

# さよなら平成、ようこそ令和

## Good bye 'Heisei', welcome 'Reiwa'. Outlook for Japan's economy

'Reiwa' is the name of the new era under Emperor Naruhito, meaning 'beautiful harmony' that started on May 1. It follows the 30 year long era of 'Heisei', interpreted as 'achieving peace' that ended when Emperor Akihito stepped down. Japan's economy is facing challenges as growth remains tepid and another consumption tax hike is scheduled for October 1. 'Beautiful harmony' could prove challenging.



Source: iStock

“ Just as the plum blossoms announce the arrival of spring after the harsh cold of winter ... all Japanese will be able to make their own blossoms come into full bloom, together with their hopes for tomorrow. ”

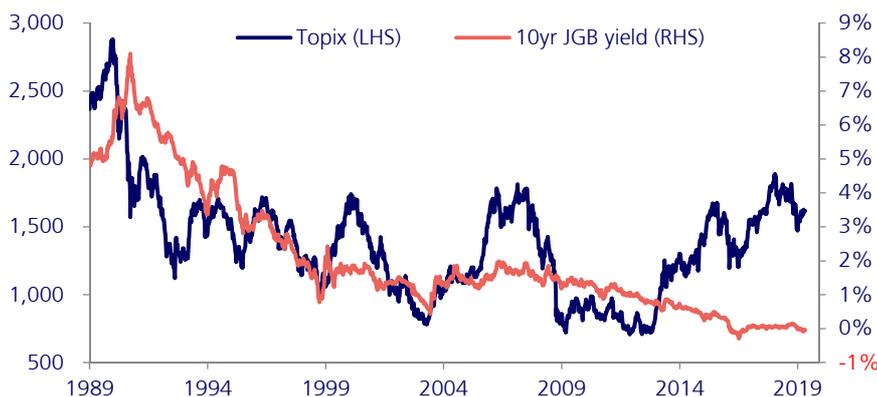
PM Shinzo Abe referring to Manyoshu, Japan's oldest poetry anthology, from which the word 'Reiwa' was derived.

### Farewell 'Heisei'

At the start of a new era it is worth taking a step back to pay tribute to the events of the 30 years of Japan's 'Heisei' era. The first year of 'Heisei' was actually the last year of the big bubble economy of the eighties. This was the time when the land value of the imperial palace in Tokyo was worth more than that of California, and 'Juliana's Tokyo' disco seemed to be the centre of the world. This exciting period was followed by a decade long

hangover as the bursting of the bubble saw a multi-year collapse in equity, property and land prices; the bankruptcy or merger of famous banks and brokers, and the collapse of the 'jusen' housing loan companies; JGB yields falling from above 8% to below 0%; negative Bank of Japan policy rates; and years of deflation. The Japanese economy became synonymous with stagnation. It is striking that the 'Japanification' of the European economy is a topic, as negative interest rates are now common in the Eurozone and Switzerland.

### Japanese equities and bond yields during the 'Heisei' era



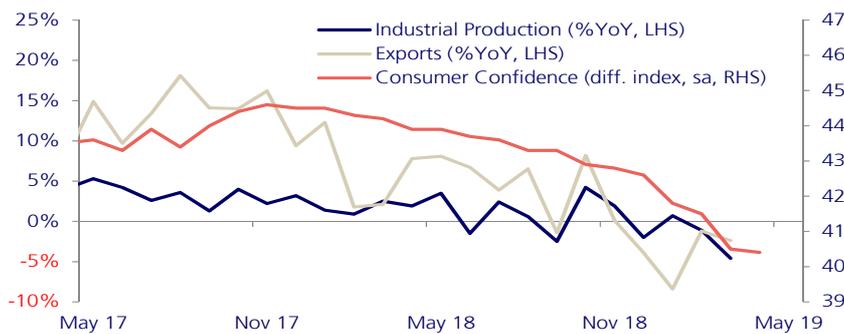
Source: Bloomberg

Japan has also had to deal with a series of major natural catastrophes, including the Great Hanshin Earthquake around Kobe in 1995 and the Tohoku earthquake in 2011, followed by a big tsunami that killed thousands and induced major nuclear accidents. Japan has overcome these tragedies with resilience.

