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Reality check and monetary policy hostage

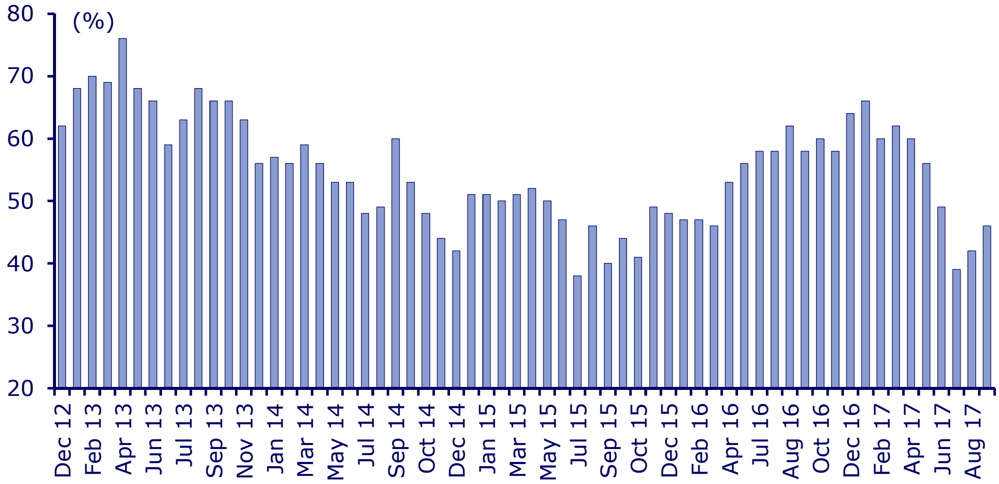
Tokyo

"Thou protest too much". This has to be the reaction to the flurry of rhetoric and diplomatic activity triggered by North Korea's nuclear test on Sunday. For the greater the verbal condemnation the more evident it becomes how few options America and its allies really have; most particularly as China still seems unwilling to apply the one real source of leverage available. That is to stop supplying North Korea with oil.

The above means that, sooner or later, America will likely have to accept the reality that North Korea has become a nuclear power and adjust its policy accordingly towards a focus on containment. Interestingly, voices in Washington are already beginning to make this point in public, be it Obama's former National Security Adviser Susan Rice or her namesake Condoleezza Rice, Secretary of State under George W Bush.

This will be a bitter pill for The Donald to swallow after his bellicose rhetoric. But it seems to be the direction where things are headed while the fact that Pyongyang timed its blast, which occurred only 200km from the Chinese border, to coincide with the opening of the BRICS Summit in Xiamen on Sunday is further proof of the breakdown in relations between Beijing and Pyongyang. Meanwhile viewed from the standpoint of Tokyo, where *GREED & fear* has been this week, there is one positive consequence from a local stock market standpoint. That is a likely further bounce in Shinzo Abe's popularity, following the decline over the summer over "scandals". Abe's approval rating fell from a recent high of 66% in January to 39% in July and has since risen to 46% in late August, according to the *Nikkei* polls (see Figure 1).

Figure 1
Approval rating for Prime Minister Shinzo Abe's Cabinet



Source: Nikkei polls

Abe's hawkish views on defence and reform of the constitution will have been endorsed in the eyes of much of the electorate by North Korea's escalating nuclear build up. That said Abe like Trump, and the two apparently talk together all the time on the phone, will be under similar pressure to acknowledge the reality of North Korea's nuclear weaponry. But if Washington and Tokyo are going to accept the reality of Pyongyang's nuclear status they may as well coordinate the announcement. That in turn will likely set up talk of summit meetings with the 33-year-old North Korean leader, who by then may have become more willing to talk. On that point, the last and only Japanese leader to make a visit to Pyongyang was former Prime Minister Junichiro Koizumi when he met with Kim Jong-un's father Kim Jong-il twice in 2002 and 2004.

