Wealth
Management

Economic View

Japan was the best performing major stock market in 2013, driven by a combination of global and domestic factors. Companies in Japan have benefited from an improving global economic outlook and supportive measures being taken by the Bank of Japan.

In this document, we discuss some of these key elements and what they mean for Japanese equities and for the economy in 2014.

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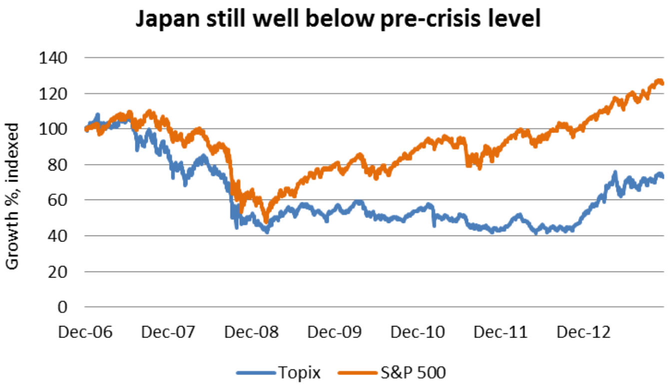
PRIVATE BANKERS SINCE 1672

Further to go

The Japanese equity market has been the best performer in 2013, but remains significantly below its pre-crisis level. This suggests further room to grow when we compare it to US equities, which have more than recovered their losses.



Source: Bloomberg, as at 17th December 2013

Japanese earnings have risen sharply over the last year, leaving stocks still reasonably valued on 14x their 2013 earnings. They also look cheap on other valuation measures.

Headwind from strong currency

One major reason why the Japanese market struggled before this year was due to the relative strength of the yen. This move in the Japanese currency was triggered by other developed markets rapidly slashing their interest rates following the start of the crisis. Fears about a potential euro collapse strengthened the yen further.

Since then, Prime Minister Abe and Bank of Japan (BOJ) governor Kuroda announced a regime change in economic policy with an ambitious attempt to escape deflation and achieve significant nominal GDP growth. They adopted a 2% inflation target and an extremely aggressive expansion of the money supply to achieve it.

Trends turning more positive

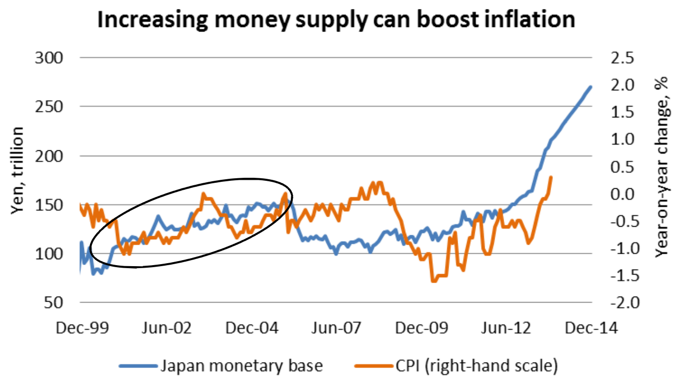
The yen has since weakened to 100 versus the dollar, boosting company earnings and the stock market. We believe the yen can weaken further, because Japanese monetary policy is likely to remain extremely loose whilst the US begins to tighten policy over the next few years.

This should lead to the real yield in the US once again becoming significantly more attractive than that on offer in Japan, resulting in further yen weakness and, in turn, upside for Japanese company earnings and the equity market.

By the end of the first quarter of 2014, the upcoming April consumption tax hike in Japan will probably lead to fears over a slowdown in the Japanese economy, prompting the BOJ to ease further. The Federal Reserve will have already begun slowing the pace of its asset purchases by then, with the first reduction taking place in January. This combination could be the catalyst for renewed yen weakness and stock market gains.

The rise of Abenomics

After the initial market rally, there has been some scepticism as to whether this new regime, dubbed Abenomics, can succeed given some initial disappointment with the growth policies proposed so far. Whilst the growth policies are key in the longer term, they are trumped in the shorter term by the phenomenal size of the monetary expansion under way. As can be seen from the chart, the last period of significant monetary expansion in Japan coincided with an increase in inflation.

