Japan and the impact of Abenomics
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We work with clients to understand their individual objectives, investment appetite and ability to absorb risk in order to design a tailored structure for their assets, often resulting in more than one investment mandate. Our extensive experience in managing assets across the risk spectrum, coupled with a choice of currencies and a broad range of investment styles, incorporating direct investments, actively managed and index tracking funds, allows us to build solutions to suit the unique and diverse needs of our clients.

What sets us apart is that our clients build relationships with the investment managers themselves, fostering a closer connection between client mandates and the market opportunities that our managers seek out and analyse on their behalf.

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INTRODUCTION

In our search to seek attractive investment returns from around the globe, we recently turned our attention to investigating whether, five years on, Abenomics is having a real impact and to identify potential opportunities for our clients to capitalise upon these political and monetary shifts.

During our recent research roadshow to Tokyo, we met some of the most influential asset managers, banks, think tanks, listed companies, and government offices in the country. Having experienced first-hand the fundamental changes which are taking shape in the third largest economy, we are now keen to share our findings.
Japan’s post-war economy developed from the remnants of an industrial infrastructure that suffered widespread destruction during World War II. In 1946, the country’s industrial production had fallen to approximately a quarter of its pre-war level. The government took a central role in co-ordinating economic recovery and administered policies which promoted extensive mechanisation. The long-term credit bank system was introduced to provide public funds and long-term loans to businesses. Production was concentrated in certain priority sectors such as steel, coal mining and electricity in the 1950s, consumer products and automobiles for exports in the 1960s and 70s, and subsequently, knowledge based-products such as computers and electronics. This ushered in an era of remarkable economic growth, wherein the country’s GDP grew at an average annual rate of 11% through the 1960s and barring a couple of oil-driven recessions in the mid-1970s, grew at a robust average annual rate of 5% through 70s and 80s.

By the mid-1980s, the country’s trade surplus reached unprecedented levels. The Plaza Accord of 1985, which sought to weaken the dollar against other major international currencies, resulted in the yen appreciating by 40% over the next two years, making foreign investments cheaper for Japanese companies.

Financial deregulation, loose monetary policy and deteriorating lending standards led to aggressive speculation in the domestic stocks and real estate markets. During the 1985-1989 period, the Nikkei index tripled and urban land prices almost doubled. Concerned with the asset bubble, the Bank of Japan tightened monetary policy repeatedly over a span of 15 months in the 1989-90 period which contributed to the crash of the stock market in 1990 and the real estate market in 1992.

Collateral values declined, and even as companies stopped servicing debt, banks continued injecting funds or relaxed credit terms to keep them afloat. Comprehensive recognition and disposal of non-performing loans kept being deferred until the late 1990s, when the government finally responded decisively with a series of capital infusions. Economic stagnation, however, set in well into the late 2000s – over the 1995-2007 period nominal GDP declined by almost 20% and real wages declined by 5%. Private consumption and investment declined and Government debt levels escalated as it attempted to revive the economy via large scale spending on public infrastructure and multiple fiscal stimuli packages.
THE PRESENT DAY CHALLENGES

Deflation

Japan’s efforts continue as it attempts to dispel its population’s deflationary expectations which were cemented over a 15 year battle with economic malaise. Inflation remains anaemic, as consumers hesitate to increase consumption in the absence of expectations for real wage growth and corporates, failing to see demand growth, choose not to invest. Despite large scale fiscal stimuli and monetary easing, pessimism about future inflation prospects remains entrenched.

Aging Demographics and Rising Public Debt

Decades of improving life expectancy and falling birth rates have resulted in a rapidly aging and shrinking population. The old age dependency ratio (calculated by dividing the aged population by the population of the working age group) has more than doubled since 1990 and is expected to exceed 50% by 2030. An aging population poses a challenge to Japan’s fiscal and macroeconomic stability given the increased outlay on pension, healthcare, and social benefits programs, particularly when asset inflation remains hard to achieve. Sluggish growth has eroded the country’s tax base and the government has increasingly relied on debt funding to bridge its fiscal deficit. Consequently, Japan’s gross government debt to GDP ratio has increased from 100% to 250% over the 2000-2016 period.

