

JAPAN: TEN POTENTIAL MARKET SURPRISES IN 2018

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It's that time of year when economists and strategists present their forecasts for the year ahead. Quantitative forecasts are based on probability models that cannot help but assume the future will be correlated to the past, and qualitative scenarios are based on, well, a combination of experience and common sense. Either way, most methodologies it would seem leave little room for discussion of true outliers and surprises.

This article attempts to address this deficiency. Here are the outlier scenarios that I personally worry could have large Japan investment implications. By definition, these 10 surprises lie outside the consensus. Their primary purpose is to make the reader think. Improbable as they may appear, any movement toward their far-out direction is poised to force an about-face in market consensus. Enjoy, and best wishes for a successful and happy 2018.

1) Prime Minister Abe goes to Pyongyang and secures a \$1 trillion Japan-led infrastructure upgrade for North Korea

At the end of 2017, it may not be prudent to expect a reversal of fortunes on the North Korea issue. However, as long as cool heads prevail, the path towards a constructive endgame is not impossible to foresee. From an economic development perspective, North Korea and Japan are a match made in heaven: an ample supply of natural resources and labor meets world-leading technology and capital. PM Abe has an outstanding track record as a champion promoter of Japan-led infrastructure projects. Engaging North Korea constructively would not just boost Japan's economic fortunes, but surely create a historic legacy for Abe worthy of the Nobel Peace Prize. Unlikely, unfortunately, but so is a peaceful endgame solution without stepped-up economic engagement. Sooner or later this will happen, in my view.

2) Accelerated Yen depreciation towards ¥150/\$ forces China to devalue the Chinese Yuan by 30%

De-synchronised monetary policy cycles raise the probability of de-synchronised asset price movements in general—FX markets overshoots, in particular. In my view, this leaves the Yen very vulnerable for 2018. I know, in both 2016 and 2017, the BOJ-Fed cycle did not de-synch as much as anticipated, but this does not mean it won't do so in 2018. After all, US fiscal policy has changed. More importantly: when the next cycle of US Dollar strength accelerates, the circuit breaker I am most worried about is China. Japan and China now compete head-to-head in many markets, including high-tech and bullet-trains, so Yen depreciation is now more of a worry for China's factories than for US ones. The weaker the Yen gets, the greater the risks of a Chinese Yuan devaluation. When the Yen slips past ¥140/\$, I fear a 30% Chinese Yuan devaluation more so than a potential backlash from the US.

3) The new Federal Reserve Chairman imports the BoJ operational model and fixes the US 10-year yield at 2.5%

If Trump gets his wish and the US economy speeds-up to a sustained 3.5-4% growth rate, US bond yields are poised to come under substantial upward pressure, possibly as high as 6% or more for the 10-year bond. After all, real GDP growth of 3.5-4% implies nominal growth of at least 5.5-6% and, historically, it has been rare for bond yields to stay much below the sustained nominal GDP growth rate. In any event, rising US bond yields will start to put downward pressure on US risk assets in general, equities, real estate and credit in particular. Before long, rising bond yields will be followed by a genuine downcycle. To pre-empt this, a professional real estate developer and very unorthodox President may find it hard to resist the temptation by getting the Federal Reserve to import the Bank of Japan operational model: fix the US long bond at an agreeable level, say 2.5%, and let the economy go into overdrive for the next election cycle.

4) Toyota buys TESLA and turns the newly integrated US-based factories into the most productive car factories ever

Toyota and Tesla appear to be perfectly complementary. The Japanese maker is the undisputed global champion of top-quality massive-scale manufacturing, which is exactly what Tesla is still struggling to create. Meanwhile, Tesla offers a turbo-charged on-ramp to the future of transportation, which is exactly where Toyota wants to get to. At the operational level, one can easily imagine Toyota-led production expertise delivering the world's most productive car factories for Tesla. Of course, combining the two corporate cultures may prove impossible, but nothing would prove the ambitions of the new Japan better than a successful Japanese takeover of a US silicon valley superstar. This would be a huge surprise, given that the more likely strategy is for Toyota to come from behind and beat Tesla at its own game. Out-producing and out-designing a first-mover like Tesla is, after all, Japan's proven core-competence.

