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ABENOMICS CAN SHINE THROUGH IN 2015

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With the consumption tax hike and the election now behind us, benefits of Abenomics will be more visible in 2015.

The strong December 14 2014 lower house election results for the Liberal Democratic Party (LDP) mean that the Japanese public has endorsed the government to continue with Abenomics. The LDP now commands a comfortable majority having kept most of the seats gained during the landslide victory at the end of 2012. By most measures, the Japanese economy is in much better shape compared to two years ago, but the long term recovery story has only just begun. The economic data volatility and confusion due to the consumption tax increase in 2014 will be absent in 2015. Investors will be able to clearly see the benefits resulting from current policies.

A RARE TURNAROUND SITUATION FOR A LARGE ECONOMY

Two years ago, the Japanese public was skeptical about Abenomics. The series of monetary, fiscal and growth policies were bold, but many doubted the government's ability to pull the third largest economy in the world[1] out of 20 years of stagnation. The results so far have been impressive; Deflation, one of the main causes for the prolonged slowdown, has been reversed. CPI has been in positive territory since June 2013[2]. Unemployment has fallen from 4.5% in December 2012 to 3.5% in October 2014[3]. Tokyo center office vacancies have declined steadily to 5.5% in November 2014 from 8.67% in December 2012[4]. The average 2014 summer bonus increased 8.48% yoy, the highest level in over 20 years[5].

Despite the second quarter pullback in GDP following the consumption tax hike in April from 5% to 8%, (which was decided by the previous government), third quarter nominal GDP was 2.5% higher than what it was in the fourth quarter of 2012[6] when the current government first came to power.

[1] World Bank, updated September 24 2014
[2] Bloomberg
[3] Bloomberg
[4] Miki Shoji, Miki Office Report Tokyo
[5] Nikkei Newspaper July 14 2014
[6] Cabinet Office, Government of Japan

THE LONG-TERM ATTRACTION

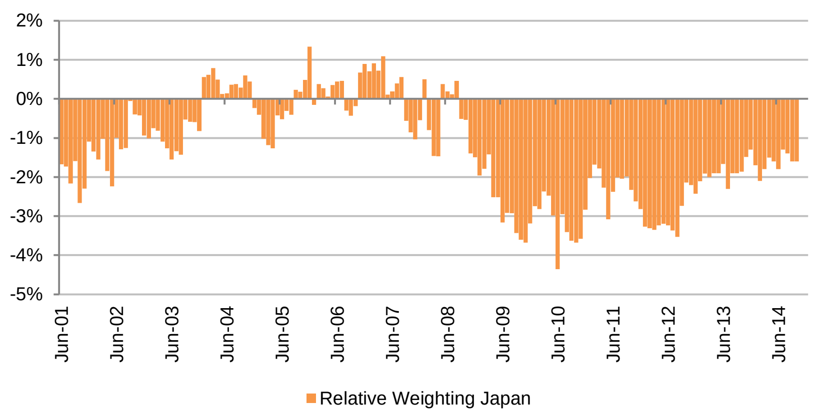
The most attractive aspect of the Japanese market is the prospect of a sustained, longer term recovery. Japan's nominal GDP (a more appropriate measure for a country suffering from deflation than real GDP), peaked in 1997 and declined about 10% by the end of 2012[7]. In this environment, companies curtailed capital expenditure and spending of all kinds including investing in people. This is evident from the fact that 44.9% of manufacturing facilities were over 15 years old at the mid-year point of 2013, compared to 33.1% in 1994[8]. It is also reflected in the increase in the proportion of part-time workers from about 18% in 1995 to about 35% in 2013[9]. As a result, the loan to deposit ratio of the banking industry has fallen from over 100% in 1995 to only 60% in 2013 reflecting a vicious cycle of deflation and negative business sentiment[10]. Once deflation ends, we believe the investment opportunities for the Japanese market are attractive on an extended time horizon, and we believe that Prime Minister Abe is on track to accomplish this.

Last but not least, despite complaints that the positive effects of Abenomics are not being felt by everyone just yet, the election results confirm that the public endorses the government's current policies and have accepted some of the pain associated with changes that include an increase in consumption tax, inheritance tax, and medical costs for the elderly. The public seems willing to swallow a bitter pill for the sake of its future. This public support combined with a stable government for the first time in many years is an encouraging sign.

IS THE GOOD NEWS ALREADY PRICED IN?

Very unlikely. Despite the significant positive turnaround in the political and economic backdrop with company earnings and the stock market both rising, global investors are still underweight in Japanese equities and we expect this to change over time as fundamentals continue to improve.

Chart 1: Global Investors are Underweight Japanese Equities

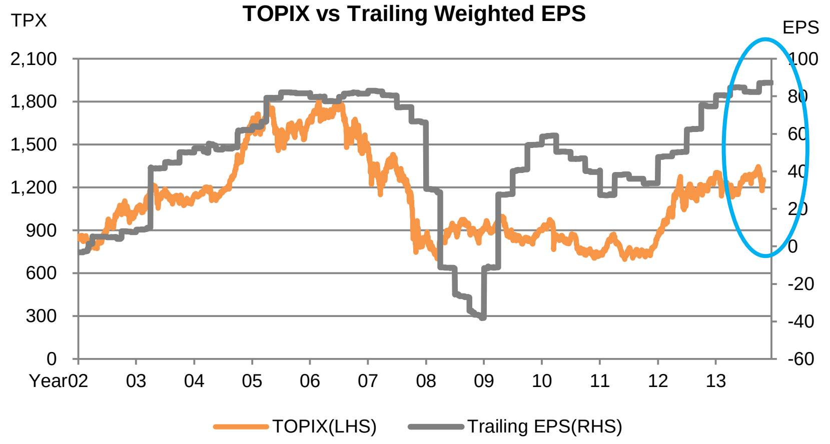


Source: Nomura Securities

[7] Cabinet Office, Government of Japan
[8] Ministry of Economy Trade and Industry, Report May 31 2013
[9] Statistics Japan, Statistics Bureau, Ministry of Internal Affairs and Communications, December 2013
[10] Bank of Japan, September 2014

We believe the Japanese equity market presents a compelling opportunity as the recovery in the stock market has significantly lagged earnings as shown in Chart 2 below. The earthquake, the strong yen and the ever-rotating prime ministers held back Japan's recovery. Even after the sharp stock market rise in 2013 and a further modest rise in 2014[11] the Japanese equity market, unlike the rest of the world, has not caught up with the earnings recovery, underway since 2008. And it has yet to factor in the potential for change.

Chart 2: The market has not caught up to the earnings recovery



Source: Bloomberg

For the 2015 fiscal year which starts in April, we believe the corporate earnings outlook is particularly positive. There are several reasons for this. In addition to the longer term benefits of Abenomics which are starting to come through, the weaker yen, and oil price will be a plus for EPS growth, as well as the expected 2.5% decline in the corporate tax rate and the postponement of the additional 2% rise in the consumption tax from Oct 2015 to April 2017. The consensus EPS growth for next year is about 10%, but we are starting to see estimates being revised upwards into the teens and even above 20%[12].

[11] Bloomberg, January to November 2014
[12] Nomura Securities Survey, 2015

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