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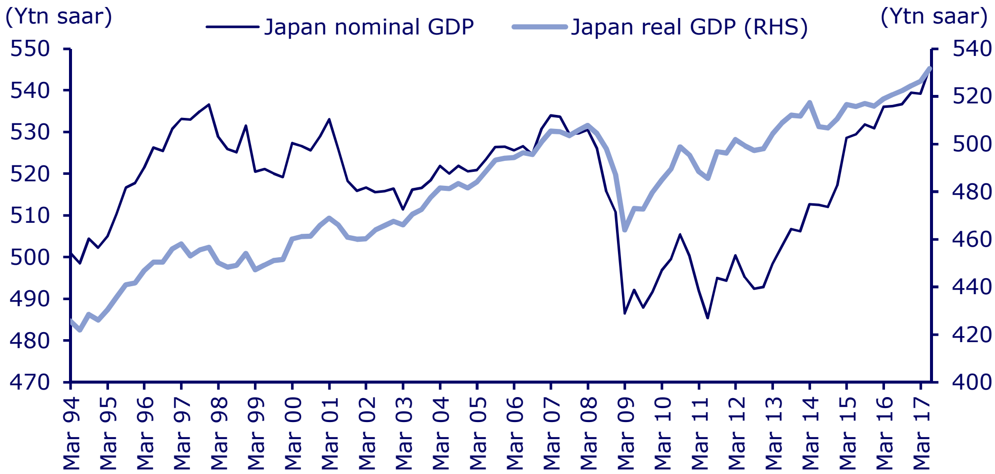
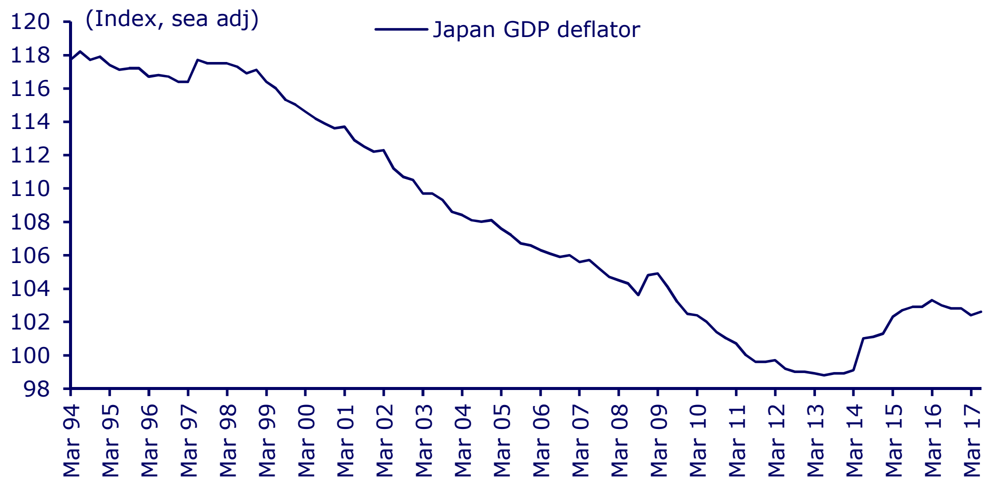
Figure 2
Japan nominal and real GDP trends



Source: Japan Cabinet Office

The official narrative of financial markets this year is that G7 central bank policy is in the process of normalising. A visit to the Bank of Japan this week reveals that career central bank officials are hoping that the extreme limits have already been reached in the Japanese central bank experiment in unconventional monetary policy. This is not just because BoJ Governor Haruhiko Kuroda's term in office formally ends in April next year. It is also because there is growing comfort taken from the pickup in economic activity, both in real and nominal GDP terms. Japan's nominal and real GDP rose by 1.6% YoY and 2.0% YoY respectively in 2Q17 (see Figure 2). Most important perhaps, given the enduring obsession with deflation, the GDP deflator has seemingly bottomed. The GDP deflator reached its low in 3Q13 and has since risen by 3.8% over the past four years, though it was down 0.4% YoY in 2Q17 (see Figure 3). Another encouraging sign is that loan growth has picked up this year. Domestic bank loan growth has accelerated from 2.0% YoY in August 2016 to 3.4% YoY in July 2017 (see Figure 4).

