WEEKLY ANALYSIS

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Japan: does the government have good reasons to turn to optimism?

Japan's revitalization strategy should boost investors' interest and push the stock market up ... although the effectiveness of certain measures remains quite uncertain.

Key Points:

- After a year of stagnation, the Japanese stock market could finally be back on the rise
- After the currency collapse and a few successes in terms of inflation, growth suffers a setback
- Decrease of the negative effects of the VAT
- Economic recovery expected for 3rd quarter 2014
- The announcement of a new strategy to revitalize Japan is expected
- Ten measures to strengthen supply and production on several fronts: corporate tax cut, employment, agriculture, healthcare, governance and entrepreneurship
- GPIF reform could act as an additional indirect QE
- Increasing demand for Japanese stocks could push the Nikkei to 18,000

After a year of stagnation, the Japanese stock market could finally be back on the rise

After Prime Minister Shinzo Abe's appointment in 2012, and Mr Kuroda as President of the Bank of Japan in 2013, the country ultimately started a new phase of economic expansion (GDP +6.7% annualized as of 1st quarter 2014), mainly due to the radical change to the country's monetary policy.

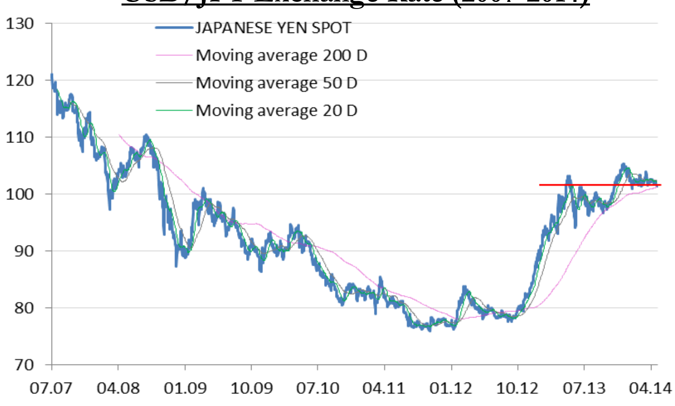
The government's new strategy aimed at triggering an economic recovery by depreciating the yen and targeting a return to a 2% inflation rate.

In order to implement this monetary policy, Japan adopted what became known as « Qualitative Quantitative Easing » and followed similar policies and economic imprint which had already been embraced by the United States and the United Kingdom.

The -30% decline of the Japanese yen against the U.S. dollar and the +80% rise in equity markets in six months (December 2012-May 2013) were the first actual results of the government policy reversal and the new Japanese monetary policy.

In the 2nd quarter 2013, we had expressed some concerns with regard to the ability of the Japanese economy to keep on positively surprising investors, which at the time seemed to be particularly euphoric. The truth is that the Japanese economic plan was very ambitious and estimated to reach almost $80 billion a month. It was roughly matching the Federal Reserve's asset purchase program. Following the massive fall of the yen and a historical progression of Japanese equities in anticipation of the results of these new policies, it seemed to be the right moment for a phase of uncertainty, while attending concrete results. Back to the 2nd quarter 2013, when the Japanese yen was approaching 100 yen for $1 dollar, we had already suggested that a stabilization phase was probably to be implemented for the Japanese currency.

USD/JPY Exchange Rate (2007-2014)



Sources: Bloomberg, BBGI Group SA

This is actually what happened, as illustrated by the chart above. After an initial -30% depreciation, the exchange rate stabilized between 95 and 105 yen and now stands at 101.5, corresponding to its end of May 2013 level. The yen seems to have found its stability in over one year and the economic performance of Japan may well already be sufficient to prevent further currency depreciation.

But after this long smooth period and a generally more positive environment for the US dollar, the yen, however, should probably go through a weakening phase and return to its pre-financial crisis level of 110 JPY/USD.

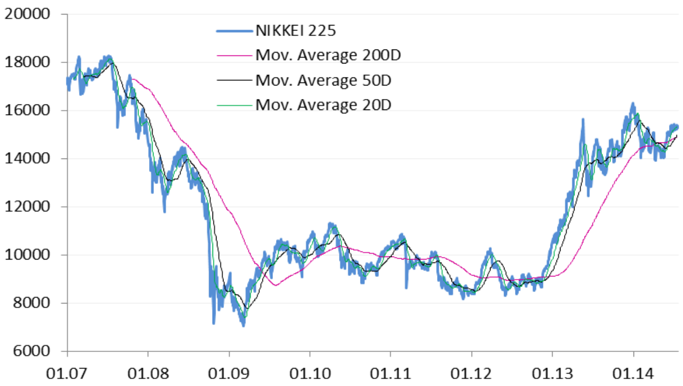
This further decline should also provide additional momentum in terms of competitiveness and support the ongoing recovery of imported inflation.

The relatively strong correlation during the period 2007-2014 between the evolution of the Japanese currency and the behavior of the Japanese equity market is likely to remain significant and have a positive impact on the price of equities in the coming months.

