VIEWPOINT

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Prepared for professional clients only

REASSESSING ‘ABENOMICS’

Executive summary

- *Miyuki Kashima, managing director and head of the Japanese equity investment division at BNY Mellon Asset Management Japan, reflects on the remarkable approach taken by Prime Minister Shinzo Abe and his government, and the potential once-in-a-generation transformation that this could prompt for the long-suffering Japanese economy.*
- *While financial markets have been spooked by some of the finer details of ‘Abenomics’, it is the combined power of Abe’s ‘three arrows’ that makes the success of his plan such a genuine possibility; investors need to step back and see the bigger picture.*
- *The stars seem to have aligned for Abe; with a very high approval rating, the prime minister looks set to have the luxury of time in which to push through his deflation-busting plans. Furthermore, with domestic ownership accounting for over 90% of the Japanese government bond market, he won’t need to rely on the support of international bond market participants.*
- *At the heart of Abe’s plans lie a weaker Japanese yen, a shift in the Japanese psyche towards spending and away from saving, and a greater utilisation of women in the workforce as a riposte to the challenges of an ageing population; none of these seem unachievable.*
- *Why is it different this time? This question is misplaced; the scale of Abe’s plans is genuinely of the like that has never been seen before.*

“… IT IS THE COMBINED POWER OF ABE’S ‘THREE ARROWS’ THAT MAKES THE SUCCESS OF HIS PLAN SUCH A GENUINE POSSIBILITY.”

BNY MELLON

Since returning to power as Japan's prime minister in December 2012, almost six years after the end of his previous term in office, Shinzo Abe has wasted no time in shaking the very timbers upon which Japan's economy is built; 'Abenomics' has been born. Abe's three-pronged economic strategy – monetary, fiscal and growth – is referred to as his 'three arrows'; this harks back to a legend from the prime minister's own region, Yamaguchi, in Southern Japan. In it, a lord asks his three sons to each break an arrow in two; with some ease, this is achieved. He then challenges his sons to break three arrows at the same time; they all duly fail. The lesson, he explains, is that one arrow can easily be broken. Three arrows together, on the other hand, are unbreakable. Like the three arrows in the legend, Abe hopes that his unprecedented three-pronged policy attack will be too strong to fail in its attempt to drag Japan into a new and improved economic reality.

Miyuki Kashima, managing director and head of the Japanese equity investment division at BNY Mellon Asset Management Japan, reflects on the remarkable approach taken by Abe and his government, and the potential once-in-a-generation transformation that she believes this could prompt for the long-suffering Japanese economy.

"… WE BELIEVE THAT WE ARE NOW IN ANOTHER TRULY TRANSFORMATIONAL PERIOD FOR BOTH THE JAPANESE ECONOMY AND EQUITY MARKET."

It is hard to remember the last time something truly transformational occurred within the Japanese economy. Arguably, to find an example, one has to look as far back as the late 1980s when the government tackled the overheated Japanese property market. At the time, there was talk about introducing a high additional property tax for large scale real estate owners, perhaps as high as 1% of property value. This possibility, coupled with sharply increasing rates caused asset markets – notably the highly correlated property and equity markets – to decline precipitously. In fact, by the time the property tax was introduced, such was the impact of rising rates and the fear of higher taxes that asset prices were already in decline; in the event the tax was introduced at only 0.3%, promptly reduced to 0.1% and then suspended.

From a policy perspective, the most striking thing was that the government was prepared to use both fiscal and monetary tools to deal with the bubble; this combination is a powerful prospect. After years of poor performance in the aftermath of the bubble's collapse, we believe that we are now in another truly transformational period for both the Japanese economy and equity market. Monetary and fiscal tools are being used together once again, but this time to boost the economy, with the added stimulus of growth policy. What's more, the scale of Abe's policies dwarfs those of the late 1980s.

Prime Minister Abe's three arrows, in short, are as follows:

- **Bold monetary policy** – a target of 2% inflation and the doubling of the monetary base in two years.
- **Flexible fiscal policy** – to date, a ¥10.3 trillion supplementary budget has been announced.
- **Growth policy** – a focus on encouraging spending through tax breaks, deregulation and higher utilisation of women in the workforce.