### Not everything was bad

Despite the gloom and doom, Japan has also experienced periods of hope on the political front, including the short period when opposition parties won the general elections against the dominant LDP led regimes, the boom during the PM Koizumi led government and the second term of Premier Abe, who inspired Japan and global observers with his three arrows of 'Abenomics'. The last few years saw Japan open up to foreign tourists and workers, leading to a massive, record-

## Economic conditions are deteriorating



Source: METI, MoF, ESRI, Bloomberg

high inflow of foreign visitors that has influenced department store sales, hotel infrastructure and a language course boom. Measures to incentivise women to join the workforce have inspired 'womenomics', with female labour participation surging and a boost to the labour market despite an ageing society.

Let's switch from looking at the rear-view mirror and have a glimpse into the beginning of the 'Reiwa' era, as business is back to normal following the extended 'Golden Week' holidays in Japan.

### The short-term outlook is depressed

Japan's economy struggled last year, and the trend has carried over into 2019. Since the end of 2017, each quarter with positive real economic growth was followed by GDP contraction. On a YoY basis, Japan's GDP was up a mere 0.2% in the second half of 2018. With Japan suffering from various natural disasters last year, growth was clearly below its potential rate.

In Q1 of this year it remains to be seen whether another quarterly contraction has been avoided. If so, we believe it will probably be only by just a slim margin, as many economic indicators show that the economic environment remains tepid. Indeed, industrial production was down 1.7% YoY in Q1, exports suffered, falling 4% compared to a year ago, and core machinery orders were down 4.2% in the first two months of the year. The monthly Reuters Tankan survey continued to deteriorate in April. Business surveys reveal a cautious stance toward corporate investment. Investment into labour saving automation certainly remains a structural theme, but the cyclical outlook is less positive. Even though service related consumption seems to be holding in, and the BoJ real consumption activity index remains firm, we note that consumer confidence has been falling for seventeen months in a row, a trend that is supported by the bleak Eco Watchers survey.

Taking into account our global economic outlook and incorporating April PMIs for major manufacturing countries, which are giving mixed signals, our core view is that some stabilisation should be visible in Q2, before a moderate global recovery kicks in during the second half of the year. By then we

believe that China's fiscal and monetary stimulus measures will have a more notable impact on global demand than now. Japan's economy should also show signs of a recovery by then.

### The impact of the consumption tax hike will be less severe than that of prior hikes

The biggest anticipated idiosyncratic domestic impact is linked to the hike of the consumption tax from 8% to 10%, scheduled for October 1. There has been speculation that the planned hike, which has already been postponed twice, might be cancelled or postponed again as the economy continues to suffer

This option is likely to be kept open until the next Tankan corporate survey is published on July 1. If it were to show a slump in business conditions, PM Abe may need to extend the current Diet session and opt for an early Lower House election to coincide with Upper House elections at the end of July in order to get the mandate for another postponement. Despite these theoretical options, we maintain our core view that PM Abe will follow his agenda. He explicitly said that he would only consider a delay if a crisis similar to the Global Financial Crisis of 2008 were to occur, which seems unlikely.

The government has taken various steps to alleviate the impact of the next consumption tax hike. These measures include a reduced tax rate on specific food items, permanently abolishing pre-school education fees, making childcare for three to five-year-olds free of charge, as well as fiscal spending programs incorporated in two supplementary budgets for FY18 and the budget for FY19. In addition, Japanese consumers have been made aware through the media about special point rebate schemes, which will be made available when buying cashless at convenience stores. Many small retailers have invested in cashless payment systems to enable their customers to participate in the program.

Despite all these measures to temper the impact of the consumption tax hike, we still expect the typical pattern of a front-loading boost to consumption in Q3 before a slump in Q4, though we anticipate the impact to be less big as in the prior instances when the consumption tax was introduced or hiked.

