Q1/Q2 2016

Debating the state of... ...Japan

BNY MELLON

Contents

Introduction

After two decades of treading water, there are indications that Japan's economy may be ready to move back into the fast lane. Japanese equities were among the strongest performers globally in 2015, while a return to inflation, rising employment and wages all appear to have contributed to a sense of new hope.

Abenomics – a policy of economic renewal combining fiscal stimulus and monetary easing launched in 2013 by Prime Minister Shinzo Abe – has been credited with creating some of the conditions behind the resurgence.

In January 2016, Bank of Japan governor Haruhiko Kuroda, reiterated a pledge to 'do what it takes' to bring the country out of years of persistent deflation by achieving a 2% inflation target. He noted the trend in inflation is 'improving', helped by a strengthening of the country's labour market.

Nonetheless, despite recent progress, the green shoots of recovery have appeared and withered in Japan numerous times in the recent past and commentators could be forgiven for asking whether we've been here before. The country is also still pushing against the tide on two fronts: an ageing population and a mountain of public debt. How much progress it can make against those dual challenges is a key question in the years ahead.

Economic growth

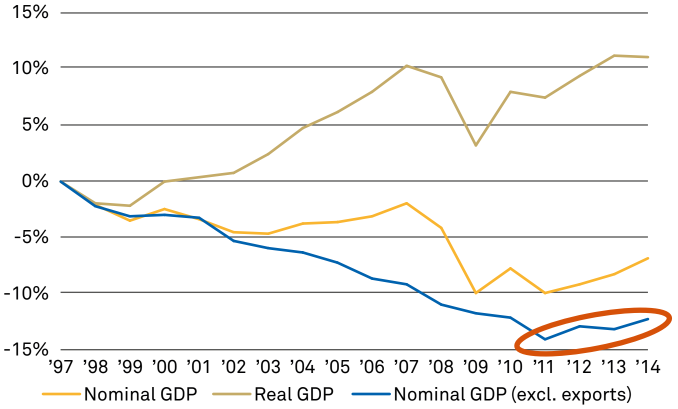
When Prime Minister Shinzo Abe came to power in 2012 one of his first economic pledges was to increase Japan's inflation rate to 2%. The target was seen as an important one. Decades of moribund growth and deflation had pushed Japan's GDP into a declining trend since its 1997 peak of ¥524.5 trillion, falling to ¥483.9 trillion by 2014.

Nonetheless, with GDP of US$4.6 trillion in 2014, Japan is still the third largest economy globally after the US (US$17.4 trillion) and China (US$10.4 trillion). Germany was the fourth largest economy in 2014 with GDP of US$3.9 trillion.[1]

Thanks to stubborn deflation, Japan's nominal GDP (the yen value of its annual output, without making any adjustment for changing prices) has remained more or less flat for more than 20 years. This flatness is considered a macroeconomic oddity: it is hard to find another economy quite like it.

Simon Cox, BNY Mellon IM Asia Pacific

JAPAN GDP, CALENDAR YEAR



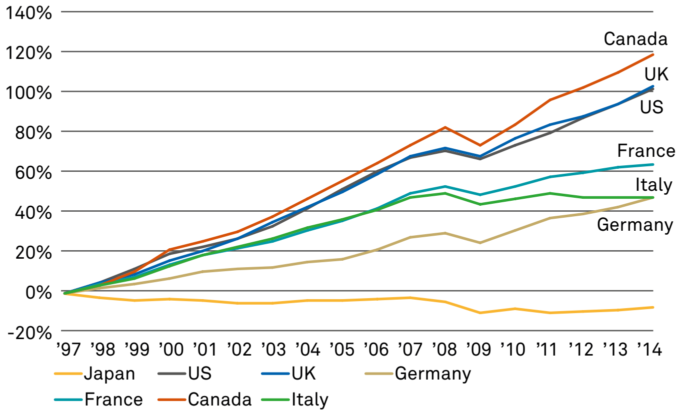
Source: Cabinet Office, Government of Japan, World Bank, 12 February 2015.

Recent data offers a mixed picture on how close the government is to sparking a lift-off in growth. According to the second preliminary GDP estimate by Japan's Cabinet Office, the Japanese economy grew by 0.3% quarter-on-quarter in Q3 2015. This was ahead of initial estimates which suggested a 0.2% decline. The Cabinet Office cited private capital expenditure and private inventory investment as the two major sources of growth over the quarter.

The revision upward lifted the Japanese economy out of a putative recession in 2015. Instead of falling into the red, last year looks set to have been characterised by an overall growth rate of 0.6%-0.9%, depending on fourth quarter data.

1 World Bank data, 14 January 2016.

G7 NOMINAL GDP, CALENDAR YEAR



Source: Cabinet Office, Government of Japan, World Bank, 12 February 2015.

The fact remains, however: despite nearly four years of unprecedented economic stimulus, Japan's economy remains 2.2% bigger in real terms than when Abe came to power.[2] In January, the International Monetary Fund (IMF) reiterated its 1% growth outlook for Japan in 2016.[3]

National debt, government spending

According to the OECD, Japan's national debt tops ¥1 trillion. The ratio of gross public debt to GDP jumped from 67% in 1990 to 246% in 2015, while the ratio of net debt increased from 13% to 126%.[4]

In December 2015, Prime Minister Abe's Cabinet approved a record-high ¥96.72 trillion budget for fiscal 2016, focusing on welfare measures to tackle a rapidly ageing society while trying to restore fiscal health. Of this total, ¥23,612.1bn – or 24.4% – is earmarked for debt servicing alone.

Doomsayers like to talk about Japan's mountainous public debt. Less often discussed is the country's impressive stock of national wealth, which includes real assets like land and property, as well as the world's largest stock of net foreign assets. This amounted to 635% of annual GDP at the end of 2013, according to Japan's Cabinet Office.

Simon Cox, BNY Mellon IM Asia Pacific

The government expects a projected rise in revenues which should enable it to cut its bond issuance by some ¥2.4 trillion from the fiscal 2015 initial budget to ¥34.43 trillion. Under the new budget, the ratio of debt issuance to total revenue should fall to 35.6%, the smallest in nine years.[5] This still remains high compared to other countries, however. For fiscal year 2015, the ratio for the US stood at 15.5%, France 25.4% and Germany 0.1%.

2 *FT:* 'The third arrow of Abenomics: a scorecard', 9 September 2015.
3 *Bloomberg:* 'IMF Cuts Global Growth Forecast to 3.4% in Year of 'Great Challenges', 19 January 2016.
4 *FT:* 'The prime minister's 'arrows' miss the mark', 14 January 2016.

JAPAN'S FISCAL 2016 GENERAL ACCOUNT BUDGET

	Amount ¥ billion	Percentage Change
Revenue		
Tax revenue	¥57,604.0	5.6%
Non-tax revenue	¥4,685.8	-5.4%
Debt issuance	¥34,432.0	-6.6%
Expenditures		
Policy spending	¥73,109.7	0.3%
Social security	¥31,973.8	1.4%
Public works	¥5,973.7	0.0%
Education, science	¥5,358.0	0.0%
Defense	¥5,054.1	1.5%
National tax revenue grants to local governments	¥15,281.1	-1.6%
Debt servicing	¥23,612.1	0.7%
General account budget	**¥96,721.8**	**0.4%**
Fiscal investment and loan	¥13,481.1	-7.8%
Special account for reconstruction work	¥3,246.9	-16.9%

Source: *The Japan Times*: 'Cabinet approves record JPY 96.7 trillion budget for fiscal 2016', 24 December 2015.

