Heartwood
Investment Management

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Investment Insight

Weekly Insight

Japan's politicians shy away from answering the big questions

Japan's electorate goes to the polls this weekend and in all probability Shinzo Abe's LDP (Liberal Democratic Party) will be re-elected to government. Assuming Abe secures another term, the economic outlook is not expected to change materially. For some observers, Abe's achievements have only amounted to coercing the Bank of Japan into bankrolling an ever-rising debt mountain, thereby propping up the stock market rather than reflating the economy.

Japan's 'lowflation' conundrum has mired domestic growth prospects for more than two decades. When Abe first came to power in 2012, the three arrows of so-called Abenomics – monetary easing, fiscal stimulus and structural reforms – were heralded as the great panacea to revive Japan's economic fortunes. As events transpired, Abe has focused on just one arrow, monetary easing, with the economy relying heavily upon the Bank of Japan's shock-and-awe tactic of flooding the market with liquidity. In part, this policy was used as a response to the consumption tax increase in 2014, which constrained demand. Consequently, the Bank is now one of the largest shareholders of the Nikkei, owning approximately 3.5% of the index via ETFs and investment trusts (rather than direct equities). The Bank also owns around 75% of the country's domestic ETFs. In effect, the yield curve and other price setting mechanisms in Japan's financial markets have been nationalised.

An election campaign devoid of substance

There appears little prospect that things will change anytime soon. In many ways, this election campaign was devoid of substantive policy discussions, having being called at short notice. New Hope, a newly established party to emerge as the main opposition, offered the '12 zeros'. A few of its more outlandish proposals included plans to ban packed commuter trains; ban tree pollen that causes hay fever; and ban passive smoking. Noble ambitions for some, but not a recipe for addressing the economic challenges facing Japan over the next decade.

The LDP's focus was principally on constitutional reform, allowing Japan the right to defend itself against military threat, particularly amid rising North Korean tensions. Other areas of debate were expanding free childcare places for the under-fives and free tuition for those in higher education. Both of these initiatives would be funded by further increases to the consumption tax - having been twice delayed - in 2019.

Of course, all of the above avoided difficult questions around how Japan addresses its greying workforce and shrinking population. Costs for social security and health care are expected to rise exponentially over the next decade, adding to Japan's gross debt burden, currently 245% of GDP. By 2025, a new generation of baby boomers aged 75 and over will start drawing on social security benefits, placing even more burden on the public finances.

Corporate Japan is improving profitability but more reform is needed

While the longer term macro story appears less than compelling, Japan's economy is reassuringly seeing shorter term improvements helped by stronger global demand, yen depreciation and rising corporate profits. In fact, at the end of June, the economy achieved six consecutive quarters of positive growth for the first time in over ten years. Optimism among manufacturers remains elevated

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and capital expenditure levels are rising, although corporates still retain very high cash levels. Moreover, away from the political arena, some of the more significant developments are happening within corporate Japan. The focus on improving competitiveness through corporate governance reform has been notable, and may well have contributed to record-high profitability this year.

There is still, though, a large amount of pent-up private capital among corporates and consumers, which if unlocked could be a key driver to stimulate growth. So far this year, domestic demand has been supported through fiscal spending via public works construction, but this stimulus will soon fade. The weak link remains wage growth, despite very tight labour market conditions. Delivering a higher wage economy that takes Japan's economy away from its deflationary trap still requires meaningful reforms to free up the labour and capital markets. In particular, the services sector in Japan has not globalised in the same way as manufacturing - the car industry being a prime example.

Again, it all comes back to the boldness of policymakers and their willingness to restructure Japan's economy. For these reasons, many overseas investors are understandably discouraged from committing capital to Japan. While we are not under any illusions that the macro story will change following Sunday's election, we believe that the entrepreneurial spirit in Japan is not dead and there are a number of attractive opportunities to exploit, independent of the wider economy. We consider these are best accessed through active managers who have a specific tilt, whether in smaller companies and/or in the more value-orientated parts of the market. We aim and believe it is necessary to be very specific about the investments we make in Japan.

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