## Foreign tourism boom likely to continue

Tokyo will hold the 2020 Summer Olympic and Paralympic Games. Construction has given a major boost to GDP growth since 2014, though the impact started to diminish late last year and will evaporate next year. However, the boost from inbound tourism should be maintained. The number of international tourists, mainly from China, Korea and other Asian countries, has quadrupled since 2012, as has tourist spending. The target of 40m visitors by 2020 appears achievable, and a long-term annual growth rate of 5% seems realistic, even though a setback can be expected in 2021 after the Olympics.

## The Bank of Japan will stay put

Speculation that the Bank of Japan will tighten its monetary policy has been popping up every now and then, but we believe that the BoJ will maintain its easing policies well into 2021. Some adjustments may be incorporated, but that will not change its principal easing stance. The 2% inflation target seems unlikely to be reached within the next two years, as even all members of the monetary policy committee have adjusted their inflation forecast to an average 1.6%, with the highest forecast at only 1.7%. However, inflation expectations will be eagerly watched. Limited further accommodation remains an option should the economy not recover as anticipated and if deflationary fears were to increase again. Expanding its policy to buy riskier assets outside of JGBs and ETFs is possible, though currently unlikely. Overall, the Bank of Japan believes that the negative side effects of its monetary policy approach are smaller than the overall benefits, even though it recognises the negative impact on regional banks and JGB market liquidity.

Currently, wage statistics are distorted due to sample changes, showing that wages are falling. We prefer to look at data on a same sample basis, which show that wages are growing at a rate of roughly 1%. This rate does not seem to reflect tight labour market conditions, with the unemployment rate at a 25-year low of only 2.4%, and the job-to-applicant ratio at 1.63, its highest level since 1974. Certainly, with trade unions not having the same power as for example in Germany or France, regular wages and particularly bonus payments depend more on the medium-term corporate earnings outlook, which tends to be conservative. In order to have an inflationary impact, we believe wages would need to grow at a 4% annual pace, which appears unrealistic.

## Trade tensions with the US can be tackled

The US and Japan have entered into talks about a Trade Agreement on Goods (TGA) in mid-April. So far the US has refrained from imposing tariffs on imported Japanese autos based on US national security concerns, as long as trade talks are ongoing, but it remains a risk for Japan. There are also different views as to whether a currency clause needs to be included in the negotiations. Such a clause would require Japan to refrain from currency manipulation to gain a trade advantage. We

## Japanese equities start outperforming China's 'H'-shares



Source: Bloomberg

believe that Japan has not been engaged in this kind of currency manipulation for years, but it seems to be a sensitive issue.

We see some risks for Japan as the trade talks will extend to the hot phase of the 2020 US presidential elections, when President Trump may want to show a tougher negotiation stance, particularly in the fields of agriculture and autos. The good relationship between President Trump and PM Abe may prevent any escalation though. President Trump will visit Japan from May 26-28, and there is speculation that he will be given the honour of handing the champion's cup to the victor of the Sumo summer tournament, as a sign of the friendly relationship between Japan and the US.

Even if trade tensions between Japan and the US were to escalate, which is not our core scenario, we do not believe that the impact on Japan's exports would be dramatic. More than one third of all exports are already covered by Free Trade Agreements (FTA) or Economic Partnership Agreements (EPA) with the EU and ASEAN countries, as well as within the TPP11 trade agreement. Furthermore, Japanese auto manufacturers are already running huge production sites in the US with a high local content, which reduces export vulnerabilities.

### Will Japanese equities be re-discovered?

Japanese equities have been underperforming their global peers since autumn 2017. Several reasons come to mind: disappointing earnings, the slowdown in Japan's major export market, China, no sign of a global cyclical upswing, vanishing hopes of yen depreciation, and, last but not least, competition from China's equity market.

### Foreigners prefer Chinese equities to Japanese equities

Foreign investor appetite for Chinese equities has risen, not at least due to the partial inclusion of 'A'-shares in major global benchmark indices. Furthermore, as China is a major component in the MSCI Emerging Markets benchmark index, and EMs have been everybody's darling so far this year, Chinese equities have benefitted. That is also visible in the substantial underperformance of Japanese equities versus China equities. Comparing the Topix to the HSCEI, which

represents China's 'H'-shares listed in Hong Kong, reflects this fact. We believe this trend looks overdone, and the history of the last few years shows that a turnaround may happen at this 'oversold' level in relative terms.