Rigid corporate culture

For too long, the Japanese corporate society has embraced a culture of conformity, rooted in a seniority-based system, where quantity and not quality of work determines opportunities for advancement. Labour productivity remains around a quarter below the top half of OECD countries, with overtime regarded as a virtual condition of employment for regular employees. Entrepreneurial spirit is low compared to other developed economies, as evidenced by one of the lowest annual entry rates of new enterprises among OECD countries. Labour market dualism has become more entrenched, with non-regular workers accounting for almost 40% of total employment, engendering greater inequality in wages and human resource development. Also, female employment is plagued by a 27% gender pay gap, the third largest in OECD – in 2014, women accounted for only 9% of private-sector managerial employees.
“Abenomics” refers to the set of economic policies advocated by Shinzo Abe, since December 2012, when he was elected to his second term as PM of Japan. It consists of the simultaneous ‘firing’ of three arrows: aggressive monetary policy, flexible fiscal policy and growth strategy including structural reforms designed to engineer a break from the past in order to forge a new, progressive future.

The First Arrow

Aggressive monetary policy includes the Bank of Japan’s (BoJ) significant asset purchase program and its administration of an ultra-low interest rate policy, in order to achieve its inflation target of 2% sustainably. As a part of this programme, the monetary base has more than tripled, from 29% to 87% GDP over the 2012-2017 period. Quantitative and Qualitative easing (QQE) was introduced, which involved large scale purchase of Government bonds in conjunction with first, an application of a negative interest rate policy, secondly “Yield Curve Control” (YCC) – a policy that entails keeping 10-year government bond yield near 0%. The central bank’s highly unconventional set of policy procedures includes exchange-traded fund (ETF) buying, which has resulted in it becoming one of the largest players in the domestic stock market, with a 70% share of Japanese ETF assets under management.

The Second Arrow

Flexible fiscal policy, is based on the principle that “Without economic revitalisation, there can be no fiscal consolidation”. Its objectives include the achievement of a record ¥600tn economy and primary surplus by 2020, as well as nominal and real GDP growth rates of 3% and 2% respectively, with plans to gradually reduce reliance on government debt for fiscal funding thereafter.

The Third Arrow

Japan’s growth strategy, is arguably the most important over the longer-term as it seeks to reform entrenched societal norms. This involves implementation of work style reform initiatives in order to raise productivity, address disparity between regular and non-regular workers, provide greater public support to households for raising children, promotion of advancement of women in the workplace and boost private consumption and investment.
Upward pressure in wages seems to be emerging with signs of a shift towards permanent employment, as competition to hire skilled labour intensifies. The rate of full-time workers entering the workforce is growing as fast as that of part-time, thereby creating potential for an increase in average overall wages. Labour shortage, as well as higher import prices, against a backdrop of weaker yen and commodity input inflation, has led to some companies announcing price hikes for the first time in close to three decades.

Corporate sentiment has seen noticeable improvement as well, driven by growth in demand for exports and higher order backlogs. The December 2017 reading for the closely watched Tankan Index for Large Manufacturers was at its highest level since 2006. Corporate culture, which has historically skewed towards employees at the expense of shareholders, has seen progressive reforms with increased adoption of the return on equity (RoE) metric and initiation of dividends and share buybacks by several companies.

Private equity deal volumes have reached new highs on the back of slashed corporation tax rates and attempts at improving corporate governance standards.

Recent economic data has been strong. Japan has notched eight straight quarters of nominal GDP growth\(^1\), its longest stretch since 1994. Labour demand continues to rise steadily due to a shortage of workers and increased activity in services and construction. Latest figures reveal the unemployment rate at 2.8%, levels last witnessed in 1994, and the active jobs to applicants ratio at 1.59x, which is the highest since 1974. Notable improvement in the female participation rate since 2012 as well as improving penetration of foreign workers in the economy as a consequence of more relaxed immigration policies, have helped plug the labour gap.

