

BREXIT & JAPAN

Jesper Koll — Senior Advisor
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Japan got hit hard initially by the [risk-off](#) tsunami forced by [Brexit](#). The force of the hit was compounded by the fact that Japan was the first and only major developed market that was open for business when the results of the vote were released—Tokyo became the first shock absorber, operating amid peak uncertainty. I expect this “discount” to be worked out next week, i.e., relative performance should normalize. For Japan Inc., London is primarily a financial center, not a commercial or industrial one. Japanese banks and insurers rely on London markets for 25% to 35% of their non-yen funding.¹ Fears that this could now be in jeopardy will need to be proven wrong in the next couple of trading days.

Counterparty Worries? Specifically, we need to have confirmation that global macro [volatility](#) does not force a micro event. In other words, that European banks will prove strong enough to absorb the losses forced by macro markets volatility; and more fundamentally, European banks will have to demonstrate their creditworthiness and future earnings power in the new Brexit reality. In my view, risk-off may prevail until it is clear that a European “Bear Stearns” negative spiral does not occur. Containing counterparty risk is the potential big challenge. [Credit default swap \(CDS\)](#) pricing for European banks is probably a good lead indicator here, in my view.

Marginal Impact on Japan Inc. Against this overriding focus on financials, the impact of Brexit on Japan's commercial and industrial outlook is relatively marginal. Basically, corporate Japan has focused on Asia and North America as the principal growth strategy, not on Europe. From this perspective, today's sell-off is likely to prove overdone. Specifically, Europe and the UK account for barely 5% of listed companies' [Earnings Stream](#). North America (U.S., Canada and Mexico) account for 24%; China for 11% and Asia ex-China for 7% (my calculation, based on Ministry of Economy, Trade & Industry (METI) and Ministry of Finance (MOF) data).²

Impact on Abenomics It is highly probable that the Brexit shock will depress consumer confidence and thus domestic demand. If so, this is likely to expedite Prime Minister Abe's supplementary budget boost, which was already set in motion in late May, with full details of exact spending items to be delivered September–October. If the Brexit shock does depress data in coming months, Japan's extra budget will likely come earlier and bigger, in my view. In other words, rather than ¥5–8 trillion, an ¥8–12 trillion extra fiscal boost is likely, in my view. Meanwhile, Abe himself is poised to use the external Brexit shock as a solid argument that more aggressive Abenomics is needed. In my view, the Brexit shock could well prove a positive catalyst for re-energized policy steps to boost domestic demand, i.e., the need to isolate Japan from external shocks.

From Brexit to Trump? The local “chattering class” has decided to take Brexit as a positive lead-indicator that the unthinkable can now happen anywhere. American voters following suit and electing an outright protectionist president is now seen as more likely. But for markets, this means that expectations for further U.S. dollar weakness in the run-up to the presidential vote has probably risen here in Tokyo, sparked by the Brexit vote.

¹Source: Bloomberg, with data as of 5/31/16, with statistics available as of that point. ²Sources: Ministry of Economy, Trade & Industry and Ministry of Finance, most recent available data as of 5/31/16.

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DEFINITIONS

Brexit : an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Credit Default Swap : A swap designed to transfer the credit exposure of fixed income products between parties. The purchaser of the swap makes payments up until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third party debt if this party defaults on the loan.

Earnings Stream® : Earnings per share x the number of shares outstanding. For an index, these totals are added for all constituents.

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.