We believe the fundamental outlook for Japan is better than the sceptics towards Japanese equities believe. Earnings revisions, though still negative, have already started to pick up, while reasonable to cheap valuations leave scope for upside surprises. Foreign investors sold Japanese equities at an unprecedented pace last year. While some foreigners continued to sell Japanese equities on a cash basis this year, others have been strong buyers of futures. However, it is evident that their appetite for Chinese equities has been much greater since last year. Foreigners were heavy buyers of Japanese equities during the 'Abenomics' boom, but their affection has lost steam, and they have sold about half of their acquired positions since then. However, other statistics show that foreign investors are now more underweight in Japanese equities than at the start of 'Abenomics' when applying an MSCI EAFE benchmark.

### Foreigners seem to be neglecting Japan equities, though not excessively

The latest BoA Merrill Lynch Fund Manager Survey shows that global investors are underweight Japanese equities, with the lowest weighting since November 2016, though not to the extreme extent seen on previous occasions. At the same time, foreigners admit that Japanese equities are undervalued. The survey also shows that emerging markets take the top spot in terms of market favour. Investors also do not have much trust in Japan's corporate profit outlook, while they are more optimistic about the US and emerging markets.

Another survey amongst institutional investors revealed that Japan ranks as the equity market with the lowest expectation to outperform in the short term. We believe these perceptions are too extreme, even if some of the fundamental concerns may be justified.

### Progress in corporate governance

We recognise that cheap valuations are not a reason on their own for an asset to perform well, but there are other facts to keep in

mind. While still clearly far below the US, RoE has risen significantly close to 10%, while earnings per share continue to rise, and operating profit margins are at a record high. Over the last few years, significant progress has been made in corporate governance; more companies are setting clear shareholder return targets, and cross-shareholdings continue to be unwound. Quarterly disclosure of earnings reports will be required in English as part of the Japan Exchange reform.

Companies have substantially increased share buybacks, which has become a major pillar of support for the equity market. Buyback announcements increased nearly 40% last year, bringing the total to JPY 6.2tn, even slightly more than the Bank of Japan's ETF buying program. Buyback announcements are even accelerating so far this year, while dividend payouts keep increasing at a steady pace. In the medium term, pressure on small companies to improve corporate governance will come from the Toyo Stock Exchange (TSE) reform. 2,136 companies are now listed on the first section of the TSE, as represented in the Topix index. The aim is to significantly reduce the number of TSE1 companies, including a higher market cap threshold and stricter corporate governance criteria. This will create an incentive for small companies to increase their market cap, for example through mergers, and to improve corporate governance, resulting in more buybacks and an increase in dividends, which over the next few years should make the Topix more attractive.

### The yen remains a risk factor

All these fundamental factors argue for a brighter future for Japanese equities, but we also recognise there are risks. Even though one could debate whether the high correlation between the performance of Japan equity indices and the USDJPY rate makes sense, we have to accept that foreign investors tend to sell Japanese equities when the yen appreciates versus the USD and the EUR. Were the US Dollar index, DXY, to head south again, indicating USD weakness, a stronger yen would have a negative impact on earnings forecasts for Japanese exporters, which tend to be favoured by foreign investors, while a weaker DXY would benefit emerging markets and, accordingly, Chinese equities as an EM index heavyweight.

### Challenges remain for the 'Reiwa' era

Even in an era of 'beautiful harmony', Japan will face many challenges going forward and will need energy to tackle these. One hope of the Bank of Japan and many politicians is a return to a normal inflationary environment. In order to tackle the challenges of an aging society, the corporate sector will have to foster automation efficiencies, while the government needs to make progress with labour market reform.

As for the equity market, it will be worth watching whether the Topix range of 1,820 - 1,910 that has proven to be a strong resistance for the last 25 years will finally be overcome in a convincing manner.

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