Japanese equities have also entered a phase of horizontal consolidation during the same period, while waiting for more concrete economic results which could justify a new phase of price appreciation.

Looking beyond the purely economic results, there is also the pending issue of major government decisions and the lack of structural reforms, which are essential for the long-term development of the Japanese economy. These factors have retained investors from engaging into the Japanese market. Japan must intensify its structural and fiscal reforms in order for growth to overcome the support of monetary policy.

Japanese Equity Market – Nikkei 225 (2007-2014)



Sources: Bloomberg, BBGI Group SA

More reforms coupled with a decline in the currency could engender +15%-20% growth for Japanese equities, setting the Nikkei stock index at around 18,000 and back to pre-crisis levels.

The Japanese government and the Bank of Japan's new optimism on the health of the country's economy after a halftone second quarter, could well be justified, but the challenges are important for domestic demand to sufficiently grow.

Return to growth and optimism after a probably disappointing 2nd quarter

Just a few days ago, the Japanese government was reviewing for the first time in six months the appreciation of its nascent economic recovery. The announcement of an increase in the sales tax (VAT), implemented on April 1st from 5% to 8%, had initially boosted consumption, before causing a decrease in demand in April (lower household spending (-4.6%) and -2.5% contraction in industrial production and rising inflation +3.2%). The Japanese government on this issue marked a decrease of induced adverse effects and an already substantial improvement in consumer confidence. Consumption represents approximately 60% of Japanese GDP, and the signs of recovery in household electrical goods, electronics and automotive sectors have shown encouraging signs. Unfortunately, the situation for exports and industrial production remained unchanged, this justifying in our view, the need for a further yen decline.

The negative effects of the VAT are, however, considered to be temporary and should rather see a return to growth for the third quarter thanks to a rebound in domestic demand.

But for the time being, the economic surprise indicators for Japan remain highly uncertain. Specifically, the Nomura Overall Surprise Index still registered negative trend since its peak in July 2013. It further indicates that for July 2014, published economic statistics continue to disappoint investors.

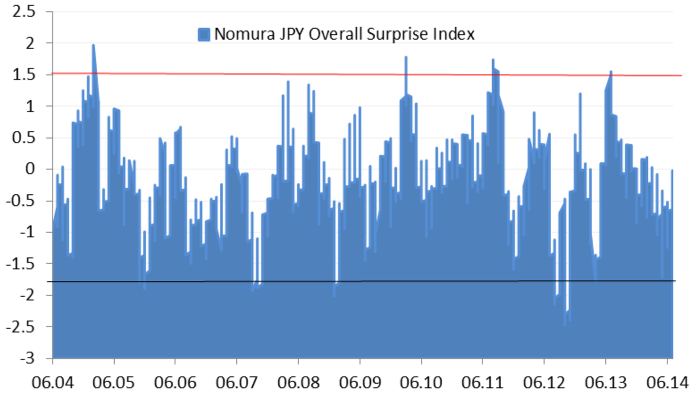
With that said, the current level of disappointment is historically relevant and in May 2014 it stood close to extreme levels which had not been observed since 2004, possibly indicating a trend reversal.

Expectations were undoubtedly too high in relation to the results published in recent months. Yet, the media widely reported the rumors of a generalized increase in doubts about the chances of success after a year-and-a-half after the launch of "Abenomics". At the same time, the risk of weakening domestic demand related to the VAT increase also motivated some negative revisions to growth prospects of Japanese GDP.

Regarding the Bank of Japan, its monetary policy remained unchanged and the decision to unleash 70 trillion yen per year beginning April 2013 is maintained. The policy is viewed as optimistic situation because of the temporary nature of the current economic slowdown due to weaker domestic demand.

Therefore, we believe that a potential positive surprise is now increasingly high. Major new measures announced by the Abe government could therefore be the perfect answer to market expectations in the short and medium term.

Nomura Overall Surprise Index - Japan



Sources: Bloomberg, BBGI Group SA

Focus on the new growth strategy unveiled by the Abe's government

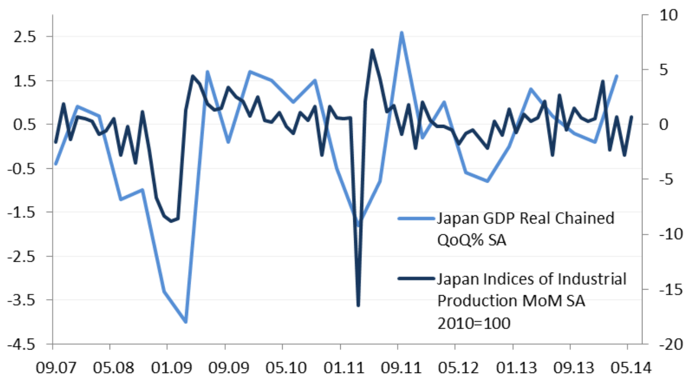
Just a few days ago, Prime Minister Shinzo Abe unveiled the details of a new growth strategy to complete or update the structural reform package contained in the "third arrow" of the Abenomics reform program. The latter has caused some disappointment on financial markets after the success of the first two arrows, which had reached their target effectively by boosting economic growth.