An export-impedingly strong Japanese yen, deflation, and the resulting weakness in corporate earnings and the economy; these are the ills of the last 20 years that Abe is determined to reverse. Unprecedented in terms of speed and size, his policies are leaving few stones unturned in an effort to put Japan back on a growth path. Furthermore, luck is on his side. A historically conservative nation that has disliked rapid change appears ready to break away from two decades of stalemate. With the overwhelming support of the electorate – following a disappointing three-year rule by the Democratic Party of Japan (DPJ) – Abe has the tools at his disposal to create history.

Rewinding the unwind

In the aftermath of the collapse of the bubble, Japanese companies found themselves, in essence, unable to borrow. Starved of the credit needed to fuel growth, a prolonged period of corporate and consumer unwinding was the inevitable result.

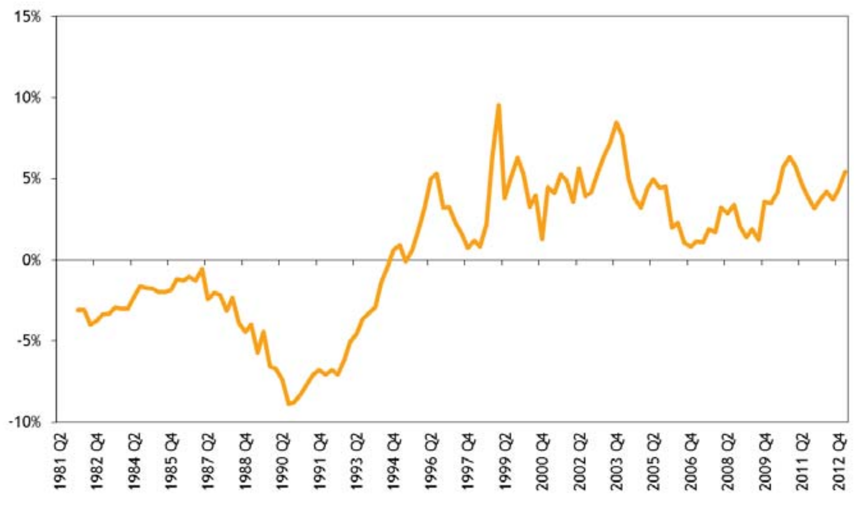
Traditional economic theory has it that a long period of deleveraging should be followed by a recovery. But, in the case of Japan, as a deflationary cycle took hold and the yen strengthened steadily versus all major currencies, a recovery simply failed to materialise. In this unique economic climate, the propensity of both individuals and companies to postpone purchasing decisions became a self-fulfilling prophecy. By delaying spending, consumers and businesses alike were doing the right thing; logically, holding cash and not borrowing makes absolute sense in a deflationary environment. It was, however, a big negative in aggregate for the economy.

Indeed, prolonging the realisation of demand in this way over such an extended period can have a debilitating effect on the long-term prospects of the economy. It is essentially a truism that long-term economic change will only come about in Japan if companies decide that return prospects are high enough for them to resume normal economic activity – to borrow money to invest, let alone invest the large cash piles upon which many corporates, in particular, currently sit (see charts 1 and 2).

In other words, if businesses decide that it is wise to spend the money they make, and borrow once again, thereby replacing the government as the sole borrower of funds in Japan. Clearly, the most important measure of success will be if proper inflation is achieved, enabling the country to emerge from its long deflationary slumber.

"CLEARLY, THE MOST IMPORTANT MEASURE OF SUCCESS WILL BE IF PROPER INFLATION IS ACHIEVED, ENABLING THE COUNTRY TO EMERGE FROM ITS LONG DEFLATIONARY SLUMBER."