Under *Abenomics*, the government has pledged to restore fiscal health with the goal of turning the primary balance deficit into a surplus by fiscal 2020.

Along with a weaker yen, another key development for which the Abe administration can justifiably claim credit is the signing of the Trans-Pacific Partnership (TPP) trade pact. The free trade agreement, which encompasses 12 Pacific Rim countries including Japan and the US, covers around 40% of global GDP.

The Abe administration government has committed to removing 95.1% of tariffs on farm, industrial and other imported products in value terms, which it expects to translate into a 2.7%, JPY 14 trillion boost to domestic GDP.[6]

Under the terms of the treaty, five politically sensitive farm product categories in Japan – rice, wheat, beef and pork, sugar and dairy products – enjoy some degree of protection from tariff reductions. As a quid pro quo, some of the barriers to entry for US auto sales in Japan have been lowered.

Japan was one of the best performing major stockmarkets in 2015—even in dollar terms. That surprised many critics of Abenomics. The policy has entailed aggressive monetary easing, some reshuffling of taxes, and piecemeal structural reforms, including improvements in corporate governance, with the aim of lifting spending, wages and prices. According to conventional wisdom, progress has been mixed at best but our view is that Abenomics has rescued Japan from two decades of deflation.

Simon Cox, BNY Mellon IM Asia Pacific

5 *The Japan Times:* 'Cabinet approves record JPY 96.7 trillion budget for fiscal 2016', 24 December 2015.
6 *Kyodo News,* 'TPP touted as raising Japan's GDP by ¥14 trillion', 22 December, 2015.

Abenomics

No conversation around the state of Japan is complete without mention of Abenomics, the structural reform programme championed by Prime Minister Abe as a strategy for pulling Japan from two decades of economic stagnation.

The plan was announced with much fanfare in 2013, when Abe announced three main policy arrows based on monetary easing, fiscal stimulus and structural reforms.

Shortly thereafter Haruhiko Kuroda was appointed as head the Bank of Japan with a mandate to generate a 2% target inflation rate through quantitative easing. Initially the bank sought to buy ¥60-70 trillion of bonds a year through the programme but increased that to ¥80 trillion a year in October 2014.

The second policy arrow – that of fiscal stimulus – was launched with a ¥10.3 trillion spending bill; its aim was to improve social security provision as a way of increasing Japan's fertility rate from 1.4 to 1.8 while also providing for Japan's ageing society.

The third policy arrow was targeted at reform – particularly of Japan's corporations and of vested interests in the agricultural sector.

To date, the jury remains out on the effectiveness of *Abenomics*' three arrows.

For the first arrow, falling unemployment, rising wages and a buoyant equity market all seem to vindicate the strategy of monetary easing (even if the stated 2% inflation target appears to be out of reach for now).

For the second arrow – fiscal stimulus – government deficit spending has increased on everything from defence to Olympic stadia, to infrastructure projects, to childcare centres and subsidies. However, the impact of all this spending was offset by an April 2014 tax hike that plunged the economy back into recession.[7] Initial plans to gradually raise the consumption tax rate to 10% by 2015 were put on hold until April 2017 to give the economy more time to recover.

Structural reform, the third of Abe's three arrows, has also enjoyed mixed success. Some vested interests in the farming sector have been challenged as part of the US-led trade liberalisation agreement, the Trans-Pacific Partnership (TPP). Elsewhere, the introduction of a corporate governance code in Japan in June 2015 has been heralded as a positive, with companies showing signs of prioritising shareholder returns for the first time in decades. Here, the appointment of more independent directors has helped, as has a push to reduce 'cosy' corporate cross shareholding arrangements.[8]

7 *The Wall Street Journal*: 'Japan's Tax Increase Puts Abenomics at Risk', 29 August 2014.
8 *Barron's*: 'Goldman Sachs Is Bullish on Europe and Japan', 13 January 2016.

The result has been an increase in returns to shareholders. Share buybacks are estimated to increase from ¥4.1 trillion in FY2014 to ¥5.5 trillion in FY2015 (which ends in March 2016) and dividend payments from ¥9.9 trillion to ¥12.2 trillion over the same period.[9]

Nevertheless, in spite of recent signs of progress, corporate governance in Japan still has some way to go. Just six weeks after the new push for improved corporate governance was announced, for example, one blue chip multinational conglomerate admitted to overstating its operating profits by ¥151.8bn over several years of accounting irregularities involving its top management and independent investigators.[10]

Given the tightening in the labor market and the Bank of Japan's willingness to redefine precisely what constitutes 'success' we believe a meaningful expansion in the size of quantitative easing is becoming less likely. While additionally policy easing remains our base case, we believe it will take the form of modifications designed to increase the efficacy of the current program rather than an outright increase in the magnitude of monthly purchases.

Nate Hyde, global macro team, Standish

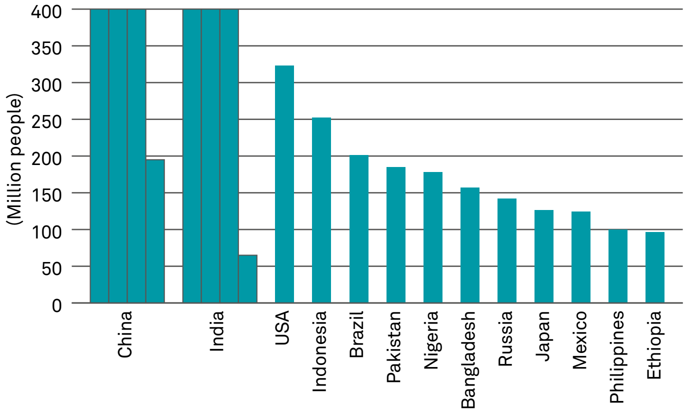
The demographic challenge

In 2015 Japan's population stood at 127.2 million, making it the world's 10th most populous country globally.[11] In common with many other developed countries around the world, however, population growth has stalled; the overall size of Japan's population began to fall in 2004 and is now ageing faster than any other globally.

- More than 22% of Japanese are already 65 or older according to *The Economist*.
- The World Bank estimates by 2060 the population of Japan will have fallen to about 87 million, of which almost 40% will be 65 or older.[12]
- Japan now has the distinction of having the world's 54th highest death rate and the third lowest birth rate globally, with a fertility rate of 1.4 children per woman versus an OECD average of 1.7.[13]
- Immigration remains minimal even as the numbers of Japanese nationals living abroad increases.

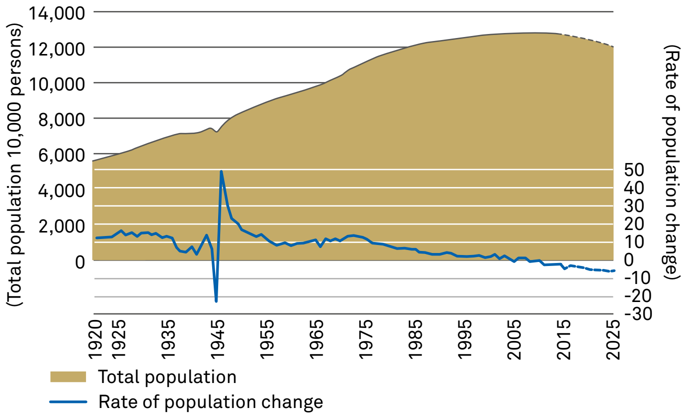
According to government projections, the likely result of these demographic changes is a chronic shrinking of Japan's working age population in the next two decades. Under a 'negative' scenario laid out by the IMF, the labour force is expected to decline from 66.3 million in 2010 to 56.8 million by 2030.[14] Even under a 'positive scenario', the labour force is still expected to decrease to 62.9 million. The number of people in employment is also expected to fall from 63.0 million in 2010 to 54.5 million in 2030 under the negative scenario.[15]

WORLD'S MOST POPULOUS COUNTRIES 2014



Source: Japanese Ministry of Internal Affairs and Communications, January 2016.

