JAPAN IN 2020: SURPRISES ON THE HORIZON?

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2020 is poised to be a great year for Japan. My main scenario is straightforward: exports get lifted by the re-acceleration of Chinese demand; and domestic demand surprises on the upside because of strong business investment, fiscal support and a steadfast rise in the purchasing power of Japanese employees. However, there will be surprises not captured by the quantitative models of the experts or the current consensus “wisdom” of the crowds. So, here are the outlier scenarios that keep me awake at night. Improbable as they may seem, any movement towards their far-out direction will force a change of direction in the current consensus -that’s why surprises are so powerful.

1) Japan cuts corporate tax for firms establishing Asia Headquarters in Japan

Japan is the undisputed bastion of stability in Asia and could easily become the Asia-headquarters location of choice for both established multinationals and entrepreneurial start-ups. However, to really capitalise on Japan’s ‘natural advantages’ like stable politics, pro-business rule of law, best-in-class infrastructure, high quality of life, and superb access to all of Asia – one obstacle must be addressed, the very high corporate tax rate. At basically 30%, companies face a tax bill two or even three times higher than they do in Hong Kong, Singapore or other Asian capitals. Given rising political risks elsewhere, all Japan needs is a little nudge. If corporate tax were cut to 20-25% for any company that establishes their Asia headquarters in Japan, many CEOs would seriously consider the relocation of their Asia leadership teams back to Tokyo. Of course, Japanese tax authorities will be opposed to this idea; but the younger generation Liberal Democratic Party leaders fully recognise that 20% of something is better than 30% of nothing. An inward investment boom could follow, boosting not just high-quality, high-paying job opportunities for Japanese residents both young and old, but also naturally speeding-up diversity and global awareness amongst local teams.

2) The 2020 ‘Shunto’[1] delivers a 4% pay rise, double the rise workers got last year

For a true decoupling of Japan’s economy from the ups-and-downs of the global business cycle, domestic demand in general, consumer spending in particular, needs a more powerful engine. After decades of wage restraints and unions lobbying for long-term job stability rather than short-term wage gains, the job market has become tight and the ‘war for talent’ should begin to feed higher wages. The higher the ‘Shunto’, the greater the chances of positive growth surprises in 2020. At the same time, watch for more companies following Toyota’s lead in introducing more genuine pay-for-performance compensation. In Japan, momentum is building for both. Make no mistake, a base-pay hike plus pay-for-performance equals a consumer boom.

3) Prime Minister Abe goes to Pyongyang and leads way for $1 trillion Japan-led

infrastructure upgrade for North Korea

For security and defence experts, North Korea remains a quagmire; but for an economist, North Korea and Japan are a match made in heaven: an ample supply of natural resources and labour meets world-leading technology and capital. PM Abe is an effective promoter of Japan-led infrastructure projects. Engaging North Korea constructively in economic diplomacy would not just boost Japan's economic fortunes, but could create a legacy worthy of the Nobel Peace Prize for Abe Shinzo. Unlikely you may say, but so is a peaceful solution without increased economic engagement. Sooner or later this is likely to happen.

4) The US Federal Reserve Bank imports the Bank of Japan (BoJ) operational model and fixes the US 10-year yield at 2.5%

If Trump gets his wish and the US economy accelerates to 3.5-4% before the November 2020 Presidential election, US bond yields are poised to rise, possibly as high as 5% or more for the 10-year bond. After all, real gross domestic product (GDP) growth of 3.5% implies nominal growth of around 5-5.5% and, historically, it's been rare for bond yields to be below sustained nominal GDP growth. What matters is that rising yields will force downward pressure on US risk assets in general, US equities, real estate and credit. To pre-empt this, the incumbent President may find it hard-to-resist to force 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 election cycle.

5) The Bank of Japan offers a "peoples swap", selling its Exchange Traded Fund (ETF) equity holding to Japanese savers

The BoJ owns almost 8%[2] of the Japanese equity market, much of this through its ETF buying program. While justifiable as an emergency measure to help overcome deflation, the central bank's de-facto nationalisation of equity capital has become counterproductive for many reasons. The biggest one is that nobody can conceive a smooth exit and if the BoJ starts selling, surely the market will crash? So, who is there to buy the BoJ equity overhang and prevent a likely crash? There is only one answer – Japanese savers, the older generation in particular (the over 65-year-olds own more than 70%[3] of Japan's net financial assets.) To get an elderly saver to swap from bank deposits into ETFs will require a real incentive like inheritance tax benefits. If the BoJ and the Finance Ministry can cooperate and devise a scheme where individuals who buy ETFs directly from the BoJ will have these ETFs exempt from inheritance tax, I believe the central bank could clean up its balance sheet within a short period of time. The net result would be the re-privatisation of Japanese equities, a healthier corporate ownership profile, as well as a better risk-return profile for household sector balance sheets.

The views expressed in this blog are those of Jesper Koll, any reference to "we" should be considered the view of Jesper and not necessarily those of WisdomTree.

Sources

[1]Shunto is the Japanese word for the annual spring round of wage negotiations conducted between big business and trade unions

[2]Bank of Japan, Q3 2019 Flow of Funds report

[3]Bank of Japan, Q3 2019 Flow of Funds report

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