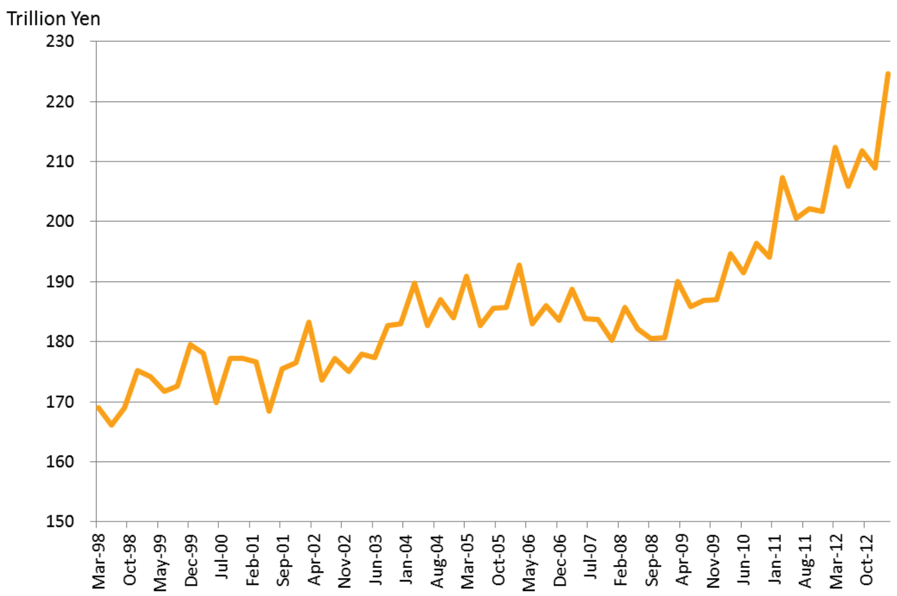
Chart 1:Japanese companies can afford to spend: corporate savings as a % of nominal GDP



Source: Bank of Japan, Bloomberg, June 2013

Meanwhile, the long-term strengthening of the yen versus most currencies and, in particular, the Korean won, has had a severe negative impact on the competitiveness of Japanese exporters. The beauty of 'Abenomics' is that it contains commitments that the authorities will do whatever it takes to address the persistent problem of yen strength.

Chart 2: Corporate cash pile — cash and deposits held by non-financial corporations



Source: Bank of Japan.

This just might be Japan's 'reset' moment – or, more likely, its 'reset era'. We believe this 'reset' will manifest itself in three main ways, and over a period of many years.

"… JAPAN IS FAR LESS RELIANT THAN MANY OTHER DEVELOPED ECONOMIES ON THE SENTIMENT OF INTERNATIONAL INVESTORS TO SUPPORT ITS FUNDING REQUIREMENTS."

The three manifestations of 'Abenomics'

1) Normalising investment and lending

The first visible sign of the long-term success of Abe's policies will be a normalisation of company behaviour as return prospects are improved, enhanced by healthier lending and borrowing conditions. The great hope here is that stimulating corporate investment will eventually lead to an increase in borrowing; indeed, Abe has introduced tax incentives for companies hiring full-time workers and is working on plans for tax breaks as a means of boosting capital expenditure (CAPEX). More precise details are expected to be announced later in the summer of 2013.

A distinctive feature of Japan's situation is that, despite the economic difficulties faced by the country, its banking sector is now in excellent health and well capitalised. As such, banks have for many years been well placed to lend, but in practice neither the populace nor corporate Japan has wanted to borrow. The latest figures indicate that lending has been increasing. However, so too have deposits, meaning that the absolute size of Japan's deposit base continues to grow.

Ultimately, it is Japan's huge surplus of bank deposits that has funded the massive expansion of the Japanese government bond market, which remains one of the world's largest in market capitalisation terms. However, an important point of context is that the market is, by a very large majority, domestically owned. Indeed, foreigners own less than 10% of outstanding Japanese sovereign debt[1]. This matters, because it means that Japan is far less reliant than many other developed economies on the sentiment of international investors to support its funding requirements.

Against this backdrop, what would be the implication of a sudden (and in our view highly unlikely) explosion in bank lending? The answer lies in the announcement by the Bank of Japan (BoJ) regarding its long-term commitment to supporting the bond

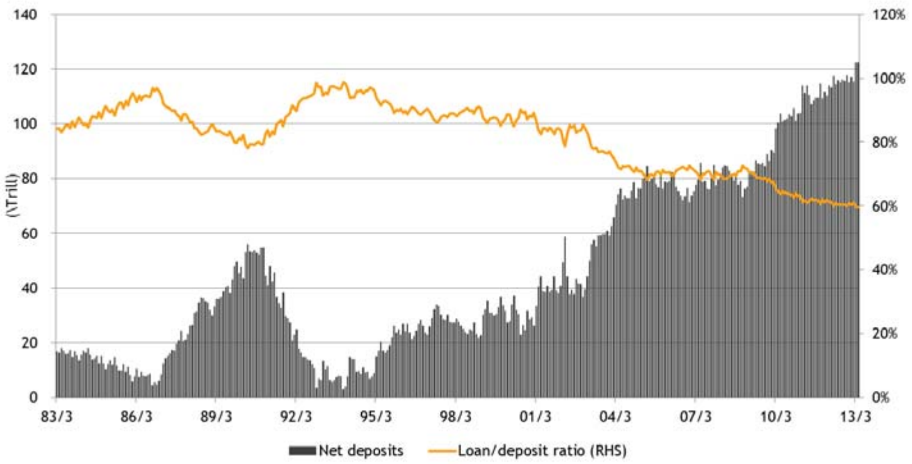
[1] Bank of Japan, June 2013.

