at one of its highest levels in 40 years—and if investors become more confident that the 25-year bear market in Japanese equities has finally come to an end, the income choice offers attractive spreads versus Japan's 10-year JGBs. **What Motivates Japanese Citizens to Potentially Look Toward Japanese Equities?**

	10-Year Bond Yield ¹	Dividend Yield ²	Spread ³	Long-Term Dividend Growth ⁴	% Market Cap Above 10-Year Bond ⁵	% of Market Cap in Dividend Payers ⁶
S&P 500 Index	2.6%	2.1%	-0.5%	7.6%	35.0%	87.9%
MSCI Japan Index	0.7%	1.7%	1.0%	7.6%	96.6%	96.6%

Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

¹ 10-year bond yield: For the U.S. row, specified by the S&P 500 Index, this refers to the yield to maturity for the U.S. 10-Year Treasury Note. For the Japan row, specified by the MSCI Japan Index, this refers to the yield to maturity for the 10-year Japanese government bond. Both are as of 9/30/2013.

² Dividend yield: Each respective dividend yield is the trailing 12-month dividend yield, specified as of 9/30/2013.

³ Spread: Refers to the "Dividend Yield" column minus the "10-Year Bond Yield" column.

⁴ Long-term dividend growth: Refers to the growth in trailing 12-month dividends on an average annual basis for the S&P 500 Index and the MSCI Japan Index, for the period 9/30/2003 to 9/30/2013, a 10-year period.

⁵ % market cap above 10-year bond: Refers specifically to the percentage weight of each respective index in stocks as of 9/30/2013, with a trailing 12-month dividend yield greater than the 10-year bond yield, with S&P 500 constituents compared to the yield of the U.S. 10-Year Treasury Note as of 9/30/2013, and MSCI Japan constituents compared to the yield of the 10-year JGB as of 9/30/2013.

⁶ % of market cap in dividend payers: Refers to the percentage weight of each respective index in stocks that as of 9/30/2013 have paid at least one dividend over the prior 12 months.

Spread over 10-Year JGBs Those looking at the trailing 12-month dividend yield of the MSCI Japan Index will realize that it is approximately 1.0% higher than that of the 10-year JGB. What this ultimately means is that traditional avenues of fixed income investment in Japan are looking expensive compared to equities. Fixed income, by definition, offers a fixed payment of interest over time, whereas with equities, one has the potential to see dividends grow over time. Over the last 10 years, dividend growth in Japan has averaged about 7.6% per year.¹

Dividend Growth Those observing the dividend growth of the MSCI Japan Index will note that, over the past 10 years, the level has been fairly similar to that of the U.S., with U.S. equities represented by the **S&P 500 Index**. Interestingly, inflation has been much higher in the United States (as measured by the Consumer Price Index) than in Japan (as measured by the Japan Nationwide Consumer Price Index), so the dividend growth of Japanese equities has been much higher, when measured against Japan's inflation, than has the dividend growth of U.S. equities (measured against U.S. inflation).²

Percentage of Market Cap Earning More Than Government Bonds One statistic that has been cited in recent years is how many stocks in the United States had a dividend yield ahead of the U.S. Treasury Bond. Since the start of the year, as interest rates³ have risen almost 100 basis points, that percentage has declined, and currently the dividend yield of the S&P 500 Index is approximately 50 basis points less than the Treasury. However, given the 68 basis point 10-year JGB, the hurdle is much lower for Japan. The fact that more than 96% of the MSCI Japan Index's market cap is in stocks with yields above that of the 10-year JGB is powerful—especially when combined with the fact that 96% of the market cap of this index actually pays dividends.⁴ Just as it was a motivator for many in the U.S. to buy dividend-paying stocks in a low-rate environment, this can become more important for the Japanese as well.

Conclusion After so many years of hunkering down in cash and government bonds, Japanese households cannot be expected to shift into equities wholesale. Many remember the bubble period of the late 1980s and the long-term deflation they faced. However, as Prime Minister Abe's economic revival plans begin to take hold and inflation returns to Japan, the current dividend yield spread for the MSCI Japan Index over JGBs and the potential for dividend growth can begin to attract more Japanese to equities. And the NISA account establishes some tax preferences that can also help contribute to slowly changing mindsets.

¹ "Dividend growth in Japan" refers specifically to the trailing 12-month dividend growth of the MSCI Japan

Index from 9/30/2003 to 9/30/2013. ²Source: Bloomberg, with data through 8/31/2013. From 7/31/2009 to 8/31/2013, the Consumer Price Index was higher than the Japan Nationwide Consumer Price Index. ³Refers to the interest rate on the U.S. 10-Year Treasury Note, measured from 12/31/2012 to 9/30/2013. ⁴Source: Bloomberg; data as of 9/30/2013.

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