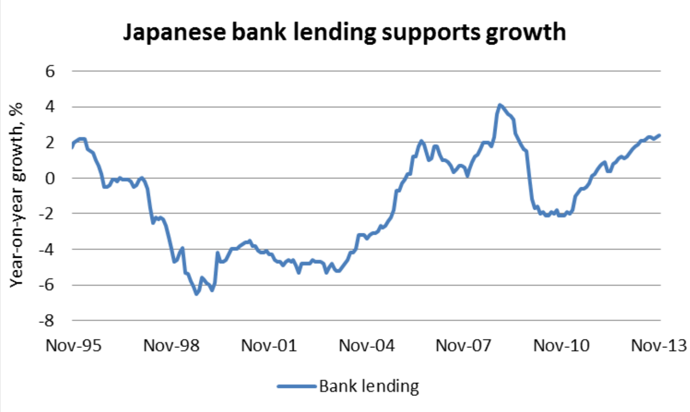


Source: Bloomberg, as at 31st October 2013

The planned expansion this time is far more aggressive. Some investors fret that a 2% inflation target is unachievable, but in our view the difficulty of achieving it will just serve to keep monetary policy extremely loose for the foreseeable future. This is generally a good environment for nominal GDP growth and equities, as we have seen in the US since the beginning of Quantitative Easing (QE).

The banks are in good shape

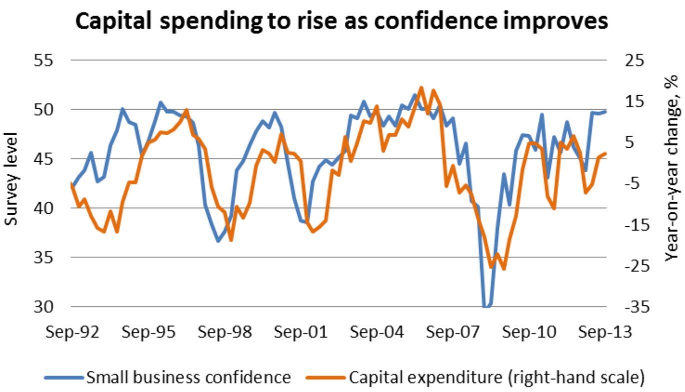
Another key positive is Japan's banking system. Japan had its property bubble and financial crisis over 20 years ago, and the repair and consolidation of the banking system since then leaves Japanese banks able to lend and support the economy. This helps alleviate concerns that the expansion of the money supply would not flow through to the real economy.



Source: Bloomberg, as at 30th November 2013

The combination of an end to Japan's multi-decade balance sheet recession, a beginning of its banks providing a boost to the economy and the extraordinary expansion of the money supply by the BOJ leads to a positive outlook for Japan.

Progress on the growth measures should be made in 2014. We expect an agreement on free trade negotiations, a corporate tax cut and tax breaks to encourage capital spending. Japanese companies have built up ¥220 trillion in cash and part of the key to the success of Abenomics will be getting them to invest that cash in capital expenditure.



Source: Bloomberg, as at 30th September 2013

Spending should pick up

Falling spare capacity, increasing business confidence, soon to be negative real interest rates and tax incentives should lead to a pick up in capital spending. Up to a third of Japan's nuclear power generation capacity could also be restarted in 2014, which will be key for supporting domestic capital expenditure plans. The Japanese economy is also likely to be supported by an acceleration in global growth through 2014.

Tax breaks also look set to be used to encourage companies to raise wages. Bonuses have already risen on stronger earnings, helped by the weaker yen, and Hitachi, Toshiba and Mitsubishi Motors are among the large firms that have made positive comments recently about the potential for increasing base pay, too.

The increasing tightness in parts of the labour market should also be positive for wages. We will be watching the key annual wage negotiations in March with great interest.

Source: Bloomberg, as at 31st October 2013

The prospect of higher wages could theoretically threaten profit margins but historically the correlation between operating profit margins and labour costs has actually been positive, as companies tend to only raise wages when their revenues are increasing. Increasing wages will be key to achieving sustainable growth in Japan.

We are not ignoring the fact that Japan faces significant economic challenges in the longer term, given its ageing population and high debt-to-GDP ratio. For 2014, however, we believe these issues can remain in the background whilst the equity market continues to blossom.

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Important Information

Image credit: http://www.123rf.com/16541900 ‘Mount Fuji viewed from behind Chureito Pagoda’

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