market by using the further expansion of the monetary base to continue to buy Japanese government bonds. In other words, the central bank is committed to absorbing the effects of sovereign bond selling activity by commercial banks, if and when it happens. This, we believe, should be more than sufficient to maintain low market interest rates, and is why these developments are likely to play out over many years.

"DESPITE FEARS IN SOME QUARTERS, WE DO NOT BELIEVE THAT JAPAN WILL ENTER A HYPERINFLATIONARY ENVIRONMENT ON ACCOUNT OF THE INCREASE IN THE MONETARY SUPPLY..."

Despite fears in some quarters, we do not believe that Japan will enter a hyperinflationary environment on account of the increase in the monetary supply resulting from current monetary stimulus. Japan has a comparatively high net debt-to-GDP ratio of around 150%[2] but, for now, it can afford to continue to issue more debt to kick start the economy because banks' loan-to-deposit ratio is only 60%[3], and deposits are still growing faster than loans (see chart 3) so banks are expected to continue to support the bond market.

Chart 3: Japanese banks can afford to lend (loan-to-deposit ratio %)



Source: Bank of Japan.

2) Social reform

Japan's ageing population and related economic problems are plain to see. The working population aged 15-64 peaked in 1995 at 87 million[4] and the government forecast says the number will decline to 44 million in 2060[5]. To boost the size of the working population, Japan has several options open to it. In common with many other developed countries, it could opt to increase immigration.

But, another obvious solution is staring it in the face; enabling more women to enter the workforce. Although legislative changes in 1986 were aimed at putting women on an equal employment footing to men, visitors from Europe and the US are regularly struck by quite how few women in Japan are hired to do the same job as their male peers. In particular, there is no escaping the fact that Japanese women are largely under-utilised in the full-time employment market.

This situation is gradually starting to change, however, and it is revealing that, for the first time ever the proportion of female graduates being offered jobs is exceeding that of males. This development will have its own interesting economic side effects, not least of which is that with the increase in the proportion of women in work, the need

[2] International Monetary Fund, June 2013.
[3] Bank of Japan, June 2013.
[4] Japanese Ministry of Internal Affairs and Communication, June 2013.
[5] Japanese Cabinet Office, June 2013.

for childcare/crèche places is likely to soar. The number of mothers in the queue for day-care availability has been high for a long time, and this demand is only going to rise further. Indeed, indications are that 79% of women aged 35-39 want to go back to work after having children, but only 34% of them are actually able to do so[6]. According to the Japanese Ministry of Labour and Welfare statistics, there were over 46,000 babies on the wait list to get into day care as at October 2012. The actual demand is estimated to be as high as 10 times that number because many mothers just give up. According to his prime ministerial website, Abe aims to increase day-care availability by 200,000 by March 2015, and a further 200,000 by March 2018. The Ministry of Health, Labour and Welfare's plan focuses on building smaller scale day-care (it is, of course, easier to build and run small scale facilities) and provide subsidies to smaller private sector facilities.

Enabling women to play a bigger role in the workforce will contribute to offsetting the problem of a declining working-age population. At present, over 50% of women who work are part-timers (compared to 20% for men), and in the Global Gender Gap Index, Japan, the world's third largest economy, ranks 101 out of 134 countries in terms of female economic participation and opportunity.

To move one real step closer to the government's target of raising participation of women in leadership positions to 30% by 2020, Abe has approached three core business federations/associations – KEIDANREN (Japan Business Federation), The Japan Chamber of Commerce and Industry, and Japan Association of Corporate Executives – and strongly requested that listed companies proactively utilise women in management and director positions. As a starter, he has asked that they appoint at least one woman on the board; this has received much publicity given that, according to the Japanese Cabinet Office, of 3608 listed Japanese companies, there were only 505 female directors as of May 2011.