JAPANESE POPULATION GROWTH, 1920-2015 (FORECAST)



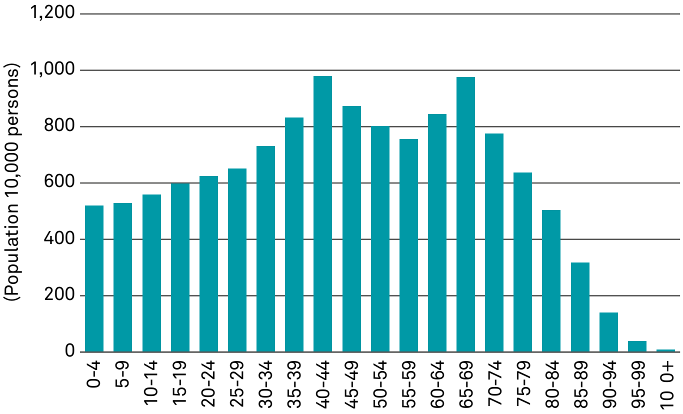
Source: Japanese Ministry of Internal Affairs and Communications, January 2016.

Demographics poses and will continue to pose a significant long term challenge for the Japanese economy. With a birth rate well below two and restrictive immigration policies it will be difficult for Japan to maintain a stable working age population stock.

Nate Hyde, global macro team, Standish

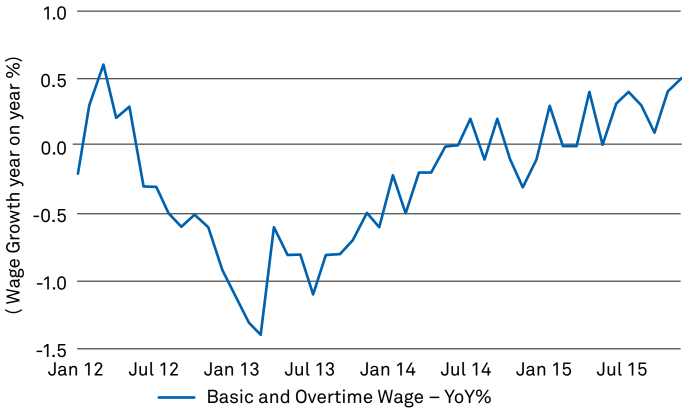
9 *Ibid*.
10 *Financial Times*: 'Foreign investors fear holding Japan Inc to account', 10 January 2016.
11 World Bank data, January 2016.
12 *The Economist*: 'The incredible shrinking country', 25 March, 2014.
13 CIA World fact book, 2015.
14 *IMF:* 'Foreign Help Wanted: Easing Japan's Labor Shortages', July 2015. Under the IMF's 'negative' scenario real growth remains near 0% and the labour force participation rate drops from 59.6% in 2010 to 54.3% in 2030. Under the IMF's 'positive' scenario, real average growth equals 2% and the labour participation rate increases to 60.1% by 2030.
15 *Ibid*.

AN AGEING SOCIETY: DEMOGRAPHIC BREAKDOWN 2015



Source: Japanese Ministry of Internal Affairs and Communications, January 2016.

JAPANESE BASIC AND OVERTIME WAGE GROWTH – YOY%



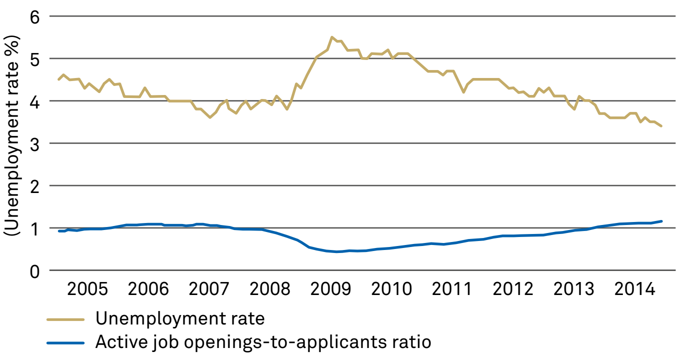
Source: Japan Macro Advisors, Ministry of Health, Labour and Welfare, 8th January 2016.

Employment and labour

Unemployment in Japan (3.3% as of December 2015) is near a 20-year low. At the same time, wages have been on an upward trend, rising 0.5% year on year in November 2015.[16]

> *Japan has one of the worst demographic profiles in the world and this is its biggest headwind for the next two decades. An ageing population increases pressure on social security budgets, impedes creative destruction and can exert a strong influence on spending and consumption and therefore monetary policy.*
>
> *Paul Markham, global and international portfolio manager, equities, Newton*

JAPANESE EMPLOYMENT: BACK ON TRACK?

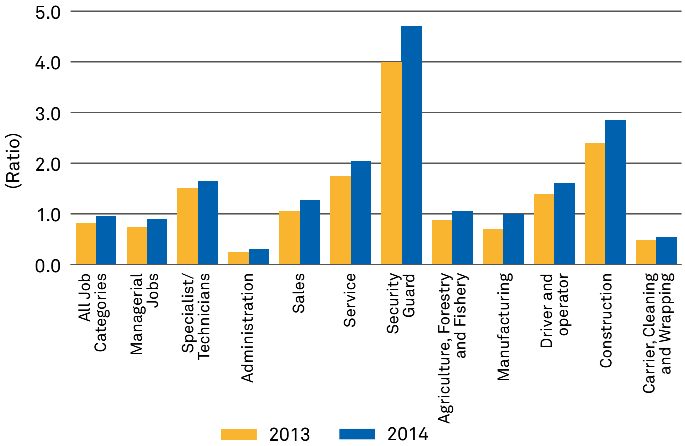


Source: Japanese Ministry of Internal Affairs and Communications, January 2016.

According to the IMF, recent trends – of a tightening labour market coupled with an ageing population and a shrinking workforce – have already translated into a chronic labour shortage. Among specialist and technicians, the IMF points out particularly strong shortages for doctors, medical technicians, nurses and midwifes. In the service sector, the most severe shortages are for restaurant servers and home service and long-term care providers. In the construction sector, there is a particular shortage of structure construction workers.

According to a survey of global employers carried out by the Manpower Group, 83% of Japanese firms reported having difficulties filling jobs in 2015. This is the highest number among all the countries surveyed and more than double than the global average of 38%.[17]

JOB-TO-APPLICANT RATIO BY OCCUPATION
(Regular Workers including Part-Timers)



Source: *IMF:* 'Foreign Help Wanted: Easing Japan's Labor Shortages', July 2015.

16 Ministry of Health, Labour and Welfare, 8th January 2016.

17 Manpower Group: 2015 Talent Shortage Survey, May 2015.

Gender and immigration

One solution to Japan's chronic labour shortage could be to bring more women into the workforce. According to one estimate, Japan's workforce would swell by seven million people while GDP could increase by 13% if women's participation in the economy equalled that of men.[18]

Prime Minister Abe has recognised the potential of this kind of change. In 2013, as part of his *Abenomics* programme, he pledged to boost the female employment rate from 68% to 73% by 2020. He said his aim is to increase the presence of women in corporate board rooms and to improve gender equality – all with the target of creating a "society in which all women can shine".

