

Japan – It has to be different this time

An unprecedented policy initiative demands a new investment approach. We have written up the bull case for Japan repeatedly in recent years and been invested in Japanese equities for most of that time. Part of the investment rationale was down to the ambitious reform efforts of the Abe administration and partly our belief that the quantitative easing being undertaken was a true commitment to reflate the economy. In this, we were correct and our investment benefitted from the sectors that typically do well in that scenario such as banks, real estate and other financials.

We also did so correctly expecting a relatively stable Yen, for whilst Japanese QE was underway, similar QE was going on in US, UK and Europe to partially offset any consequent Yen weakening and, of course, the Yen was proving to be a safe haven currency in nervous global stock markets prone to quick profit taking. Of course, Japanese QE is nothing new; the Bank of Japan practically invented it in 2001 and have been engaged with it ever since, except for an all to brief period of relative bliss before the global financial crisis hit in 2008.

But today, the scale of Japan's latest QE is truly extraordinary, a multiple of that undertaken by the USA, and we think that the game has changed – for the better. Some elements of this new effort to kick start the economy look similar but are of a completely different order to that which we've seen before.

The reason for this, we believe, is that after all previous attempts to turn things around, the reality is that Japan has been mired in a battle against deflation for two decades and, whilst total bankruptcy has been avoided, the same problems remain economically, demographically and structurally. We think that this time really is different because, frankly, the authorities (including large corporates) realise that it has to be. We believe that the triumvirate of Government, Bank of Japan and large corporates are now engaged in a joint effort to save Japan from the serious consequences of a third decade of failure.

Firstly, as we have said before, just because Prime Minister Abe has committed to reform as part of his "three arrows" approach, does not mean that he is able to implement the third in the same way as the relatively easy first two arrows of monetary and fiscal easing/reform.

The reason for this is that the economic base of Japan is vast and fragmented. Its main stock market index, Topix (rather than Nikkei 225), comprises 1,700 companies and mostly industrials. The ups and downs of these companies are a world away from the mega cap household names like Toyota, Canon and Hitachi, for example, who historically exported their products overseas and, broadly, benefited from a weaker Yen. But what we have today is a list of around 100 global multinational "winners", with operations around the world, able to dictate prices to their domestic suppliers, and whose contribution to corporate tax revenues has risen to 75% from less than 50% over the last decade.

Secondly, Japan has two clear cut objectives upon which it must now deliver; paying down the national debt (235% of GDP) and cutting the budget deficit. Question is, who can pick up the tab? Unfortunately, with the domestic economy pretty much on its back, the tax take from personal income is stagnant; virtually unchanged in nominal terms since 1987. Raising VAT looks out of the question too and it's pretty much as high as it's been since the 1970's and we know that previous attempts to raise it made no difference because A) It's not big enough to move the needle on tax take and B) the economy switched off like a light. And so we think that, in short, the only realistic source of taxation must come from the earnings of the biggest and most successful companies in Japan.

Naturally, it's not as simple as raising corporate taxes to punitive levels – this is a free market and fully fledged democracy we're talking about here, and smash and grab raids on profits are bad for everyone, especially investors. The solution has to be more sublime and this is where a weaker Yen could work wonders for the big multinationals.

If this new phase of adjustment manifests itself as a period of Yen weakness, which is clearly the objective, it should result in a huge boost to multinational profitability which in turn should, as part of the plan, feed through into wage growth and higher prices paid to domestic suppliers. If this sounds like an unlikely level of cooperation between corporate, government and central bank, we would add that we would never expect anything like this to happen outside of Japan.

In conclusion, we believe we are entering an unprecedented period of engineered growth and inflation for

Japan, underpinned by a collective need to break the 20 year malaise and rebalance the economy.

Furthermore, we see this as an opportunity that goes beyond participating in a reflationary trade as we have done, successfully, until now. In order to optimise the potential returns, we think the best way to exploit the opportunity is to stay invested in Japanese equities but with a strategy that is very selective in the sectors which it invests. In addition, and most importantly, we will want the investment to be hedged from Yen back into Sterling in order to offset Yen weakness which, we believe, will weaken further than many expect.

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