"ABE IS THE FIRST PRIME MINISTER TO PLACE SUCH AN EMPHASIS ON THE IMPORTANCE OF BOOSTING THE EMPLOYMENT OF WOMEN, ALTHOUGH PROBABLY MORE OUT OF NECESSITY THAN IDEOLOGY."

The affordability of having children should rise if more women enter the workforce, which itself will have beneficial demographic side effects. Interestingly, boosting female employment was one of the earliest causes to be championed by Abe as an important component of his plan to raise the potential GDP growth rate from the current level of below 1%. This in turn should raise the outlook for more investment. While such a policy might seem obvious, and although most governments in the past have agreed that it is a good thing to have more woman participation, Abe is the first prime minister to place such an emphasis on the importance of boosting the employment of women, although probably more out of necessity than ideology.

3) Business reform

The third manifestation of the long-term success of Abe's policies will be tangible changes within Japanese corporate culture. We would not deny that the common complaint from the international business community that "it's hard to do business in Japan" has been a fair one. Indeed, this sentiment is shared by many Japanese companies. However, we believe that these problems have resulted primarily from the negative effects of overregulation; as such, we believe that internal and external investment should be boosted by pragmatic but careful deregulation.

An interesting example of Abe's determination to make Japan more 'open for business' was his rapid decision to join the Trans-Pacific Partnership (a free-trade agreement between a number of countries, including the US); a shift towards free trade is clearly good for Japan, and Abe, unlike his predecessors, was able to achieve membership despite strong opposition from the established agricultural lobbying groups. We expect this development to raise the return prospects on investment,

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[6] Japanese Ministry of Internal Affairs and Communication, June 2013.

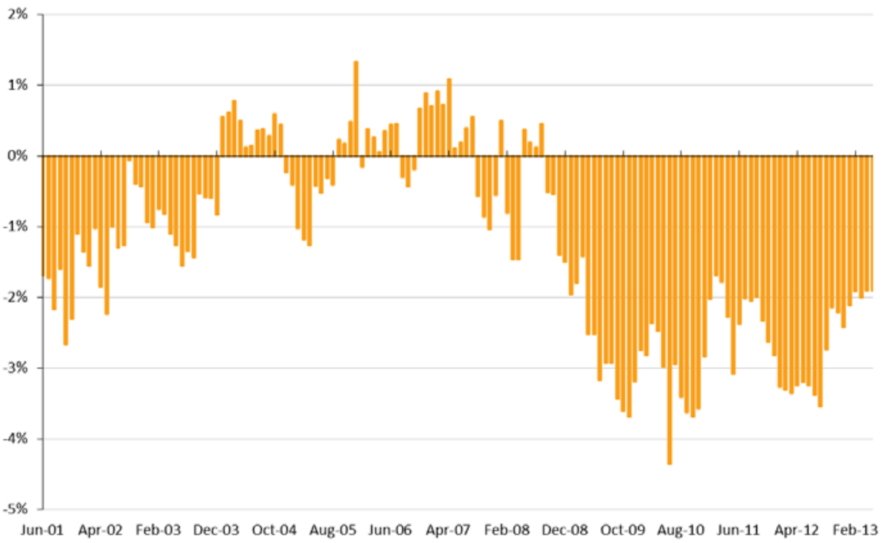
which should also support a return to more normalised behaviour and investment by corporate Japan.

More broadly, while we believe that a small number of failures of corporate governance (such as the highly publicised Olympus accounting scandal of 2011) are isolated examples, there is a strong case to argue that Japanese corporate culture has long been in need of change. Fortunately, there already signs that this is happening.

One of the many long-term consequences for Japan of the global financial crisis has been that some Japanese companies – struggling to break even – have been forced to do the previously unthinkable, and shed large numbers of workers. This, coupled with reform-driven increases in labour market flexibility, means that by and large Japanese workers can no longer expect to spend the majority of their career working for a single employer. The silver lining of this cloud is that culturally, these developments have helped to foster an attitude among workers that says there is 'something to play for', replacing the attitude that had previously dominated in which it was widely felt in workplaces across the country that, from an employee's perspective, there was only ever 'something to lose'.

"… CULTURALLY, THESE DEVELOPMENTS HAVE HELPED TO FOSTER AN ATTITUDE AMONG WORKERS THAT SAYS THERE IS 'SOMETHING TO PLAY FOR'..."