Figure 3
Japan GDP deflator



Source: Japan Cabinet Office

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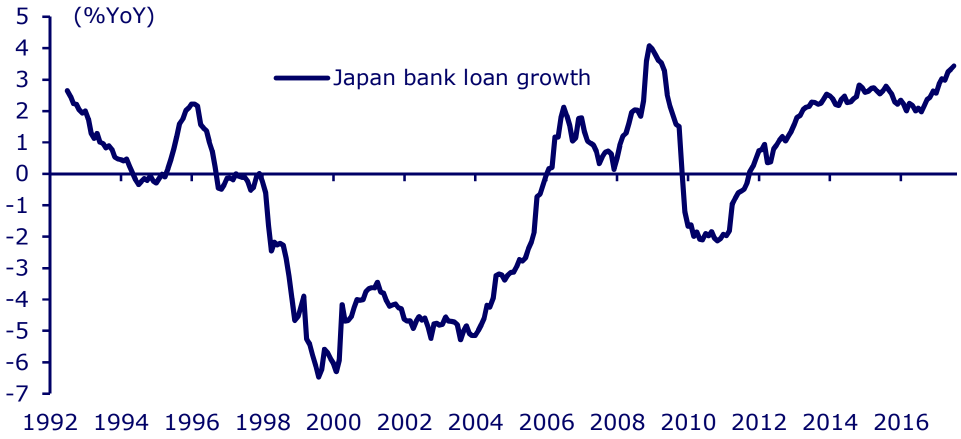
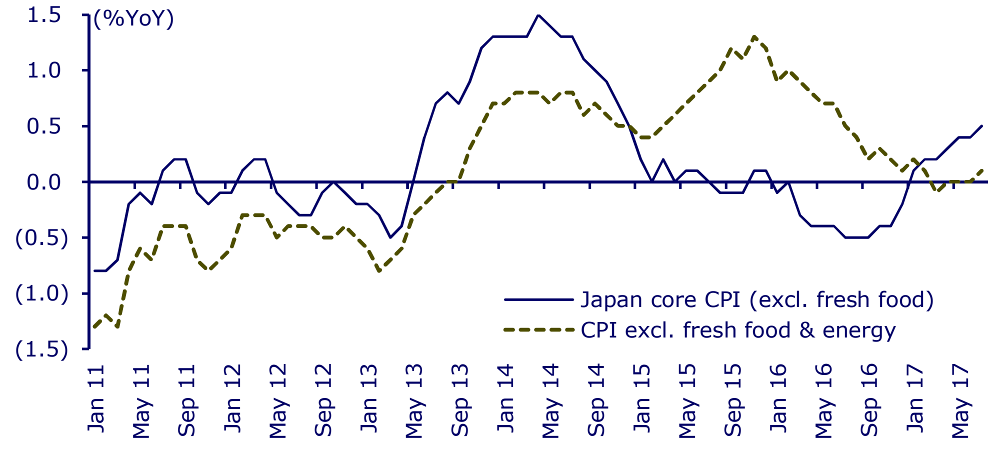
Figure 4
Japan domestic bank loan growth



Source: Bank of Japan

If the above is true, it is also true that the Bank of Japan remains nowhere near meeting the 2% inflation target set by Kuroda when he became BoJ governor back in April 2013. Japan core CPI inflation, excluding fresh food but including energy, rose from 0.4% YoY in June to 0.5% YoY in July, while the more relevant "core core" CPI, excluding fresh food and energy, rose from 0.0% YoY to 0.1% YoY over the same period (see Figure 5). Moreover, no one expects the 2% target to be reached save for some dramatic short-term spike caused by a macro shock, be it a surge in the oil price or a collapse in the yen. This is because the inflation target of 2% has always been seen as unrealistic in the context of Japan's trend growth rate of around 0.5-1%. Indeed this is why the inflation target was only 1% under Kuroda's predecessor Masaaki Shirakawa and 0% under his predecessor Toshihiko Fukui.

