



MARKET INSIGHT

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MARKET ANALYSIS – VIEW FROM ASIA

Is Japan Back?

Prime Minister Shinzo Abe's gambit to call for snap elections a year ahead of schedule paid off handsomely with his ruling coalition maintaining its two thirds "super majority" in the more powerful Lower House of Parliament. This is a remarkable turnaround for both the Prime Minister and his party after various scandals over the summer saw their approval ratings plunge to 30% - dangerously low levels that has seen previous administrations ousted. A cabinet reshuffle in August led to an uptick in ratings. Ultimately though, it was disarray in the opposition ranks that split opposition votes, which was the main factor behind the landslide win.

Solid Economic Fundamentals

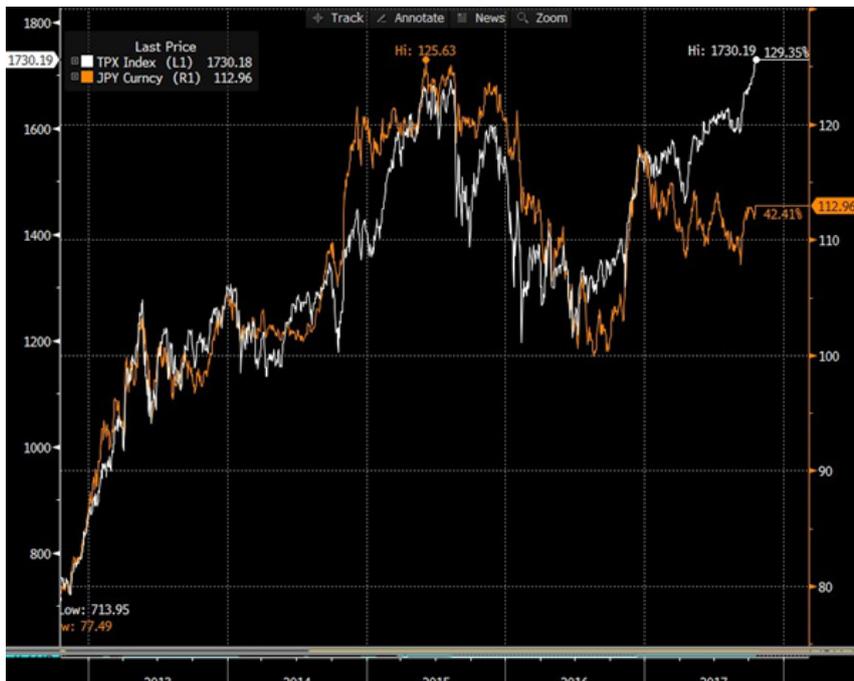
Prime Minister Abe certainly picked an ideal time to hold an elections. Besides capitalizing on the weak state of the opposition, current tensions in the Korean Peninsula reinforced the perceived need for a strong leader. The strength of the domestic economy also certainly helped, as Japan is on track to clock seven consecutive quarters of economic expansion. Sentiments on the ground are relatively bullish with unemployment currently standing at the lowest rate in over two decades. While full employment has not translated into strong wage gains thus far, there are signs that this could materialise soon, as wages increased by 0.9% in August, the best in almost a year. The ratio of part-time workers as

part of the total workforce has also fallen, suggesting more part-timers are being converted to full-time status with companies becoming more optimistic. All these are positive signals that domestic consumption growth, which has been sluggish, could soon rebound. The domestic property market is also ticking along nicely with condominium prices hitting 20-year highs, though this is partly driven by the low interest rate environment.

Meanwhile, the positive global trade cycle has led to a resurgence of Asian trade flows, which has helped to boost Japanese corporate earnings. Corporate profits are at a record high relative to GDP, with Japanese companies currently sitting on US\$4 trillion in cash. It is not surprising then that recent Tankan survey results at the best levels since 1991, show broad-based bullish corporate sentiment amongst large companies and SMEs alike, suggesting capital expenditure is poised to pick up.

The recovery in Japan's economy will be supported by five more years of Abenomics. The main implication of the election results is the likely reappointment of Bank of Japan Governor Kuroda, or a candidate who is similarly dovish, when his term is up next April. Monetary conditions in Japan are expected to remain easy for the foreseeable future. The emergence of Tokyo Governor Yuriko Koike and her Party of Hope dangling populist policies like free education and universal basic income, has forced LDP hardliners to soften their original strict fiscal consolidation plans. While PM Abe has reaffirmed that the GST tax hike will take place as scheduled in 2019, he has announced a JPY2 trillion spending package that includes providing free education and childcare services. This will be funded by some of the revenues

"Correlation between JPY & Topix"



expected to be received from the GST hike, which would have otherwise gone to pare down debt. The credit rating agencies will keep a close eye on the situation should the goal to achieve a budget surplus by 2022 be pushed back further, but Japan's fiscal position could improve with higher tax revenues because of the rise in corporate profits.

Overweight Japanese Equities

Japanese equities have surged to 20 year highs but this has mostly been driven by earnings growth rather than multiple expansion. Despite the 15% gain this year, Japan remains the cheapest of the three main developed markets, with the Topix trading at a forward PE of 14.4x, compared to the S&P500 (17x) and the Eurostoxx50 (15.5x).

One frequently made comment about the Japanese stock market is that it is essentially an inverse play on the Japanese Yen (JPY). The chart below shows that this indeed has been the case in the past, when JPY weakness is highly positively correlated with strong performance in the Topix and vice-versa. Interestingly however, this relationship appears to have broken down this year, with the Topix rallying despite gains in the JPY. Indeed, one could argue that this historical correlation should have broken down a long time ago, since many Japanese multinationals have relocated their manufacturing plants overseas. The Japanese economy today is only one-third dependent on exports with domestic consumption and investment contributing to the bulk of the economy. This break down in the historical correlation between the JPY and Japanese equities is an important development since the JPY is arguably 10-15% undervalued on a purchasing

power parity basis. Should this new paradigm hold, then both Japanese stocks AND the JPY could continue to appreciate, which will be a double positive for international investors.

Potential Pitfalls

It is interesting then that global investors are still underweight on Japanese equities. Many investors have probably not forgotten the times they have been badly burned when Japan looked to be turning the corner, only for her to be dragged down again by old problems. Sceptics could point to the potential pitfalls on the horizon - the biggest of which is when the Bank of Japan has to start to unwind its various quantitative easing measures, including its significant JPY1.5 trillion holdings in ETFs. The election results however suggest that this process will be carefully managed under a dovish central bank. PM Abe could also face a challenge for the LDP leadership next year should his approval ratings remain low. PM Abe's track record though speaks for itself and I would not be surprised if he successfully wins a third term as Prime Minister.



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