LOOKING INTO THE FUTURE

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\(^1\)Bloomberg: 13th February 2018
Japanese equities are gaining momentum having delivered a strong total return of over +18% in 2017 all while valuations remain low relative to history. Interestingly, recent stock market strength has begun diverging from the direction of the Yen, which could signal a decoupling. We also note that the uptrend in Japanese return on equity metric has been driven by improving profit margins but offset by lower asset class turnover, and as such, expect further improvement in this metric as total shareholder returns remain low compared to other developed markets.

In terms of sector preferences, we are bullish on Healthcare IT, Automation and Auto Parts. Controlling the rapid increase in social security expenditures is central to the Abe administration’s goal of achieving a primary surplus by fiscal year 2020. As such, the absence of a universal registry of hospital and clinic data in the country, necessitates further adoption of electronic medical records and ordering systems among hospitals (38% adoption rate as of 2015). With the implementation of the My Number System in 2016 and greater attention being given to regional medical cooperation, areas with new business opportunities include security/privacy, big data and cloud computing.

Secular tailwinds in the form of a rapidly aging demographic as well as a chronic shortage of labour, induce multiple opportunities for further productivity and efficiency gains in existing systems. While Japan already assumes a leading position in the production of industrial robots, opportunities for further penetration exist within the nursing care and welfare services sectors, particularly for applications in rehabilitation, monitoring and mobility.

Finally, we expect the auto parts sector to be beneficiary of a synchronised global growth regime and a beneficial USD/JPY rate, with potential upside from further weakening of the Yen. Beyond cyclical factors, increased use of auto electronics, global growth in autonomous driving and widening demand for lithium-ion batteries, driven by new and potential emission regulation frameworks in China, US and Europe, represent secular growth opportunities.

Regarding opportunities in the government bond market, many market participants have been calling an end to the Japanese Government Bonds (JGB) bull market for years (as the interest rate declines – other factors being equal - the bond price appreciates). As interest rates rise, investors will take positions which benefit if the bond price declines; this strategy is often referred to as the ‘widow maker trade’, as the failure to make money on this investment over the years has ‘ended’ the careers of many successful money managers. It is true that rising yields contradicts the existing easy monetary policy of the BoJ, but equally, could signal their conviction that inflation is indeed expected in the future (it is very difficult to have long-term bond yields at zero while inflation expectations are on the rise). We are in the camp which believes that the BoJ will maintain its accommodative policy stance in 2018, but we do see some potential for upward pressure on the long and ultra-long-term part of the yield curve in 2019 as the Japanese economy nudges toward a normalised inflation rate of between 1% to 2%. Only at this stage will we consider participating in the ‘widow maker’ investment.

As it relates to Foreign Exchange, we still believe the Yen should continue to weaken but not dramatically. We believe that the value of the currency has begun to decouple from the stock markets however, as the yield differential widens (as the Federal Reserve raises rates and the BOJ remains on hold), this should support the USD, which would, on a relative basis, appreciate against the yen; hence the rationale behind our hedged yen exposure.
In many ways, the Japanese economy continues to be at war – with itself. It continues to struggle breaking from the past, as it seeks to strike the right balance between traditional domestic values and modern international norms. After World War II ended, many countries dismantled their wartime economic system. However, Japan arguably adopted an even more extreme version of a centralised economy. An interventionist Government policy, backed by a main-bank system, facilitated the country’s meteoric rise as an economic and political powerhouse. The mystique of Japan’s miracle economy endured until 1990, when fuelled by years of excess capacity, employment and easy credit supply, the asset bubble which had been building through the 80s, burst. While the country did emerge from the crisis in early 2000s, economic stagnation became entrenched to such an extent, that policymakers continue to grapple with the consequences of the lost decades.

However, perhaps, there’s some room left for optimism – Abenomics seeks to re-invigorate the economy via regulatory reforms and a productivity revolution. Recent economic data has been positive and while the jury is still out on the success of the implementation of the second arrow, we believe that there are grounds to feel confident that the current regime remains committed to reform and that the economic recovery is on sound footing.
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