Chart 4: Japan allocation of global funds



Source: EPRP, Nomura.

In general, corporate governance in Japan is becoming 'normalised' from an international perspective. Although many foreign institutional investors are underweight the Japanese market (see chart 4) – notwithstanding that they already own around 28% of the market[7], a record high – we believe that improving economic fundamentals should prompt greater international investment and, in turn, more 'shareholder-friendly' polices. While mistrust of the thesis that 'it's all different this time' will be the understandable first reaction of many foreign institutional investors, one irony is that Japanese investors are even more sceptical about the domestic market than foreign investors; indeed, some of the biggest sellers during the May 2013 sell-off were the large Japanese trust banks.

Cultural change alone will be insufficient to help corporate Japan back onto its feet, though, and we believe that significant improvements in corporate governance are likely to remain something of a 'slow burner'. Once again, we return to the promise of

[7] Tokyo Stock Exchange, Nikkei, June 2013.

Abe's multi-pronged approach, a key component of which that is designed to support business reform is an effort to dampen the strength of the currency. Yen strength has been a serious threat to Japan's competitiveness, and when the US dollar has fallen to lows of 75 yen, it has been virtually impossible for many Japanese exporters to compete internationally, particularly with South Korea, which benefits from a weak currency and is a direct industrial and manufacturing rival. Furthermore, as the yen strengthened, investors had to keep assuming that the trend would continue, thus lowering the potential return on capital and in turn overall CAPEX.

All of this said, we believe there is sometimes a tendency to overstate the importance to Japan of the export economy. As it stands, the contribution of exports to Japan's GDP is only around 15%[8]. Against this backdrop, the improving economic health of the US – accompanied by any strengthening in the US dollar – should be beneficial for the rest of the world and, therefore, for Japan.

"… THE FORTHCOMING RISE IN THE CONSUMPTION TAX IS UNIVERSAL – VISIBLY ENSURING THAT THE FISCAL BURDEN IS EVENLY SHARED WILL BE CRUCIAL TO SUCCESS."

Meanwhile, although we recognise the concerns of some investors, we do not believe that the government's actions amount to engagement in currency wars. Rather, we believe efforts to suppress yen strength are a recognition of Japan's need for a break from the pernicious effects on exports of having a *perpetually* strong currency.

Abe's unique position

Prime Minister Abe's economic policies are beginning to show early signs of success, although it could be argued that, over the very short term, financial markets are focusing on the individual announcements of policy changes. However, notwithstanding the upcoming elections, there is a palpable sense among the investment community that Abe is very much more 'market aware' than his predecessors, and his appointment of the dynamic and pro-business new BoJ governor, Haruhiko Kuroda, would appear to back up this thesis.

Furthermore, Abe's mandate and rate of support (currently running at around 67% approval, according to some polls) position him ideally to make the necessary changes in Japan, for example, in relation to the level of Japanese fiscal spending that has been a source of much comment over recent decades. In part, high levels of public spending have been a by-product of the famously short tenures of many of the country's post-war political leaders. In this context, the timing of Abe's return to power was fortuitous, coming after a period in which the ruling DPJ had over-promised and failed to deliver, but had 'delivered' on the one aspect of policy it had promised to leave untouched, namely the introduction of a consumption tax.

To many external observers, Japan can sometimes give the impression of being a 'socialist country in disguise', with a narrow dispersion of household incomes relative to many other developed economies. However, there is an identifiable correlation between dispersion of incomes and economic success, and this is a reality that Japan will need to overcome in the coming years. Here again though, Abe's policies show promising signs; the forthcoming rise in the consumption tax is universal – visibly ensuring that the fiscal burden is evenly shared will be crucial to success.

Hitting bullseye

Few commentators would dare to suggest that the task facing Abe is a small and straightforward one, and many who have taken it on before him have failed. However, we believe it is the unique combination of policy tools being employed at the monetary, fiscal and regulatory policy levels, as well as the flexibility thereof, that will enable 'Abenomics' to come to fruition.