Japan now employs a higher percentage of its working-age women than the United States. The rising number of female workers is one underreported success of "womenomics", Japan's campaign to revitalize the economy by making better use of women's talents.

But the campaign still faces significant obstacles, some of them deeply rooted in Japan's economic history.

Simon Cox, BNY Mellon IM Asia Pacific

Concrete measures include:

– increased spending on healthcare and nurseries (important since women are statistically more likely than men to be primary carers for both the old and the young in Japanese society),

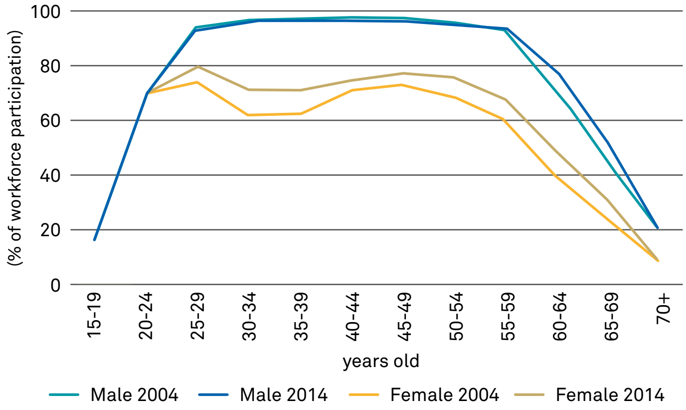
– legislation to force public and private organisations to publish data on the number of women they employ, and what positions they hold,

– in addition, the Abe government has promoted the so-called '20-30' numerical target, which aims to "increase the share of women in leadership positions to at least 30% by 2020 in all fields of society".[19]

However, despite the rising visibility of gender parity as an issue, data from the World Economic Forum paints a picture of patchy progress. In its most recent annual *Global Gender Gap Index*, the Forum ranked Japan 101 out of 145 countries, a decline of four places since 2012.

According to the Forum, the overall score of 0.67 on a scale of 0 to 1 can be roughly interpreted as meaning that only about 67% of the gender gap between women and men in Japan has been closed. In the words of the report, this means women "have only 67% of the resources and opportunities available to men in terms of health, education, economic participation and political empowerment, the four areas measured by the index".

LABOUR FORCE PARTICIPATION RATE BY SEX AND AGE GROUP



Source: *Japanese Ministry of Internal Affairs and Communications, January 2016*.

Elsewhere, both the OECD and the IMF have highlighted increased immigration as another possible route to addressing Japan's acute labour shortage. As of July 2015, foreigners made up just 0.3% of Japan's labour force, the lowest among advanced economies.[20] Asylum applications are similarly low. According to US think tank the Migration Policy Institute, of the 5,000 individuals who filed for asylum in Japan in 2014, just 11 were granted refugee status – a 0.2% acceptance rate.[21]

Prime Minister Abe has set out measures to increase foreign participation in Japan's workforce. Under the so-called 'third arrow' of *Abenomics*, the government has already taken steps to increase foreign labour supply, with the following measures having been implemented or under consideration:

– The requirements for highly skilled foreign professionals to work in Japan (eg in terms of salary level and research achievements) was relaxed (in December 2013), and a new type of residence status with unlimited period of stay was created for such professionals (in June 2014);

– Plans are under consideration to allow foreign housekeeping support workers to work in Special Economic Zones.

– The government is also considering allowing businesses to bring foreign employees with technical backgrounds to Japan for short-term training. The programme is meant to target employees at overseas subsidiaries of Japanese corporations with technical backgrounds.[22]

18 *Bloomberg*: 'Closing Japan Gender Gap May Boost GDP 13% Goldman says', 7 May 2014.
19 *East Asia Forum*: 'Is Abe's womenomics working?', 27 August 2015.
20 *IMF*: 'Foreign Help Wanted: Easing Japan's Labor Shortages', July 2015.
21 *Migration Policy Institute*: 'Open Wallet, Closed Doors: Exploring Japan's Low Acceptance of Asylum Seekers', 7 October 2015.
22 *IMF*: 'Foreign Help Wanted: Easing Japan's Labor Shortages', July 2015.

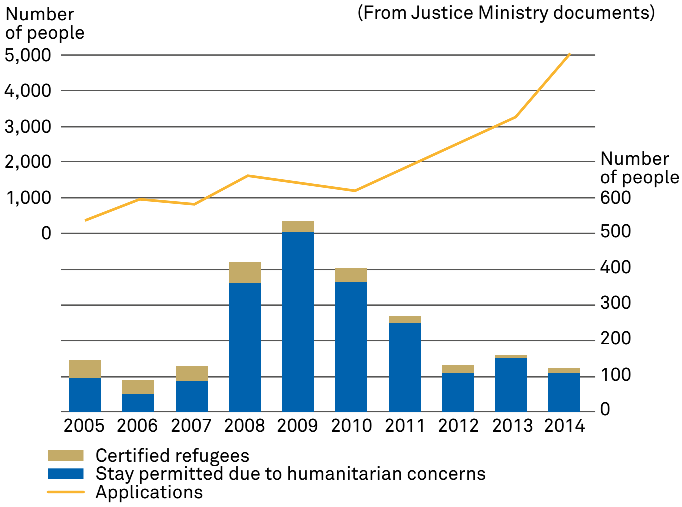
The Japanese government has yet to develop policies which can tackle the demographic issue at its heart: the populace is fiercely opposed to widespread immigration and the birth rate remains stubbornly low. It appears tax incentives to encourage more children will be considered, but these will take many years to come to useful fruition.

Paul Markham, global and international portfolio manager, equities, Newton

Even so, commentators have questioned the commitment of the government to increased immigration.[23] In June 2015, for example, the Justice Ministry published its *Basic Plan for Immigration Control*, which set out measures to implement pre-screenings of refugee applicants, thus making it harder for economic migrants to even apply for leave to remain in Japan.

Likewise, when asked by reporters in September whether Japan would open its doors to higher immigration, Abe was quoted as saying: "It is an issue of demography. I would say that before accepting immigrants or refugees, we need to have more activities by women, elderly people and we must raise our birth rate. There are many things that we should do before accepting immigrants."[24]

TRENDS IN REFUGEE STATUS APPLICATIONS AND CERTIFIED REFUGEES



Source: *Asahi Shimbun*, 5 September 2015.

Inflation and interest rates

In 2013 the Bank of Japan's governor Haruhiko Kuroda scrapped interest rates as the bank's main policy tool and instead embarked on its own version of a quantitative easing (QE) programme. Since then the Bank has committed to expanding its holdings of Japanese government bonds bought through QE at a rate of ¥80 trillion a year.

Also in 2013, Kuroda set a 2% inflation target, pledging the Bank "will do whatever it can" to raise growth in the consumer price index from its current near-zero level.

