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CIO Viewpoint

Abenomics After Abe

Investment Solutions

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The Japanese economy often serves as a signpost to the path ahead for other advanced economies, but rarely attracts foreign investors' attention. Prime Minister Abe Shinzo's resignation and Warren Buffett's investment in Tokyo-based trading houses changed that.

Seven months into the pandemic, the world's third-largest economy managed to limit Covid-19 infections with a combination of disciplined mask-wearing and social distancing. While Japan's economy slowed sharply in the second quarter, its 7.8% quarter-on-quarter decline was less dramatic than in the US or Europe. The corporate sector looks healthy with a resilient labour market and strong policy support.

However, Japan's public debt levels, equivalent to 237% of GDP in 2019, mean that government pandemic support for the economy may need reining-in more quickly than elsewhere. Japan, as the world's most indebted nation, has committed to discretionary spending over the next few quarters of as much as 8% of GDP. Nevertheless, much of this indebtedness is held domestically by the central bank.

The Bank of Japan (BoJ) has held interest rates close to zero for more than two decades and first implemented negative rates in January 2016. Faced with an historic recession, the central bank may struggle with the challenge of pushing interest rates any lower to boost investments because Japan's real rates remain stubbornly in positive territory (see chart 1). This is because nominal rates are just below zero while inflation expectations remain depressed. The BoJ wants to avoid any further cut in interest rates that would affect Japan's financial sector. Japan's experience is being closely watched by both the European Central Bank and the US Federal Reserve, the latter having just enhanced its approach to average inflation targeting.

Three arrows, three candidates

The resignation on 28 August of Japan's longest-serving prime minister on grounds of poor health, comes almost one year before his current term ends. It is not likely to lead to a change in Mr Abe's economic policies, known as 'Abenomics.' The strategy consists of the 'three arrows' of aggressive monetary policy to tackle deflation, fiscal stimulus and structural reforms to promote growth. Abenomics has focused on addressing the country's long-term challenges of an ageing population, stalling growth and public debt.

Key takeaways

- We expect Mr Abe's successor to continue with 'Abenomics'
- Japan's economy still relies on the central bank to avoid deflation
- Value investor Warren Buffett is positioning for an economic recovery
- We anticipate a slow global recovery and prefer US and Chinese stocks.

The success of Mr Abe's legacy is warmly debated. Abenomics has navigated the global shocks of recent years while struggling to carry out structural reforms; the economy still depends on the BoJ's monetary stimulus efforts to prevent it from slipping back into deflation.

Mr Abe's getting out before some of the most difficult challenges post-Covid. His widely-expected successor is Suga Yoshihide, chief cabinet secretary. Mr Suga, 71, supports continuing with Abenomics, as well as the weaker yen, BoJ reforms, trade policies and consumption taxes. He also enjoys the backing of large factions of the Liberal Democratic Party, including the deputy prime minister Aso Taro and the LDP leader Nikai Toshihiro. Mr Suga is credited with coordinating much of the work behind Abenomics over the past eight years, and served as Minister of Internal Affairs and Communications during Mr Abe's first prime ministerial term between 2006-07. Mr Suga also held a position under his predecessor, Koizumi Junichiro.

Two other candidates, Kishida Fumio, a former foreign minister and Ishiba Shigeru, an ex-defence minister and critic of Mr Abe who formed a faction to challenge the premiership in 2015, are running for leadership of the LDP. The LDP is scheduled to vote for its next leader on 14 September. Three days later, the National Diet where the LDP holds a majority of seats, will name the party's leader as prime minister.

The new Japanese prime minister will need to call an election before October 2021, and opposition parties are beginning to coordinate by turning the eventual vote into a referendum on the government's economic policy. In particular, they are focusing on criticism of Japan's consumption taxes that have proven unpopular under Abe's administration and have Mr Suga's backing. The next prime minister may also have to manage a more delicate relationship with the LDP's junior coalition partner, Komeito, a party with religious roots that has traditionally delivered dependable votes for the government.

In 2021, the new prime minister will appoint two new board members to the Bank of Japan, while the central bank's chairman, Kuroda Haruhiko, has another two years as governor.