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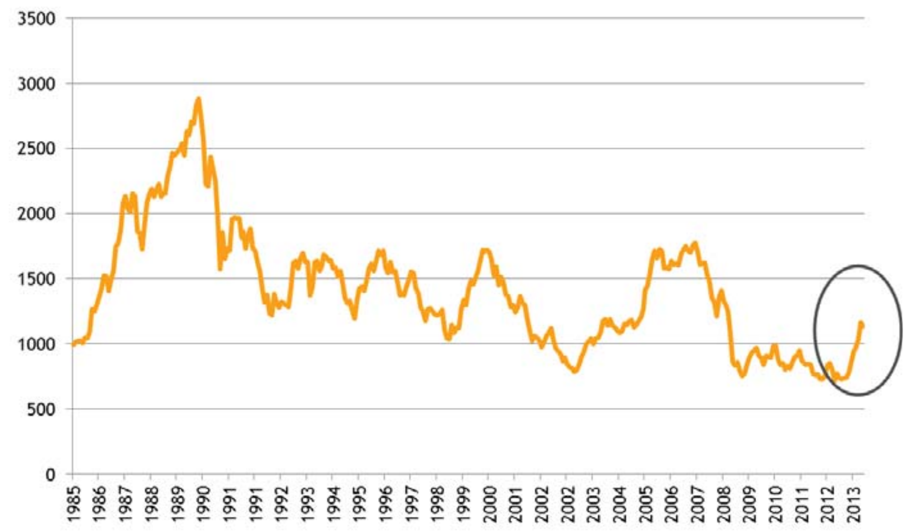
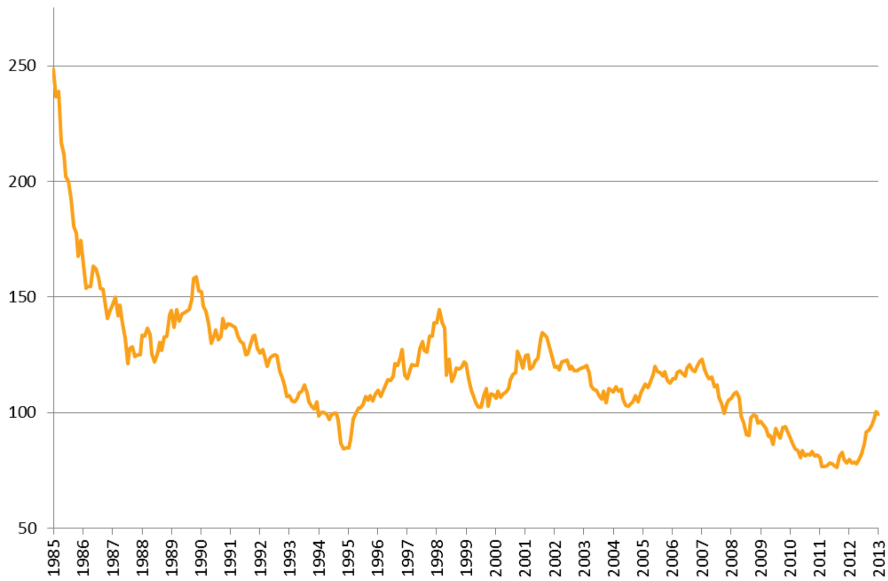
[8] Japanese Cabinet Office, June 2013.

Chart 5: TOPIX: the start of a new phase?



Source: Bloomberg, June 2013.

Chart 6: A reversal in the strength of the Japanese yen? Yen versus US dollar



Source: Bloomberg, June 2013.

"THERE ARE ALREADY EARLY INDICATIONS THAT HIS (ABE'S) ARROWS ARE WELL AIMED."

Firstly, monetary policy is boosting the stock market and reversing yen strength (see charts 5 and 6). Secondly, his fiscal policy will help Abe push through the required tax changes and thereby lend support to areas such as construction, which should be a key beneficiary of rising capital expenditure in the long run. Finally, growth policy will help boost businesses in all segments of the economy.

As we have said before, there are already early indications that his arrows are well aimed. For example, efforts to encourage large firms to award pay increases are showing signs of having had the desired effect; summer bonuses in 2013 increased by around 5% for manufacturers[9]. Meanwhile, the government encouraged manufacturers to raise full-time pay for the new financial year (starting in April) and a

[9] Nikkei Survey, June 2013.