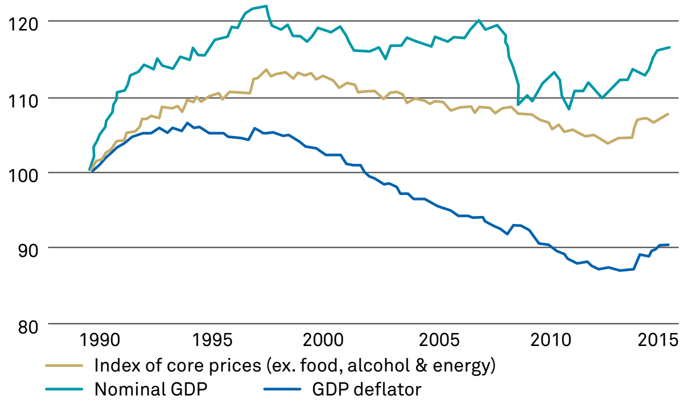
Although the policies implemented under *Abenomics* have spurred corporate profits, increased tax revenue and boosted equity markets in the years since Kuroda's announcement, recent data highlights how much of a challenge that 2% inflation target remains.

Household spending fell for a third month straight in November 2015, as industrial production dropped for the first time in three months, while real wages adjusted for inflation declined. According to the same data, consumer prices in Japan excluding fresh food costs rose just 0.1% from a year earlier in November, while an inflation gauge stripping out both food and energy prices increased 0.9%.

Although headline inflation remains low in Japan, that is largely the result of falling energy costs. Remove energy as well as fresh food from the index and consumer prices have clearly turned around since Abenomics began. About two-thirds of the items in Japan's consumer basket are now becoming pricier, including ketchup – to cite one famous example – which has risen in price for the first time in 25 years.

Simon Cox, BNY Mellon IM Asia Pacific

PRICE INDICES AND NOMINAL GDP (1990 = 100)



Source: FT, IMF, OECD, 14 January 2016

23 *the guardian*: 'Japan says it must look after its own before allowing in Syrian refugees', 30 September 2015.
24 *Reuters*: 'Abe says Japan must solve its own problems before accepting any Syrian refugees', 30 September 2015.

Overall, the consumer price index for Japan in November 2015 was 103.5, down 0.3% from the previous month, and up 0.3% over the year, with the weakness partly attributed to the effect of cheaper oil imports. The index was rebased to 100 as of 2010.

In January, the Bank of Japan shocked markets with a decision to attempt to stave off deflation by adopting negative interest rates. It blamed falling oil prices and a slowdown of growth in China for the weak inflation data.

CONSUMER PRICE INDEX DATA, NOVEMBER 2015

	Index	Monthly Change (%)	Annual Change (%)
	103.5	**-0.3**	**0.3**
All items, less fresh food	**103.4**	**0**	**0.1**
All items, less food (less alcoholic beverages) and energy	**101.7**	**0**	**0.9**
All items, less imputed rent	104.5	-0.4	0.4
Food	106.3	-1.1	2.9
Housing	99.1	0	0
Fuel, light and water charges	112.3	0	-6.8
Furniture and household utensils	94.8	-0.2	2.1
Clothes and footwear	108.4	0.7	1.8
Medical care	99.9	-0.1	0.7
Transportation and communi-cation	103	-0.2	-2.8
Education	102.6	0	1.5
Culture and recreation	100.1	-0.4	2.5
Miscellaneous	110	-0.1	0.7
Goods	104.5	-0.6	0.1
Services	102.6	-0.1	0.5

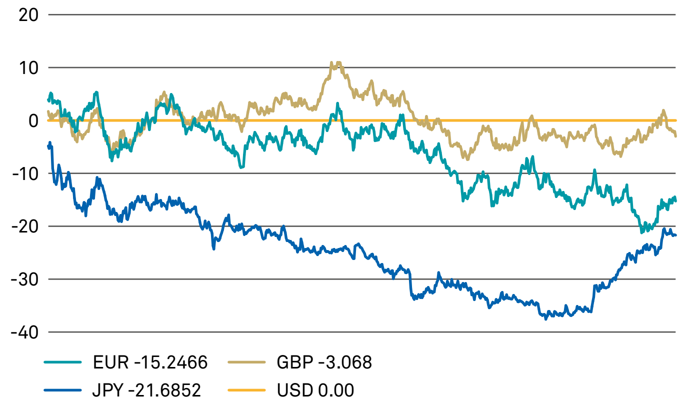
Source: Japanese Ministry of Internal Affairs and Communications, Japan Statistical Yearbook 2016, January 2016.

Currency

One of the successes of Abenomics has been a gradual decline in the value of the yen relative to other currencies since 2013. For the 20 months between the announcement of the government's economic revival programme in April 2013 and the close of 2015, the currency declined 21.7% versus the US dollar, offering a welcome respite to exporters.[25]

Even so, the yen's perceived-'safe haven' status still brings periods of relative strength, particularly in times of turmoil in other markets. This was the case from the second half of 2015 when uncertainty around Chinese economic growth buoyed the yen. As a result it ended the year as one of the strongest performers versus a basket of other major world currencies, second only to the US dollar over 12 months.

JPY VERSUS EUR, GBP AND USD SINCE ABENOMICS' LAUNCH



Source: *Bloomberg*, 14 January 2016. Data from 28/3/2013 to 31/12/2015.

Property

Japan's residential property sector was a major casualty after both the bursting of the country's asset-inflated bubble in the early 1990s and the global financial crisis in 2008. Latterly residential property prices in Japan's key urban areas have sparked back into life, with condominiums in Tokyo rising in value around 20% over the past four years (see graph overleaf).

The more recent property bounce can partly be explained by the Bank of Japan's stimulus programme, which lowered mortgage rates and weakened the yen, helping attract a wave of international buyers. A further tonic came in 2013 with the decision to award the 2020 Olympics to Tokyo. This was credited with helping to kick-start a round of speculative buying.

Property price rises have not been uniform across Japan and for rural areas returns on property have been flat at best (see graph overleaf).

According to the Fujitsu Research Institute, the country's demographic challenge could also have a devastating effect on the Japanese property sector in the years to come. It estimates:

Support from the Bank of Japan and perceived 'safe-haven' status, especially in Tokyo and from investors in other Asian nations, have helped Japanese real estate to perform well over the last few years. However, supply is due to increase; and the ongoing move offshore of some Japanese companies' operations will be a headwind to further significant appreciation in our view. Some sectors – especially those with exposure to the 2020 Olympic Games – may prove to be exceptions.

Paul Markham, global and international portfolio manager, equities, Newton

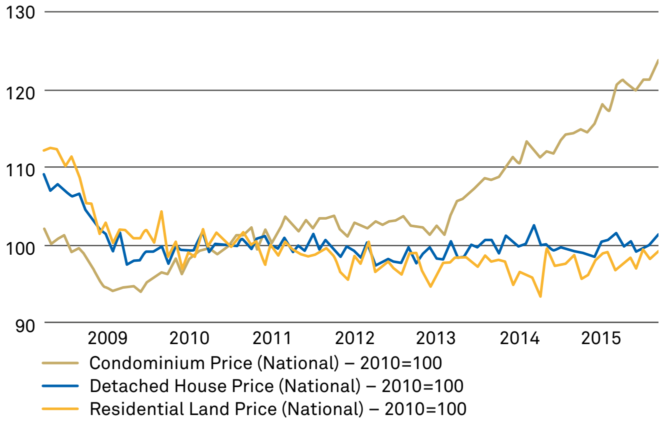
25 Source: *Bloomberg*, 14 January 2016.