While waiting for a second wave of reforms for the Japanese economy, the initial measures were considered too general and with no real long-term perspective. The government had to quickly amend or embark on new reforms to convince investors. It took time, but it is done for good.

Ten major reforms have been announced as key measures to improve Japan's competitiveness and its economic efficiency.

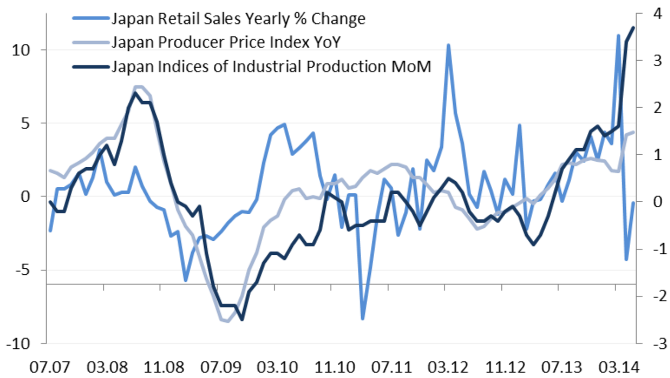
The announcement of these reforms came as industrial production and GDP show signs of improvement and the rebound in inflation to 3% has already had a negative impact on retail sales.

Japan – GDP and Industrial Production (m/m)



Sources: Bloomberg, BBGI Group SA

Japan – Inflation (CPI and PPI) and Retail Sales



Sources: Bloomberg, BBGI Group SA

We can say that the news come at a perfect timing, but we still have to see whether these measures are the most suitable and may finally cause a new sustainable economic momentum in Japan.

The new strategy aims at strengthening supply and productivity and points to tax rate, employment, agriculture, healthcare, governance and entrepreneurship as well as a new kind of QE that will certainly be the result of the reform Government Pension Investment Fund (GPIF).

The package calls for cutting the corporate-tax rate down from 35% to 20% over the next few years, thus encouraging business investment and in particular the manufacturing sector. The tax rate was, with the strong yen, one of the main obstacles to the development of Japanese companies.

Regarding the issue of low birth rate and aging population, the government will propose **measures to strengthen the participation of the female workforce to counteract the decrease in the labor force.** Japan is a developed country where the rate of female participation in the labor market is one of the lowest. According to estimates, if the female participation rate was close to that of Europe, nearly 3 million female workers could enter the labor market.

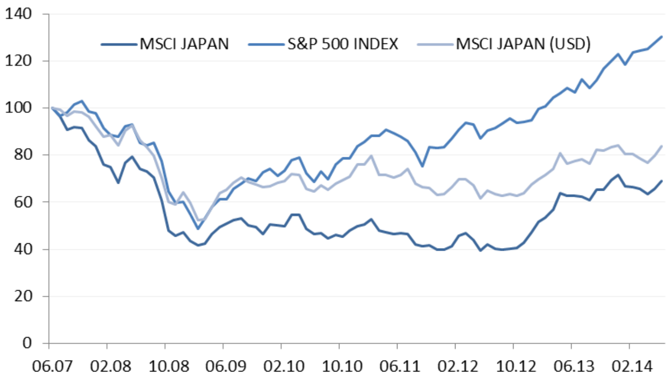
In the agricultural sector, Japan has the ability to double its rice production which could also boost its exports. But it is primarily the high cost of agricultural products - because of high customs duties - which are hitting households' purchasing power. The proposal to **abolish certain taxes with the entry into force of the Trans-Pacific Partnership Agreement (TPP)** would be beneficial to consumers, but it could also help to promote the integration of Japanese SMEs in the global economy.

The proposals for the energy sector are even more important and ambitious in seriously addressing the cost of electricity. Three major lines of development, the creation of the Organization for Cross-Regional Coordination of Transmission Operators (OCCTO) to improve Japanese electrical networks, remove the monopoly of electricity producers and ultimately separate production activities of those conveying electricity.

But the decision which will have most impact on the financial markets will be the reform of the **Government Pension Investment Fund (GPIF).** The fund is one of the world's biggest pension funds and also serves as a « benchmark » for other Japanese institutions. It represents approximately $1.2 trillion assets which are mostly invested in domestic bonds. The extremely cautious asset allocation policy could be reviewed this autumn. No official decision has been finalized, yet the GPIF has been under increasing pressure to reduce Japanese domestic bonds in favor of international bonds, Japanese shares or overseas equities and possibly other financial assets.

The change to the GPIF's investment strategy could have a rallying impact on Japanese stocks. Japanese equities could therefore well enter into an outperformance phase after having underperformed U.S. equities from 55% to 72% between 2007 and 2014.

Japanese and U.S. Equities (2007-2014)



Sources: Bloomberg, BBGI Group SA

Conclusion

Japan's revitalization strategy should boost investor interest in Japanese equities and push the market up ... although the effectiveness of certain measures remains uncertain.

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