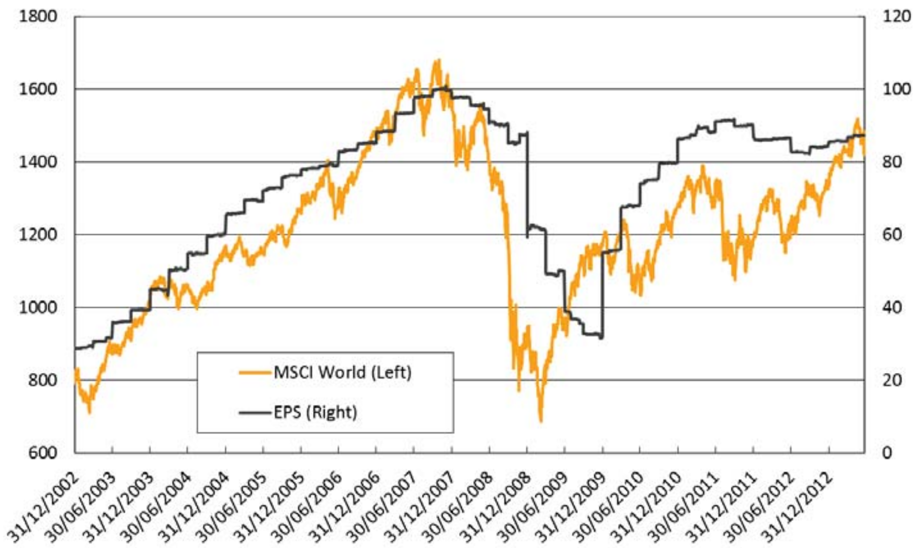
meaningful proportion of large manufacturers duly did so, their optimism buoyed by a declining yen. The hope, clearly, is that these awards will find their way back into the 'real' economy.

Japanese earnings per share have recovered but the equity market is yet to catch up

Chart 7: TOPIX versus trailing weighted EPS

Chart 8: MSCI World Index versus trailing weighted EPS

"OUR ASSESSMENT IS THAT THE MARKET HAS TENDED TO FOCUS TOO MUCH ON THE INDIVIDUAL ANNOUNCEMENTS THAT COLLECTIVELY DEFINE 'ABENOMICS'."



Source: Bloomberg, June 2013.

Our overall assessment is that the market has tended to focus too much on the individual announcements that collectively define 'Abenomics'. We believe this approach is unhelpful and that being viewed in isolation, the policy announcements need to be seen as part of a whole.

So far, the market has probably only discounted the effects of Abe's monetary policy. Indeed, the equity market still has some way to go in terms of catching up with earnings per share (EPS) growth (see charts 7 and 8). EPS is expected to increase by over 40% this year[10], yet the market has hardly even caught up with last year's growth; we expect this to change. Furthermore, the flexibility of the economic and fiscal policies being implemented should enable the authorities to offset a significant proportion of the negative effects of any single policy decision. As such, so long as the necessary reforms are implemented over the coming five to 10 years (while Japan still boasts ample domestics savings), we have confidence that the Japanese economy will begin to normalise.

"MANY WILL ASK WHY IT IS DIFFERENT THIS TIME. SUCH A QUESTION IS MISPLACED."

Japan is on the cusp of a remarkable transformation. This move will undoubtedly take time; it requires a seismic shift in the deflationary psyche of the Japanese nation, and it will not be plain sailing, but for the first time in nearly 25 years, there is a collective will and determination to turn things around. Many will ask why it is different this time. Such a question is misplaced. The scale of Abe's plans is genuinely of the like that has never been seen before.

We believe not only that Abe's 'three arrows' should prove unbreakable, but also that there is every chance they will hit their target.

About the author:

Miyuki Kashima, head of the Japanese equity investment division, BNY Mellon Asset Management Japan.

With over 25 years of Japanese equity investment experience, Kashima joined BNY Mellon Asset Management in April 2013 from ING Mutual Funds. In her role as head of Japanese equity investment, Kashima leads the Tokyo-based team and is ultimately responsible for all of its investment strategies.

A Japanese national educated at the University of British Columbia in the Canada, Kashima started her career in 1985 at Morgan Grenfell (which became Deutsche Asset Management) as a Japan equity analyst. She became a fund manager in 1987 and, in 1997, became head of Japanese equities at Chase Trust Bank before moving to Merrill Lynch Investment Managers (now BlackRock) in 2000. At ING, she was widely credited with having transformed the investment process and performance of the Japanese equity team.

[10] Nomura Securities, June 2013.

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