– Almost one in three of Japan's houses will be left empty by 2033 at the current pace of construction, compared with 23% if the pace of new building halves.[26]

– The Japanese government, meanwhile, estimates 20% of residential areas will become ghost towns by 2050 as the population shrinks and people move to the cities.[27]

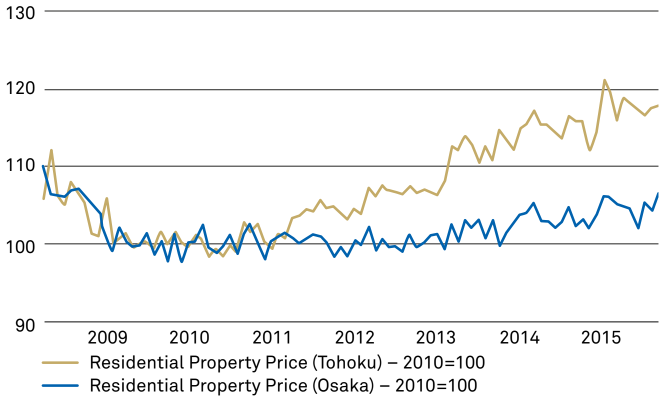
In May 2015, the Japanese parliament (known as the Diet) passed the Vacant Housing Law, providing the government with more leeway to enforce code violations and to bulldoze "unsightly or dangerous structures." The law also created a database to help resurrect abandoned 'zombie' properties by bringing them back onto the open market.

CONDOMINIUMS LEAD THE WAY IN RISING PROPERTY PRICES...



Source: Ministry of Land, Infrastructure, Transport and Tourism, and Tokyo Stock Exchange. Updated to the month of September 2015 (published 24 December 2015).

BUT THE PRICE RISES ARE NOT SPREAD EVENLY ACROSS JAPAN

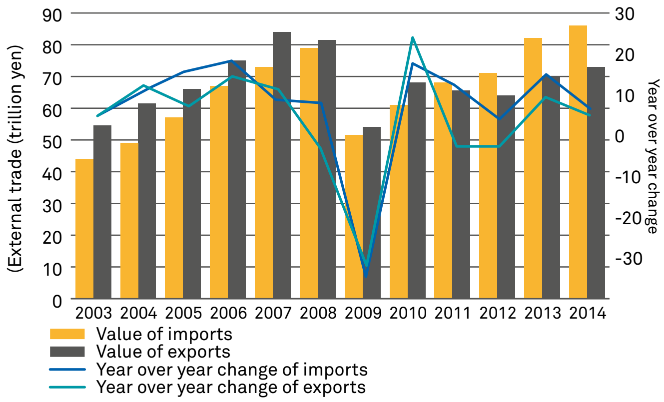


Source: Ministry of Land, Infrastructure, Transport and Tourism, and Tokyo Stock Exchange. Updated to the month of September 2015 (published 24 December 2015).

Japan Inc

Japan remains a leading global exporter, with a world-leading industrial, manufacturing and services base operating in virtually every major sector.

IMPORTS VERSUS EXPORTS 2003 TO 2014



Source: Japanese Ministry of Internal Affairs and Communications, January 2016.

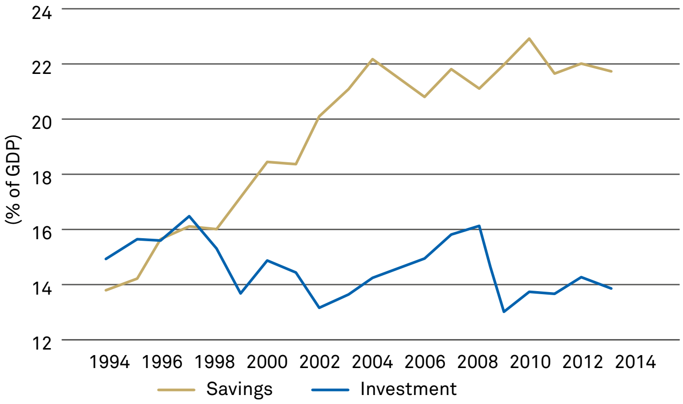
A weaker yen coupled with falling oil prices and lower corporate taxes have benefited Japanese industry in recent years. The weaker currency is said to have helped boost exports, while the slated reduction of corporate tax from the current 35% to less than 30% within a few years is expected to boost corporate profits, according to market commentators.

A relatively small minority of Japanese companies pay any tax, and the lion's share of the corporate fiscal burden falls upon the large exporters. When looking to revive the Japanese economy and tackle the huge government deficit it was therefore essential to create the business conditions in which these companies could thrive. Japanese auto and technological component companies continue to be global leaders and these have benefitted from a weaker currency through improved profitability, despite sluggish end demand in many parts of the world.

Paul Markham, global and international portfolio manager, equities, Newton

26 *FT*: 'Is this the solution to Japan's glut of empty homes?', 17 July 2015.
27 *FT*: 'Japan blighted by zombie housing', 24 October 2014.

CORPORATE GROSS SAVINGS AND INVESTMENT AS % OF GDP



Source: FT, IMF, OECD, 14 January 2016.

Corporates averaged a financial surplus of 7% of GDP between 2001 and 2013, reaching a peak, in 2009 and 2010, of 9%.[28] This surplus is due to corporate savings, which averaged 22% of national income since the early 2000s, and mildly declining corporate gross investment, which averaged 14% of GDP over the same period.[29]

In return for lowering taxes and in recognition of the boost provided by a weaker yen, the government is now calling on companies to raise wages, spend more of their savings and strengthen corporate governance.

Sadayuki Sakakibara, chairman of the Japan Business Federation (or *Keidanren*), the nation's top business lobby, responded by pledging on behalf of the Federation's members to increase domestic investment by ¥10 trillion by fiscal 2018.[30] This followed a statement by the *Keidanren* in October that average winter bonus pay-outs by large companies would rise 3.13% from a year earlier.[31]

Recent data paints a mixed picture of how well Japan's industrial base is holding up as the ripples of China's slowdown spread across the world's economies.

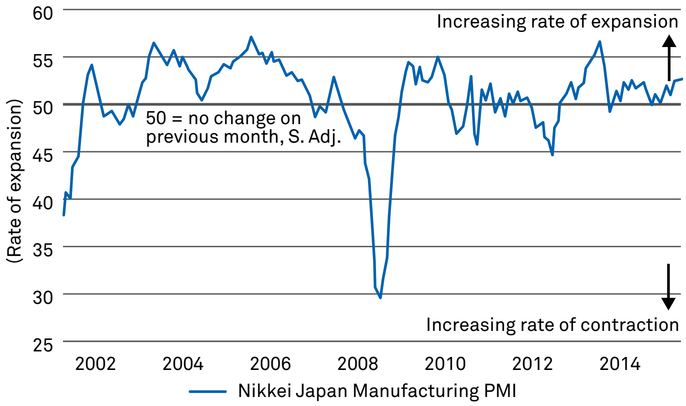
– Core machinery orders fell 14.4% in November, the most in 18 months, after a 7.5% increase in September and a 10.7% increase in October.[32]

– November's decline bucked a four-year trend of broad improvement and overshot economists' median estimate for a 7.9% month-on-month fall, according to the Japanese Cabinet Office.

– Year-on-year, orders rose by 1.2% and, despite the large monthly fall, the government left its growth forecast unchanged.[33]

Purchasing managers' index (PMI) data on industrial output paints a more positive picture. The Nikkei Japan Manufacturing PMI posted at 52.6 in December, unchanged from November (the highest reading since March 2014), thereby indicating a marked improvement in operating conditions at Japanese manufacturers. Moreover, the latest index contributed to the strongest quarterly average (52.5) since the first quarter of 2014 (55.3).

NIKKEI JAPAN MANUFACTURING PMI



Source: Nikkei/markit, 4 January 2016.

