Stop Betting Against Japan

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The Bank of Japan is launching a quantitative easing program of historic proportions.

EXECUTIVE SUMMARY

During its past two decades of economic torpor, many foreign investors have been wary of Japan's equity market. But the economic reforms undertaken by Prime Minister Shinzo Abe and his government may be enough to change that, says Miyuki Kashima, managing director and head of the Japanese equity investment division at BNY Mellon Asset Management Japan Limited. We recently spoke with Kashima about why she believes this government's reforms might succeed where others have failed and why the Japanese equity market is ripe for rediscovery by global investors accustomed to overlooking the world's third-largest economy.

***QUESTION:* Japan has been caught for what seems like forever in a trough of weak growth, massive government debt and deflation. Furthermore, its population is aging and its consumers prefer to save rather than spend. These are not usually the fundamentals that drive equity rallies. Why are you bullish on Japan right now?**

MIYUKI KASHIMA: Japan is not a country that likes rapid change, but after 20 years of stagnation, the economy is finally at a major inflection point and the willingness of the people to accept changes this time, even some unpleasant ones, is quite impressive. Recent public opinion polls show support for Abe's cabinet rising to 68 percent from 63 percent in July, and more than 70 percent support his increase in the consumption tax. The speed of Abe's policy changes has been as surprising as the nation's willingness to embrace change. One of those policy initiatives is the Bank of Japan's launch of a quantitative easing (QE) program of historic proportions that will double the monetary base in two years from 138 trillion yen to 270 trillion yen. The BoJ will also double the size of its asset purchase program and expand it to include long-dated bonds. This is an ambitious goal because the bank has also set a target inflation rate of 2 percent and intends to lower real interest rates. The timing of Japan's QE program could have a major impact on equity markets because it comes as central banks in other countries such as the U.S. are winding down similar programs. It also helps to weaken the yen. Beyond the immediate impact of the QE program, the government is also enacting other reforms that will benefit equities over the longer term.

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***QUESTION:* How does Abe's approach differ from what has been tried in the past?**

MIYUKI KASHIMA: Abe has the political mandate to take on entrenched interests that have frustrated the weaker politicians who preceded him. Only one Japanese prime minister in the last 20 years has held office for much more than a year. But Abe won the support of a two-thirds majority in the lower house of Parliament last December, and a coalition led by his Liberal Democratic Party gained an upper house majority in July. He's likely to have three to four years in office, which puts him in a strong position to execute his plan. He's simultaneously changing monetary, fiscal and growth policies with unprecedented speed and scale. In my view, choosing Haruhiko Kuroda as the new governor of the Bank of Japan was a major step forward. Kuroda was Abe's choice, rather than a consensus pick and he has demonstrated that his decisions are fast and bold, just as the prime minister wants them to be.

***QUESTION:* What other initiatives besides an expansive monetary policy is Abe implementing?**

MIYUKI KASHIMA: Abe is adopting a flexible fiscal policy designed to fund public works and other stimulus projects to offset the potential disruption caused by longer-term changes such as the rise in the consumption tax. The government is also trying to stimulate private sector capital spending and job creation through targeted tax changes and is asking companies to pay their workers more in order to stimulate consumption. The third piece of Abe's strategy is a variety of initiatives meant to foster growth. They include joining the Transpacific Partnership (TPP) talks, encouraging greater investment by corporations and broader Asia-Pacific trade, expanding the number of women in the workforce, tax cuts and deregulation.

***QUESTION:* You say that for the first time there is a real prospect of reversing deflation and yen strength, two of the biggest problems that have plagued Japan and its stock market for a good part of the last two decades. Why is that so important?**

MIYUKI KASHIMA: The strength of the yen has a strong psychological effect on the market, even if it has a less powerful effect on the real economy. Exports count for only about 15 percent of Japan's GDP. The prospect of continuing deflation has also affected the thinking of Japanese companies and consumers. If you believe that everything will be cheaper in a year or two than it is today, you are very unlikely to want to spend or invest. That's been the widespread belief in Japan for a long time and it has helped keep the economy from recovering.

***QUESTION:* Japan has tried a variety of things in the past to get its economy moving that haven't worked. Why do we think this time it will be different?**

MIYUKI KASHIMA: Japan has disappointed investors many times in the past, but the magnitude, quality and clarity of the quantitative easing plan have surprised everybody. There are signs that Abe's reforms are already producing results. The yen is weaker. Big companies have started to raise wages. They also expect to increase hiring by 10 percent next year. Inflation continues to creep upward. Beyond these indicators of short-term improvement, there are also longer-term reasons for hope.

There has not been this kind of concerted effort to change fiscal, monetary and economic growth policies at the same time in the past 25 years. The emphasis on actionable plans to spur companies to invest and attract more women into the labor force is new. Companies have cash to spend on investment that they have held onto because deflation discouraged investment. If companies see signs of deflation reversing and the yen weakening, they are in a good position to start spending. Consumers and banks are in the same situation. Japan's banks currently have a loan-to-deposit ratio of only 60 percent. There's a lot of cash waiting for an environment in which spending and borrowing make sense.

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QUESTION: **Why is the government trying to get more women to work outside the home?**

MIYUKI KASHIMA: Partly it's a way to expand the size of the labor pool without changing immigration policy. Japan is an aging country and its supply of workers has been shrinking since 1995. That effectively limits the ability of companies to meet their need for workers as economic growth returns. Japanese women also have one of the world's lowest rates of economic participation and opportunity. Increasing the number of women in the workforce both expands the labor pool and increases the potential of Japanese households to drive economic growth through more consumer spending.

QUESTION: **That sounds like a fairly radical transformation for a society that doesn't necessarily like change.**

MIYUKI KASHIMA: A lot of Japanese women want this kind of change. The Ministry of Internal Affairs says that seventy nine percent of women aged 35 to 39 say they want to go back to work after having children, but only 34 percent are actually able to do so. One big reason is a lack of childcare. Abe is the first prime minister to emphasize the importance of women participating in the work force. He's planning to increase the number of available places in daycare by 200,000 by 2015 and an additional 200,000 by 2018. He's also urged all listed companies to add at least one female director to their boards.

QUESTION: **What convinces you that a Japanese equity rally has room to run?**

MIYUKI KASHIMA: Looking at earnings per share shows that the Japanese market is still undervalued, even after its recent rise. Trailing weighted earnings per share for the TOPIX is still below the level it was at prior to the Lehman crisis. Now with the yen trading at 100 to the U.S. dollar, we expect earnings per share growth of about 40 percent during the current fiscal year. Also, many global investors, if not most, are still underweight Japan. Furthermore, Japanese institutional investors have been selling into the current rally and Japanese retail investors continue to have very little exposure to equities. On average, according to the BoJ, less than 7 percent of households' financial assets are invested in stocks. For these reasons, I believe the Japan recovery story has just begun and the time has come to stop betting against the Japanese market and Abenomics.

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