China is altering allocations to Asia

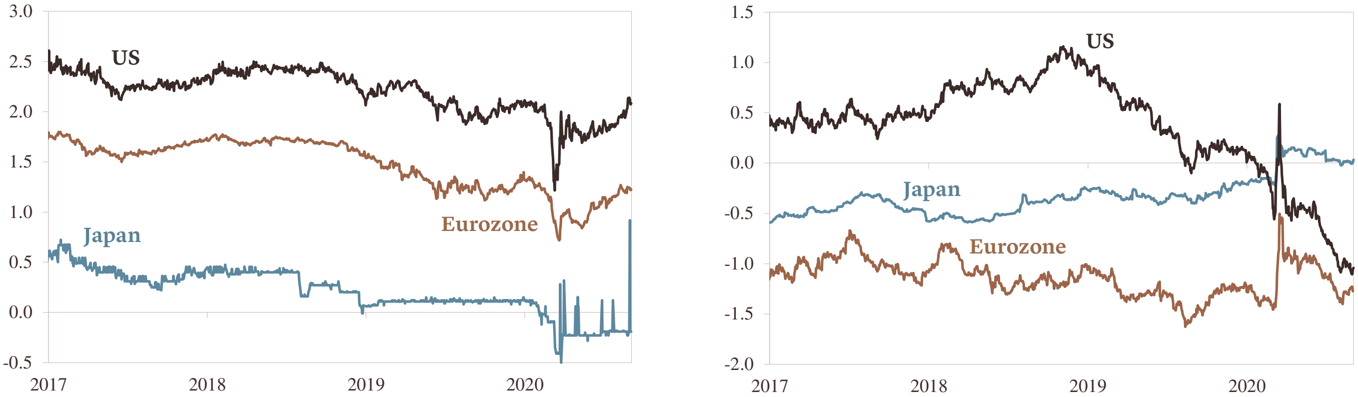
While Japan struggles with the challenges of multi-decade reforms, China's growth has changed the investment weight of Japanese equities in many portfolios. As Chinese equities listed on the Shanghai CSI 300 index have outperformed the Tokyo Stock Price Index or TOPIX by more than 21.2 percentage points year-to-date, the risk premia for investors in the Chinese market has declined. This is partly thanks to a limited impact from the Covid crisis on Chinese companies, as well as attractive domestic growth prospects and reasonable initial valuations. As a result, portfolio allocations to the rest of Asia, and Japan in particular, have declined.

The question for investors is whether there is still value in Japanese stocks. With two decades of experience of a deflationary environment, Japan's corporations have restructured balance sheets, shed debt and are generating cash flows, offering a source of dividend income. The TOPIX, for example, has offered gross dividend yields of 2.4% over the past 12-month period. Japanese stocks are also trading at cheaper multiples than US names, with 2021 full-year fiscal price to earnings ratios of 15.4 times, compared with the US's 21.4 times. Nevertheless, attractive valuations and strong balance sheets are countered by structurally low profitability and a high sensitivity to the global macro backdrop.

1. Break-even inflation and real interest rates in the US, EU and Japan

Break-even inflation 5-year 5-year forward in the US, Eurozone and Japan, in %

Real 5-year 5-year forward swap rates in the US, Eurozone and Japan, in %



Sources: Bloomberg, Lombard Odier calculations

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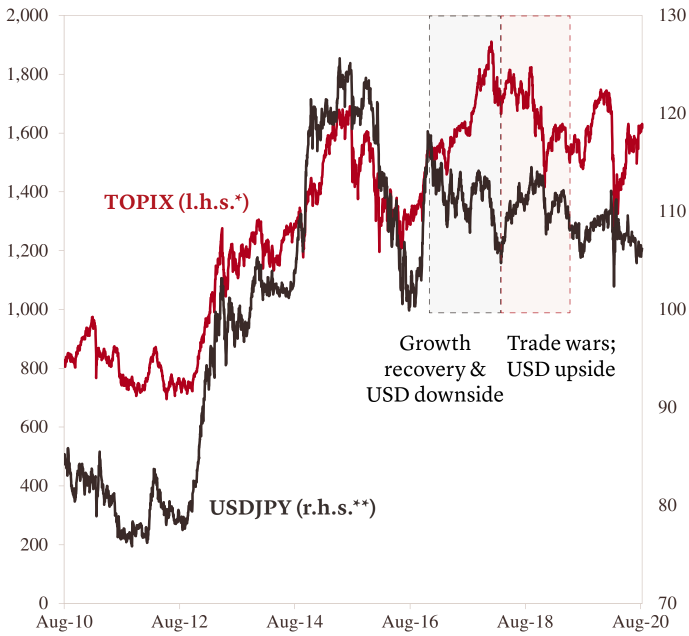
Finally, from a currency perspective, the TOPIX shows a positive historical relationship with a weak yen. However, the recent reversal of this correlation (see chart 2) should allow for further gains in the TOPIX, even in a context where the yen continues to appreciate against the US dollar.

Buffett's inflation trade

In an environment where Japan's monetary policy remains aggressively inflationary, we believe 'value' assets should benefit in the medium to long term. Therefore, it is unsurprising that Warren Buffett has diversified outside the US by investing an unhedged USD 6 billion in Japanese trading firms. Berkshire Hathaway Inc. now holds a 5% stake in each of Japan's five largest trading houses (known as 'sogo shosha'), Itochu Corp., Marubeni Corp., Mitsubishi Corp., Mitsui & Co., and Sumitomo Corp. These corporations provide services in everything from commodity imports to venture capital deals. Their stocks are trading at valuations of around 10 times 2021 earnings in the wake of the US/China trade dispute. Mr Buffett's investment would benefit in the short run from any rapid economic recovery driven by a widely-available coronavirus vaccine and a rise in Japanese inflation.

In contrast, we expect a rather slow global economic recovery. In this case, we believe that the Chinese and US equity markets' greater exposure to the technology and healthcare sectors will create outperformance compared with Japanese stocks in the short term. The risk to this scenario would be a very sudden and unexpected economic boom, as mentioned above. Clearly, some value investors, such as Mr Buffett, are positioning themselves to profit from an improvement in global trade.

2. An historical correlation between the TOPIX and dollar-yen breaks down



* left hand scale, **right hand scale
Sources: Bloomberg, Lombard Odier calculations

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