The *Tankan*, shorthand for *Tanki Keizai Kansoku Chousa* (Short-term Economic Survey of Enterprises), is one of the most widely watched measures of Japanese economic health. Carried out by the Bank of Japan at intervals of three months, the survey questions 10,000 companies on their view of business conditions and about their sales and profits. The survey uses a "diffusion index" whereby the maximum possible reading is +100, the minimum -100.

The companies' response rate is almost 100% – and since Tankan results are released ahead of most corporate data and tend to correlate closely with companies' profitability they garner close attention from investors.

In the December 2015 survey, business conditions were unchanged since September, with the headline index for large manufacturers coming in at +12, compared with market expectations of a fall.

Large service companies gave a reading of +25, unchanged since September and among the highest levels since the 1990s. The construction sector index hit +44 while the leisure sector recorded a figure of +32, showing strength in the domestic economy.[34]

28 *FT*: 'The prime minister's 'arrows' miss the mark', 14 January 2016.
29 Ibid.
30 *Nikkei Asian Review*: 'Abenomics needs corporate cash', 14 January 2016.
31 *Bloomberg*: 'Tankan's Tightest Job market Since 1992 to Weigh on Japanese Bonds', 14 December 2015.
32 *Reuters*: 'Japan machinery orders fall most in 18 months, add to outlook worries', 14 January 2016.
33 *Reuters*: 'Japan machinery orders fall to most in 18 months, add to outlook worries', 14 January 2016.
34 *FT*: 'Japan Tankan survey eases pressure on BoJ to change policy', 14 December 2015.

Consumers

Japan's reputation as a major global exporter is well deserved but domestic consumer spending is also a force to be reckoned with. Private consumption accounts for 60.9% of the country's GDP, followed by government consumption (20.5%) and private non-residential investment (13.4%). Exports and imports account for 14.7% and 16.6% respectively.[35]

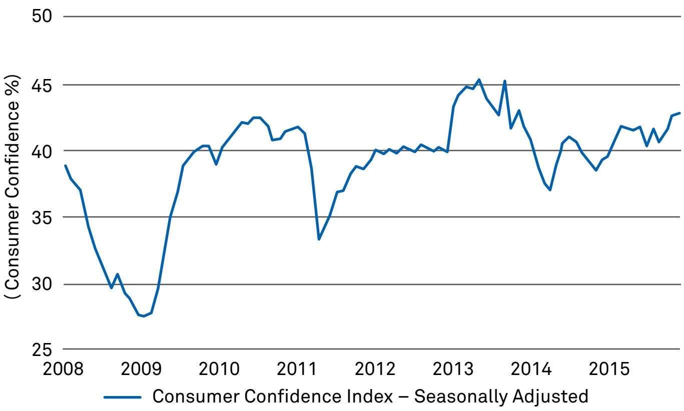
Nevertheless, statistics around long-term consumer confidence reveal how fragile sentiment in Japan has been. Between 1983 and 2013 the average index level was 42.8 and the index has rarely risen above 50, a level that would imply that consumers believe their situation is improving.

According to the Cabinet Office's most recent figures, sentiment rose to above 42 for the first time in two years in November. A reduction in oil pricing was credited with fuelling the rise.[36]

Elsewhere, retail sales look to be improving. For the six months to October 2015, retail sales rose by 4.4% as consumers one again began to loosen their purse strings after an April 2014 sales tax hike chilled spending.[37] A boom in overseas tourism has helped, with Chinese tourists in particular attracted by the cheap yen, looser visa restrictions and the ready availability of high quality Japanese brands and consumer goods.[38]

In the meantime, figures from the Ministry of Economy, Trade and Industry (METI) reveal Japanese consumers' continued migration away from traditional outlets such as department stores and supermarkets. Instead more shoppers are using convenience stores, a sub-sector that . saw average year-on-year sales growth of 5.5% for the 11 months to November 2015, ahead of department stores with 4.9% and supermarkets with 3.7%.[39]

CONSUMER CONFIDENCE INDEX



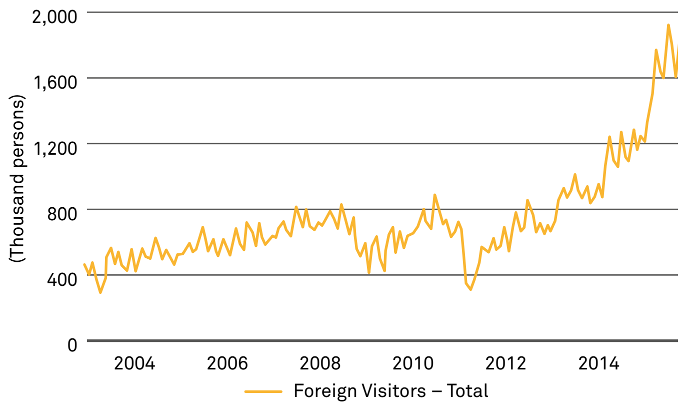
Source: Japan Macro Advisors, Japan Cabinet Office, 12 January 2016.

The number of visitors to Japan continues to rise, largely driven by an increase in the number of Chinese tourists. In November 2015, 1.65 million foreign visitors came to Japan, a 41% year-on-year hike. Of those, 0.46 million were Chinese, more than double the 0.22 million total in November 2014 (see Figure 3 below). The increase can partly be explained by the weaker yen but also by a successive relaxation of visa requirements for Chinese visitors.

Another future tailwind for Japanese tourism is said to be the 2020 Olympic Games in Tokyo, which, according to the Bank of Japan, could boost the economy by 20-30 basis points on average each year until 2018.

Investment on new hotels, venues and infrastructure related to the games will reach a cumulative ¥10 trillion by 2020, the BoJ said in a report assessing the economic impact of the event.

RISING TOURISM



Source: Japan National Tourism Organisation, 16 December 2015.

Such investment and spending by overseas visitors is forecast to boost Japan's gross domestic product (GDP) by up to ¥30 trillion between 2015 to 2020 – roughly 6% the size of the economy, according to the bank.[40]

Japanese equities

Japanese equities went on something of a tear in 2015 (only to experience falls in the opening weeks of 2016). In local currency terms, the FTSE All-World Japan index gained 11.5% to the end of 2015. This was ahead of all major peers including the US (1.0%), China (-6.1%), India (0.3%), Germany (10.2%) and the UK (0.8%). Factor in the relative strength of the yen, though and the gains were even stronger. In dollar terms, the FTSE All-World Japan index returned 11.5%, well ahead of all its major global peers including the US with a 1.0% gain, Germany with a 1.0% decline and the UK with a return of -6.3%.[41]

35 *Trading Economics*, 14 January 2016.
36 Japan Macro Advisors, Japan Cabinet Office, 12 January 2016.
37 *The Wall Street Journal*: 'Japan's Tax Increase Puts Abenomics at Risk', 29 August 2014.
38 *Bloomberg*: 'Wealthy Chinese Visitors Drive Record Year for Japanese Tourism', 19 January 2016.
39 *Ministry of Economy, Trade and Industry*: 'Preliminary Reports on the Current State of Commerce', 28 December 2015.
40 *Reuters*: 'Tokyo Olympics to boost Japan GDP by 0.2-0.3 percent point per year – BoJ', 28 December 2016.
41 *FTSE*: 'All-World Review', December 2015.

