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Nikko Asset Management

The Japan Update

July 2014

Abenomics and Expectations for a Bullish Japanese Stock Market

At an extraordinary meeting on 24 June, Japan's Cabinet approved a new growth strategy and the detailed policy proposals to implement it. This means that the long-awaited third arrow of Abenomics is finally at the implementation stage. Prime Minister Abe told a news conference following the meeting that the government would be "revving up" the economy into a positive cycle that would reach all parts of the country, emphasizing that "everything depends on (the progress in) the implementation of the growth strategy".

The items from the plan which have received the most attention are (1) corporate tax reform, (2) reforms in agriculture and healthcare (referred to as "bedrock regulation" reforms), sectors which have traditionally been resistant to reform, and (3) reforms to the investment portfolio of the Government Pension Investment Fund (GPIF, the world's largest public pension fund).

- Corporate tax reform will begin next year with a goal of lowering the effective corporate tax rate to under 30% over the next few years. The government hopes that this will result in increased investment from within and outside Japan, and, as corporate activity fires up, will boost employment and expand tax revenue.
- The "bedrock regulation" reforms will ease regulations in fields whose vested interests have long been protected. The goal of the measures is to strengthen private sector-led growth by creating a business environment in which the fundamental principles of market-driven competition can work effectively. While there are still various kind of resistance to implementing the reforms, Japan's business community has shown its approval of the government taking on such "sacred cows".
- The reforms of the GPIF are expected to improve the financial health of public pensions, as the fund aims to boost its returns by shifting away from domestic bonds, including a heavy bias to Japanese government bonds (JGBs), to assets with higher expected returns such as equities. In addition, rebalancing the asset allocation of the world's largest pension fund will on its own have quite an impact on the markets, and market participants are paying close attention to the asset classes that will see their weightings raised.

As Japan's prime minister indicated, the growth strategy is intended to be most effective among the three arrows of Abenomics in order to place the Japanese economy onto a genuine path to growth. An earlier version of the growth

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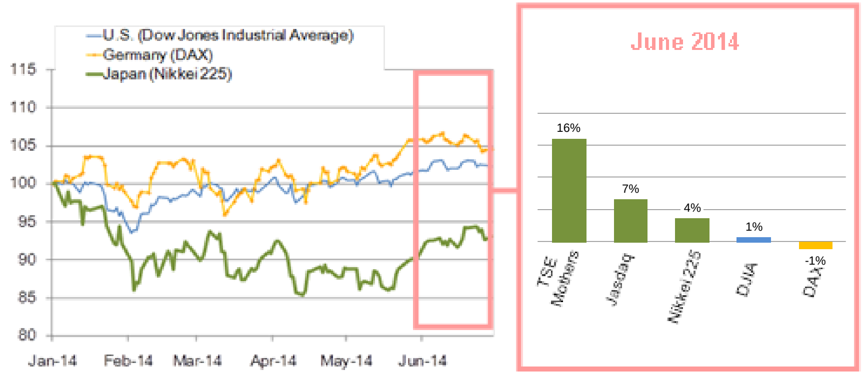
strategy was released in June 2013, but it was seen as falling short of market expectations because it shelved the corporate tax cuts and “bedrock regulation” reforms. But this most recent iteration of the growth strategy will test the government’s true commitment to reform. The Japanese stock market’s upward turn after only a draft of the strategy was released ahead of the Cabinet decision suggests that this version of the plan generally meets the expectations of the market. Amid concerns about the consumption tax hike and reduced expectations for Abenomics, Japanese stocks appeared to get off to a slow start in 2014 compared to their counterparts in other developed countries. However, it appears that the fall in consumption in reaction to the last-minute surge in demand before the consumption tax hike will be largely limited to the April-June quarter. If the release of more details of the growth strategy further raises expectations for Abenomics, this could be a source for bigger gains in the Japanese stock market.

The “Three Arrows” of Abenomics

Major Stock Markets in 2014
(January 1 – June 30)



Above indexes=100 as of 1 Jan 2014

Created by Nikko AM based on data deemed reliable. The charts above are based on past data and do not guarantee future outcomes.

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