5) PM Abe introduces "Asia-Coin," the world's first central bank-backed blockchain cyber-currency

The race is on for National Governments and Central Banks to sponsor and promote an official cyber-coin standard. Japan has the potential to take the lead here by introducing a BoJ-backed "Asia Coin," a blockchain-based currency system created by a consortium of Japan's mega-banks and the BoJ. As a new national policy initiative, it should be easy to get Japan's leading companies to adopt this "Asia Coin" as their settlement and transactions system for all their Asian/Global business, which in turn creates a virtuous cycle of trust, liquidity and, well, a head-start for Japan to set the global standard for the future of banking. Surely a surprise, but Japan's ambitions to re-build Tokyo as a leading financial center are real. The creation of a Japanese government-backed "Asia Coin" would put Japanese banks and financial institutions in an undisputed global leadership position. And the race really is on: while concerted Japanese leadership would be a positive surprise, a China government-led cyber currency is bound to be launched before long.

6) Japan introduces "financial means testing" to cut public benefits and national healthcare for wealthy individuals

Cutting public benefits and entitlements is unpopular and difficult in any country, but in Japan, it is still popular to tax the rich and re-distribute incomes. As pressure to cut the runaway fiscal deficit keeps rising, creative and unorthodox policy proposals to

cut entitlements are starting to be discussed. Introducing “financial means testing” could be one option, where, for example, anybody with net financial assets greater than, say, ¥10million, and no mortgage debt, is no longer eligible for the public pension or Japan’s national healthcare. Controversial for markets, but popular with voters? At the very least, nobody should be surprised by the creativity of Japanese policy makers.

7) Japan joins the China-led Asian Infrastructure Development Bank

Over the past five years or so, the Japan-China relationship has developed from complementary to competitive. This is true on the economic front, as well as on the political and strategic one. When China set up its version of the US-led Asia Development Bank, the Asian Infrastructure Development Bank, it was inevitable that Japan would follow the US lead and not join. Now that Japan is urged by the US to show greater independence, a change of national strategy may be in order. Both Japan and China have emerged as Asia’s champions for multilateralism. Joining forces to lead-by-example makes more and more sense. Japan joining the China-led Asian Infrastructure Development Bank would be symbolic of both Japan’s growing independence as well as its commitment to multilateralism. An even bigger surprise would be a truly grand strategy: in exchange for Japan joining the AIDB, China joins the Japan-led Trans Pacific Partnership TPP free trade initiative. Concrete progress on Japan-China cooperation would certainly change Asia’s dynamics for the better for investors.

8) Tokyo real estate prices surge past 1990 bubble-peak levels

Tokyo real estate prices have begun to recover, but still remain a good 40-50% below the bubble peak levels recorded in 1990. However, real estate developers have recently become more aggressive. Here and there, high-end luxury apartments for \$5 million or \$6 million are coming onto the market, which is more than double the price of top deals done three years ago. Demand is fueled by a new, rising group of Japanese entrepreneurs, easy credit availability and Asian/foreign buyers. It won’t be long before we see a new historic high for residential real estate purchases. Before 2020 is a reasonable forecast, in my view, but in 2018 it would be a positive surprise—a high-profile confirmation that deflation is over.

9) Bio-Tech, FinTech and AI startups lead a wave of IPOs that establish Tokyo as Asia’s premier applied innovation hub

Nothing succeeds like success. For years now, the Japanese government has been focusing on the need for more entrepreneurship, innovation and corporate creativity. The time has come to show concrete success. A wave of IPOs would do wonders to prove “Abenomics” is working, that Japan is back on track to become the innovation powerhouse in Asia. In my view, Japan has plenty of entrepreneurial activity and creativity, particularly in BioTech, FinTech and applied AI and robotics. To see a more aggressive and visible monetisation and commercialisation of these would be the best positive surprise possible to prove a Japan optimist right.

10) Japan beats Germany to become the new Soccer World Champion in the 2018 World Cup

On 15 July 2018, the FIFA Soccer World Cup final will take place. Japan winning the title would be a major surprise, particularly to me. After all, I am German and, every four years when the world Cup is held, I cannot help but turn massively biased. Team Germany not making it to a world Cup final will be not just a surprise, but a real

shock. May the best team win in 2018!

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