



MARKET INSIGHTS

INVESTING IN JAPAN: DON'T WAIT FOR ABENOMICS!

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CORPORATE RESTRUCTURING, NOT POLICY CHANGE, IS BEHIND JAPAN'S IMPROVING PROFITABILITY

Corporate Japan looks different today from any point in the last decade. The long process of balance sheet repair is at an end. Many companies are repaying debt, generating strong profits, and returning value to shareholders via dividends and buybacks. This position of strength has been achieved through meaningful company restructuring which began many years before the promise of Abenomics' top-down policy reform.

HEALTHY CORPORATE ENVIRONMENT CREATES A WINDOW OF OPPORTUNITY FOR ABENOMICS TO WORK

Prime Minister Shinzo Abe's coordinated reform package, popularly known as "Abenomics", has captured investor interest since its introduction. Abenomics is commonly described in terms of three policy "arrows": monetary policy, fiscal policy, and structural reform. The goal is to kick start growth and move from a deflationary to a mild inflationary environment. Of all the arrows, we believe structural reform is the most important. By liberalising the economy and removing obstacles to economic growth, structural reform could benefit Japanese companies and their shareholders over time.

But investors should recognise that Japan's corporate health and supportive starting valuations create an

attractive investment opportunity today independent of Abenomics, whose lasting impact on the economy will be clear only after a period of years.

FIRST ARROW: AIMED AT CHANGING INFLATION EXPECTATIONS

In January 2013, the Liberal Democratic Party (LDP) Government and the Bank of Japan (BOJ) released a joint statement introducing a "price stability target" aimed at achieving 2% inflation. Since April 2013, the BOJ has engaged in massive monetary stimulus, purchasing Japan Government Bonds at a rate of 1.5 times that of new issuance, with a target to raise inflation.

The First Arrow aims to stimulate investment and demand. Rising asset prices may create a positive wealth effect, encouraging investment and household consumption. Consumers are more likely to spend today if they expect higher price levels in the future.

Monetary easing to date has changed inflation expectations and effectively reduced the Yen versus the US Dollar. Whilst easing may act as a shorter term catalyst, in isolation it is unlikely to pose a longer term policy solution to generate sustainable growth in Japan. A coordinated policy has been planned by the LDP Government to address this.



SECOND ARROW: AIMED AT ACHIEVING FISCAL SOUNDNESS

The Second Arrow consists of fiscal stimulus, which aims to enable Japan to transition to a more sustainable fiscal path over time.

Government stimulus is not new to Japan. The difference is fiscal and monetary stimulus measures are now coordinated between the LDP Government and the BOJ, potentially making them a more potent policy lever, especially in the current healthy corporate environment.

Near-term government stimulus to rebuild and improve domestic infrastructure aims at generating economic activity. By creating jobs and growth, the spending measures, paired with tax reform, such as the April 2014 consumption tax increase, could broaden Japan's currently narrow tax base. The LDP Government has a fiscal consolidation target of halving the primary deficit by FY2015.

THIRD ARROW: AIMED AT LIBERALISING THE ECONOMY

The Third Arrow's structural reforms are the most important but the most difficult to implement.

It aims to remove inefficiencies and impediments to sustainable growth. Some of the more notable objectives include promoting capital investment, strengthening the workforce, creating new markets such as in research and development, and promoting Japanese expansion into the global economy through overseas corporate expansion and foreign direct investment.

For equity investors, some of these proposed reforms have the potential to drive further change at the corporate level through increased competition, consolidation of markets and improved corporate efficiency. It may take several years for these benefits to materialise.

POLICY PROGRESS JUST STARTING

Several important pieces of structural reform legislation have been approved to date, including industrial competitiveness enhancement; healthcare and regenerative medicine reform; electric power industry deregulation; and the designation of six cities and regions

(including Greater Tokyo) as "National Strategic Economic Zones" (SEZ).

Evidence of the LDP Government's progress on issues which have long been fiercely defended by vested interests can be seen in agricultural reform. The Government has decided to phase out the "gentan" system of rice production limits over the next five years and slash rice subsidies starting in FY2014. This is an encouraging early sign of the Government's commitment to reform.

Still there are several important policy segments that are yet to be addressed, such as labour reform. These appear to be more distant on the reform agenda. The LDP has to overcome entrenched interest groups along the path to reform.

EFFECTIVE REFORM IS ENCOURAGING FOR JAPAN EQUITY RE-RATING

Abenomics has already succeeded in bringing Japan's undervalued equity market into focus. The policy package has changed inflation expectations and served as a catalyst for global investors to reconsider their entrenched negative views about Japan. Whether reforms will spur the intended long-term economic growth remains to be seen. We believe it is critical for equity investors to distinguish between the economy and companies.

What is evident are the crucial changes that are taking place at the company level for a long time.

Japan's ongoing corporate restructuring has resulted in a strong improvement in profitability. Yet these crucial company-level positives have yet to be fully priced by the broader market. As a result, today we find ample opportunities to invest in companies trading at a deep discount to their sustainable earnings power.

These attractive starting valuations, combined with positive corporate activity, underpin our long-term confidence in Japanese equities. We believe that starting valuations are most critical when investing in equities. Continued improvement in corporate profitability, with the tailwind of effective policy reform, could support a sustainable re-rating of the Japanese equity market from current levels.



APPENDIX:

The LDP government plans to release a "Revised Growth Strategy" in June 2014 with more details of its structural reform/growth strategy agenda. In the near term, progress could be made in the following areas:

Policy	Growth Strategy Agenda
Tax reform	<p>The Government is considering additional further reductions in the corporate tax rate (from the new 35.6% level in FY14).</p> <p>In addition a new taxpayer ID system will be introduced from 2016, which aims to boost tax revenues and lead to entitlement reforms longer-term.</p>
Energy policy	<p>Nuclear reactivation; increase thermal power production; deregulation of the retail electricity market by 2016.</p>
Agriculture	<p>Phase out the "gentan" system of rice cultivation limits and slash rice production subsidies. Allow corporate agriculture land leasing.</p>
National Strategic Economic Zones (SEZ)	<p>Designate six cities and regions (including Tokyo) as SEZ. Proposals of deregulation measures for each region will follow.</p> <p>Examples include: relaxing plot ratio restrictions, permitting "fixed-term employment" contracts to improve labor market flexibility, allowing foreign physicians and nurses to practice.</p>
Immigration reform	<p>Given labour shortages in sectors such as construction, nursing care and transportation, the government is considering the expansion of the current "technical trainee program" to permit more foreign workers in these areas.</p> <p>Shorten the period required for highly-skilled foreigners to secure permanent residency.</p>
Corporate Governance Reforms	<p>On February 26, the Financial Services Authority finalized the "Japan Stewardship Code" which aims to enforce greater fiduciary responsibility on the part of asset managers.</p> <p>The Nikkei reported on February 27 that the Government Pension Investment Fund will likely follow the principles of this Code, adding to its manager selection criteria factors such as how managers exercise their voting rights and engage with their investee companies. The FSA plans to announce the asset managers who have decided to comply with this new Code in June.</p>
Casino Deregulation	<p>Bipartisan legislation to permit integrated resorts will likely be discussed in the current Diet session.</p> <p>Aim to increase tourism from 10 million visitors in 2013 to 30 million by 2030. Olympics will stimulate infrastructure rebuilding.</p>
Women in the workforce	<p>To meet the goals set for raising female labor participation, the government will likely formulate more concrete measures such as revising the tax code (where the current spousal deduction deters married women from working full-time) and offering subsidies for childcare-related services.</p>



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