

JAPAN OUTLOOK Q4 2016: FROM HEADWINDS TO TAILWINDS

31 Oct 2016

The outlook for Japanese risk assets – equities and real estate – is beginning to improve and, between now and end-year, we do expect a positive break-out from the relatively tight trading range that the equity market has been in since mid-July, i.e. 1,270 to 1,350 for TOPIX (Bloomberg). Specifically, we see the following domestic forces as turning from headwinds to tailwinds.

For the economy:

1) Pro-growth policy support, with large-scale fiscal stimulus compounded by steadfast monetary support

Prime Minister Abe and his cabinet did approve a record ¥28 trillion fiscal expenditure program – almost 6% of GDP – which will be implemented over the coming 12-24 months (Bloomberg) while not all of the program will feed into aggregate demand, the net effect should still provide a boost of around 0.7-1% to domestic demand over the coming 12 months. From October/November, first concrete signs of the positive effects of fiscal expansion should start to feed into data. Moreover, the 2017 budget negotiations – due to start late-October – should bring more evidence of Team Abe's steadfast commitment to fiscal relief. Specifically, tax-cuts for double-income families are now on the agenda.

2) Rising visibility of a domestic demand up-turn, led by a gradual but positive turn in business investment

Business investment has been the clear missing link during "Abenomics" so far. This appears to be turning, with growing evidence that "capital deepening" is now accelerating. The tightness of the labour markets is forcing a push towards more capital intensive factories amongst small & medium companies; the FINTEC revolution is beginning to feed increased spending by Japanese financials- and logistics firms; and growing replacement demand for outdated machinery is observed as small & medium sized companies take advantage of the record-low financing costs now on offer.

3) Tight labour markets beginning to lift the "purchasing power of the people" – both nominal- and real incomes are growing

The tightness of the labour market is beginning to feed not just positive wage growth – nominal wages are rising around 2% now, about double the pace recorded twelve months ago; but also improved quality of jobs – full-time employment is now rising for the first time in almost 20 years (Source: Bank of Japan statistics). The net effect is a steady upturn in both nominal- and real incomes. Importantly, this is not a cyclical phenomenon but a structural one due to Japan's demographic destiny. Here, our favourite indicator is residential housing, which has recorded a steady recovery over the past six months.

For the equity market:

1) Attractive valuations now underwritten by a clear commitment for better capital stewardship, i.e. dividend- and share-buy-back growth

Despite a first year of negative recurring profit growth since 2012 – profits are expected to decline about 10% in FY3/17 – corporate managers continue to raise dividends and increase share-buybacks. Concrete commitment to better capital stewardship is a key positive for Japan, in our view. If, as we suspect, the upcoming corporate results season brings further increases in buy-backs and dividends, this could provide a concrete trigger for Japanese equities, in our view (the results season starts late-October).

2) Earnings revisions momentum poised to inflect positive as companies have adjusted FX assumptions The negative pull from Yen appreciation has now been reflected in corporate earnings projections. For example, Japan's major car companies are budgeting for an average ¥100/\$ for the current FY3/17. Moreover, the collapse in energy and commodity prices did force sharp revisions down to the trading companies – a negative force now behind us. In addition, the negativity forced on banks' earnings by the BoJ's negative interest rate policy (NIRP) is now past its nadir. All said, we expect earnings revisions momentum to improve in coming months.

3) Banks in particular, financials in general, now poised to benefit from the BoJ's commitment to steepen the yield curve The Bank of Japan has gone out of its way to reverse its policy on banks. The new framework adopted in September explicitly seeks to promote a steeper yield curve, which in turn should be positive for banks' and other financials' profit margins. Add to this a positive turn in the capex cycle, and banks and financials are poised to become top-sector performers in Japan, in our view.

The principle risks to this view are twofold, in our view:

1. The rise in household incomes – which comes from both increased fiscal transfers and private sector employment growth – ends up boosting savings more than spending.
2. A collapse in the US dollar, i.e. growing fears of a 2017 US recession

Source: Bloomberg

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