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Abenomics: into the next phase

Structural reform takes centre stage to lift long-term growth expectation

By Soichiro Matsumoto

WE maintain our positive view on H1 2015 corporate earnings, but we think annual earnings guidance will stay conservative based on the current uncertainty of the global economy and financial markets. We believe investors will focus on corporate governance reform progress during H1 FY2015 earnings season.

After the introduction of the Corporate Governance Code in June 2015, companies are expected to release their governance plans by year end. Hence, the upcoming H1 reporting season is a good opportunity for companies to release their corporate governance reform targets.

A growing number of Japanese investors are paying attention to corporate governance quality, transparency and shareholder returns – dividends, share buybacks and the total payout ratio, which is lower than in the US.

Minister of Finance Taro Aso said at a media interview on Aug 8 that he will organise a conference to check the status of both the corporate governance code for listed companies and stewardship code for institutional investors, coordinated with the Financial Services Agency (FSA) and Tokyo Stock Exchange (TSE).

According to media reports, as at Aug 21, there were 69 companies that have released their governance code (about 3 per cent of total listed companies on the TSE, including First and Second sections covering large and mid-sized companies respectively).

We believe it is important to focus on the outcome of this governance reform that could enable companies to generate better returns through higher dividends and share buybacks, and higher allocation of corporate profits for shareholders.

Global competition

The Trans-Pacific Partnership (TPP) is a key element of Prime Minister Shinzo Abe's growth strategy. If successfully concluded, the participating economies will represent 40 per cent of the global economy. We believe the key focus of the TPP is not to reduce import taxes, but to introduce uniform rules and regulations for the enhancement of business and investment activities within this group of nations.

Japan has long been criticised for its system of high invisible non-tariff barriers. We think the TPP will help to clarify this situation and its implementation will remove some major barriers.

Generally, non-manufacturers are protected by these barriers and have not yet faced any serious global competition. Their products (and business model) are sometimes referred to as "Galapagos" syndrome, which means the products are unique and have evolved separately from the rest of the world.

We expect non-manufacturing companies in Japan, for example from agriculture, the financial sector, real estate, construction, the retail sector and services industry, will face some serious global competition once the TPP is adopted. However, it will also make them highly competitive and improve their productivity.

Fiscal reform

The Japanese Cabinet decided to adopt the "Basic Policy on Economic and Fiscal Management and Reform 2015" on June 30. The government will maintain its fiscal consolidation targets of achieving a primary surplus by FY2020, as well as a continuous reduction of the public debt to GDP (gross domestic product) ratio over the medium to long term beyond FY2020.

It has also made a soft pledge to halve its primary balance deficit in FY2015 versus FY2010. Of the three pillars of the economic and fiscal reforms plan – economic revitalisation, expenditure reform and revenue measures reform – we believe that expenditure reform, where ample room remains for further reductions, takes the centre stage of fiscal reconstruction. We believe the FY2016 budget compilation will be the first challenge for the government with its commitment to fiscal reconstruction along the above benchmarks.

Revitalisation strategy

Abenomics is now moving into a new stage where the policy focus will be placed on the enhancement of productivity for the sake of maintaining the virtuous cycle. The Japan Revitalization Strategy (Revised Strategy 2015, approved by the Cabinet on June 30) underlines the focus on productivity revolution and local Abenomics. In addition, policy measures related to "The Fourth Industrial Revolution" and the utilisation of IT while ensuring security put the focus on the reconstruction of infrastructure for future generations.

A symbolic measure in this field is the "My Number System", which will be introduced in October and will assign each resident in Japan a 12-digit number for tax and social security purposes. The extended use of this system not only in public services, but also in private sectors could result in cost reductions and the creation of new services.

Lastly, local Abenomics intends to encourage regional revitalisation to derive growth potential by utilising local resources. Such measures do not appear new today, yet continued policy support, especially in the service industries which account for about 70 per cent of GDP, may broaden the growth potential. It is inevitable that the government will fine-tune the details in the coming months to keep the policy focused on the enhancement of productivity, which boosts growth potential and makes the current economic growth sustainable.

Productivity reform timetable

We think the major achievement of Mr Abe is that he has established a long-term stable government which enables the implementation of a series of structural reforms. This has not been easy to realise in Japan for many years. In the next two years, Mr Abe has to pay attention to two major events in order to sustain Japan political stability. The first is the upper house election which is expected to take place by the summer of 2016. The second is the next consumption tax hike to 10 per cent from 8 per cent in April 2017.

In the run up to these two key events, Mr Abe needs to create further positive sentiment towards Japan's long-term growth prospects among Japanese voters. Japan's economy is in a modest recovery phase, so we think Mr Abe's reform agenda has to gain further traction to bring about long-term steady growth to Japan.

Japan equities

In July 2015, we changed our view on Japanese equities from outperform to neutral because we considered it a good time to take profits on this long-standing successful investment.

Our decision is supported by the following assessments. First, we consider additional QE (quantitative easing) less likely now. Second, the Government Pension Investment Fund (GPIF) has largely completed the diversification of its asset allocation from fixed income into equity. Third, the Japanese yen weakness is almost over. So we think there would be a lack of catalyst for Japan equity investment for some period and recommend waiting for a better opportunity.

We expect solid Japanese corporate earnings growth, and the corporate governance reform, which has just begun, should enhance shareholder value and improve the equity valuation. In fiscal 2015 (FY ending March 2016), the year-on-year increase in Japanese corporate earnings is expected to be in the high teens. It will be supported by a global economic recovery, given the Japanese industry's stronger weighting in global cyclical sectors, such as auto, auto parts and electronic devices.

We see some risk over the expected rate hike by the US Federal Reserve, declining liquidity in the financial market and the pressures in China and emerging markets, as well as weak commodity prices. Given these factors, we believe it is better to wait for a better time to invest when the market starts to re-affirm that steady global economic growth, led by developed nations, continues. W

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