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WHY INVESTORS SHOULD NOT GIVE UP ON JAPAN'S ABE JUST YET

By Esther Armstrong, BNY Mellon Investment Management

BNY Mellon's Miyuki Kashima says that while the honeymoon period appears to be over for Japan's prime minister, his policies still offer plenty for investors to look forward to.

Japan's Prime Minister Shinzo Abe has faced some serious scepticism following his speech to unveil three new policy 'arrows' at the end of September. But BNY Mellon's Miyuki Kashima believes he has built upon an already solid foundation for Japan's economic recovery.

"When Abe makes an announcement the media reception is generally not that kind," says Kashima, who is head of Japanese equity investments at BNY Mellon Asset Management Japan, "However, his lack of fear to set specific headline targets is a breath of fresh air."

His first new arrow – to grow Japanese GDP by 20% to around 600 trillion yen by the early 2020s – is the first time any prime minister has put a target on overall macro growth in decades, according to Kashima.

"It is no secret that over the past 20 years there has been a decline in nominal GDP and Japan has been in stagnation. This arrow sends a strong message to Japanese companies, its people and the stock market that the policies coming out over the next five years will be supportive of growth."

A lot of media criticism has centred round the level of debt the country has taken on to turn its economy around; not least through its large-scale quantitative easing programme put in place earlier this year. But Kashima believes a policy of unremitting debt reduction cannot foster growth.

"If a government just tackles debt, while that is laudable, it is contractionary. It is something governments should only do if they balance it with growth-supportive policies. The net effect should never be contractionary," she explains.

Goal-setting

In the past she thinks Japanese governments presented targets that seemed the "right thing to do" and then often failed to deliver despite having manifestos "so thick they could act as a doorstop".

"With Abe, even if he doesn't hit his headline target, the direction is clear. Abe says 'this is our aim' and allows himself the flexibility to reach that aim," Kashima continues.

She points to one of the policies contained in his first 'three arrows': an inflation target of 2%. "Inflation is still less than 1% overall when you look at the 'core core' measure, which removes the effect of fresh foods and energy prices as they are generally more volatile. I would argue this is the most important metric to keep an eye on. Its latest reading was 0.8% and I believe if Abe had targeted 1% inflation we would never have got close to it, so aiming for 2% he made an impressive start and was important to pull Japan out of deflation."

The second and third arrows of his second raft set out to tackle Japan's demographic problems: The second targets an increase in the fertility rate from 1.4 to 1.8 (this is the number of children a women is expected to have in her lifetime) and the third focuses on the provision of greater social security.

Says Kashima: "Everyone knows, both inside and outside Japan, that the population is expected to decline. Rather than just saying 'we should do something about it' Abe has again put a number on it."

If recent trends continue, Japan's current population of 127 million is set to drop to 87 million by 2060. Abe has pledged to prevent it falling below 100 million.

Finally, with his third new arrow he has committed to tackling the burden many working age people (mainly women) face in looking after children and ageing parents. Kashima explains: "A lot of women quit work to look after their parents so better social security could help ensure the labour force in Japan does not decline over time.

"His previous three arrows have not disappeared but have been amalgamated into the first of the second raft focusing on GDP growth," she adds.

What does this mean for investments?

Abe's continued focus on growth reinforces Kashima's belief in Japan's stock market recovery. This time, she says, it is a domestic-focused recovery and not one dependent on the growth of other countries.

"Although our stock selection is driven from the bottom up, over the past couple of years we have generally focused on the domestic-facing part of the market: Service sectors, construction and real estate. That has not changed. In fact, if anything, it is something we are even more strongly attuned to. Concerns about the global economy mean we have a bit more confidence in companies focused on internal growth drivers rather than exporters."

Kashima says the view many investors have of Japan is of an economy dependent on exports. Yet compared with its Asian and developed market counterparts, it actually measures up favourably.

"In Japan the percentage of exports as a share of GDP is only about 15%. To put this in context Korea has over 40% exports to GDP, Thailand 58%, Malaysia 70% and China 25%. In Europe, the UK has about 20%, France 20% and Portugal 28%. Of Japan's exports, only one-fifth go to China but many people mistakenly think that figure is higher."

Another piece of conventional wisdom from investors, according to Kashima, is that investing in Japanese equities is actually a play on the global economy. "In the past that may have been true because Japan was not growing so investors wanted to buy the companies benefiting from selling overseas and capturing a share of business in another country. Now domestically-focused businesses are doing well as the economy turns around."

Her all-cap strategy's top three overweight sectors compared with its comparative index are chemicals (3.65% overweight), real estate (3.5% overweight) and services (2.9% overweight), as at the end of September. Meanwhile, in her small cap strategy to the same date Kashima had a 15.7% overweight to services, 6.62% overweight to real estate and 6.21% overweight to construction.

Is the good news already priced in?

Year-to-date the Topix has returned more than 8% and over one year the stock market is up almost 29%. It peaked on 10 August before dropping significantly from 18-25 August. September was also a challenging month for the market, according to Kashima. "Despite rather fickle investors the market has made positive returns this year, which is not bad considering a lot of markets are in negative territory."

She believes the market still has some way to go before it catches up with earnings per share growth: "They have been growing by double digits this year. Who knows what is going to happen next year but if you are going to be invested in equities at all, I believe the negative impact from the global slowdown will be felt a bit less in Japan compared with most other countries. Mid- to longer-term prospects for the Japanese equity market remain attractive, as the economy is at a rare transition phase, moving from a period of contraction to that of expansion and international investors continue to be underweight.” she concludes.