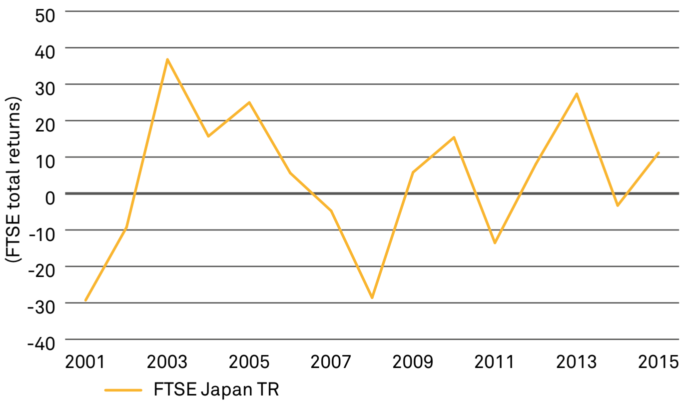
According to FTSE data, healthcare and consumer goods and services were the best performing sectors in 2015. Industrials and basic materials fared the worst.[42]

The New Year ushered in less positive news as uncertainty over the strength of Chinese economic growth bled into investor sentiment on emerging markets, which in turn affected the prospects for Japan's exporting companies. As a result, 2016 began with the worst year-opening week for Japanese stocks since 1997: five consecutive negative sessions that wiped more than half of 2015's gains off the board.[43]

There are reasons for optimism on Japanese equities. The weaker yen has provided a tailwind for the large export-led corporates – essential, given their status as among the largest taxpayers in Japan, to the repair of the government's balance sheet – and has encouraged a significant uplift in inbound tourism. Improvements in corporate governance and shareholder returns are also encouraging. We see these events as positive and remain constructive on Japan in spite of the hurdles it faces; and see stock-picking as crucial. In Japan, at least as much if not more than in other markets, differentiating between individual businesses can often yield strong results.

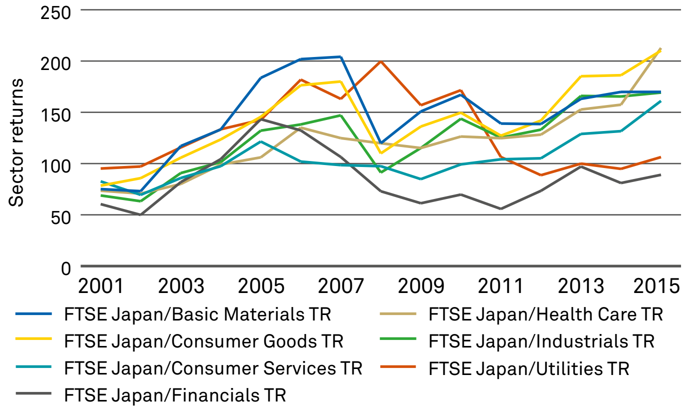
Paul Markham, global and international portfolio manager, equities, Newton

JAPAN EQUITIES



Source: Lipper, 14 January 2016.

SECTOR RETURNS



Source: Lipper, 14 January 2016.

Fixed income

The launch of the Bank of Japan's asset purchasing programme has had a major impact on the liquidity, pricing and availability of Japanese Government Bonds (JGBs). According to Japan Macro Advisors, the bank owned 33.2% of the JGB market by value as of December 2015 and 28.9% as measured in aggregate duration risk. The bank's market share is expected to approach 40% by the end of 2016 and 50% by the end of 2017 – earning it the nickname of 'the whale in the pond'.

At the same time, officials at the central bank and the Ministry of Finance appear committed to holding on to those bonds acquired under quantitative easing until they reach maturity since, given the extent of the government's presence in the market, to do otherwise could spark panic selling.[44]

We expect JGBs to remain well supported as structural demand, combined with ongoing BoJ purchases puts steady downward pressure on yields despite still high issuance. One notable area of opportunity is the inflation-linked bond market as current break evens imply an unrealistically low amount of realized inflation over the next decade. As the labor market continues to tighten and inflation trends higher, we believe the market will begin to recognize this fact and look for linkers to outperform their nominal counterparts.

Nate Hyde, global macro team, Standish

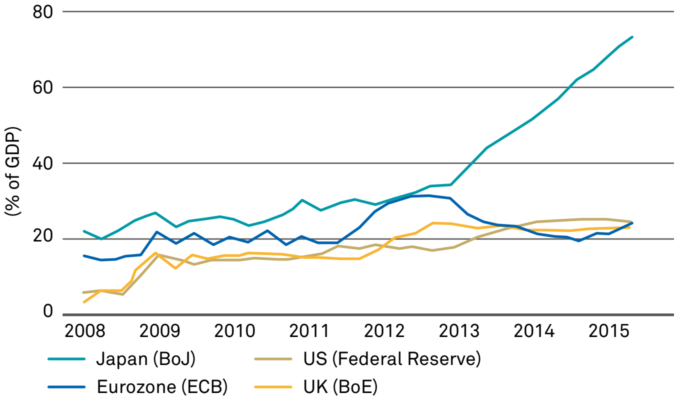
42 *Ibid*.
43 *FT*: 'Japanese stocks have worst start to year since 1997', 8 January 2016.

44 *Bloomberg*: 'Ex-Currency Chief Sees Bank of Japan Exit Nightmare on Debt Pile', 21 April 2016.

Yields have responded accordingly, with debt at all ends of the maturity spectrum offering positive returns but particularly towards the back end: Notes maturing in 10 years or less returned 0.4% in 2015 while debt due in greater than 10 years returned 2.5% in 2015.[45]

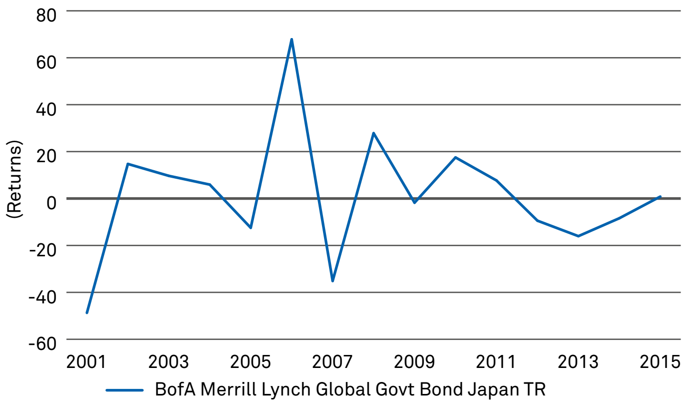
Additional support for JGBs has come in the form of weakening sentiment over China and emerging market growth as well as the adoption of negative interest rates by the European Central Bank. The resulting inflows to the perceived safe haven of Japanese bonds saw foreign JGB holdings top ¥100 trillion for the first time ever in December 2015 as investors in Europe and the US bought up more of the instruments.[46]

CENTRAL BANK ASSETS



Source: FT, IMF, OECD, 14 January 2016.

THE JAPANESE FIXED INCOME MARKET



Source: Lipper, 14 January 2016.

The political landscape

The governing Liberal Democratic Party (LDP) is one of the most consistently successful political parties in the world, having continuously been in power since its foundation in 1955, with the exception of an 11-month period between 1993 and 1994 and from 2009 to 2012.

In December 2012 the LDP returned to power with a landslide majority. For its leader, Shinzo Abe, the election victory brought a second stint as prime minister after a previous spell in the role from 2006 to 2007. Abe was re-elected in the 2014 general election with a mandate to pursue further policies promoting economic revival.

45 *Bloomberg*: 'Pimco Still Bullish as Japan Superlong Bonds Outperform in 2016', 14 January 2016.
46 *Nikkei Asian Review*: 'Foreigners holding nearly 10% of Japanese government bonds', 24 December 2015.

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