Figure 5
Japan core CPI inflation



Note: Adjusted for the sales tax hike effect. Source: Statistics Bureau, Bank of Japan

The 2% target was adopted by Kuroda in part to send a signal of his aggressive reflationary intent at the launch of Abenomics but also because 2% was seen by the current BoJ Governor as the "global standard" as this is the target of the Fed, the ECB and the Bank of England. Just how difficult 2% will be to achieve has become clear in the recent past given the lack of upward pressure on wages and prices despite the accumulating evidence of an ever tighter labour market, courtesy of Japan's demographics and the lack of immigration. This can be seen in the surging job-offers-to-applicants ratio, which rose from 1.51% in June to 1.52% in July, the highest ratio since February 1974 (see Figure 6). It can also be seen in the rising working-age female labour participation rate which is now above American levels. Thus, the Japan working-age (15-64) female labour participation rate has risen from 63% in 2011 to 68.1% in 2016 and

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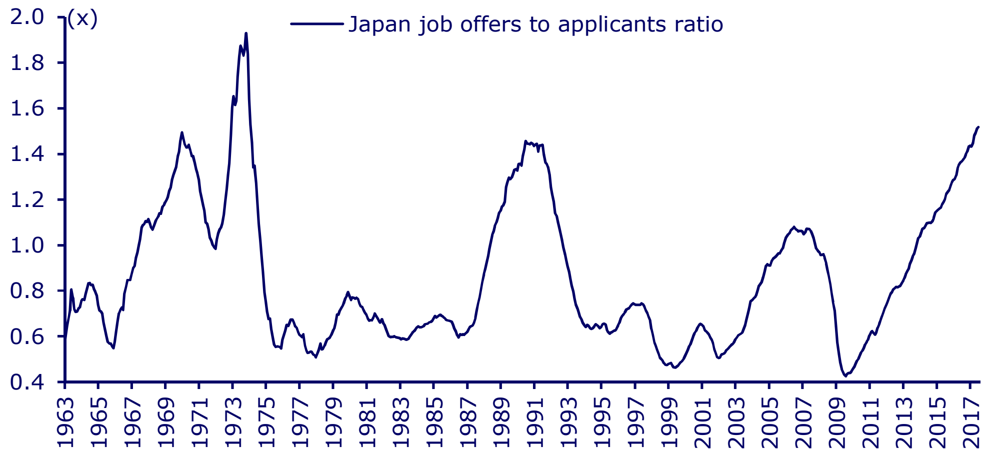
an average 69% in the first seven months of 2017, compared with 67.8% in America (see Figure 7).

Figure 6

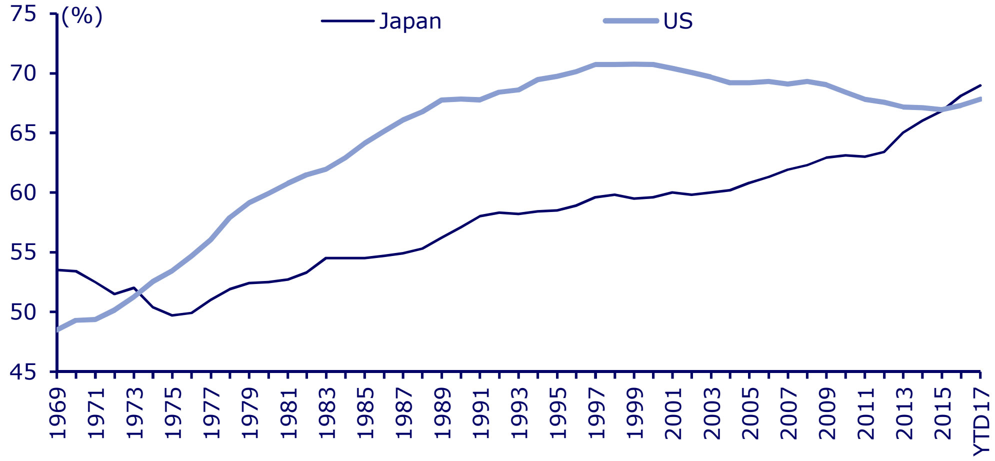
Japan job offers to applicants ratio



Source: Ministry of Health, Labour and Welfare (MHLW)

Figure 7

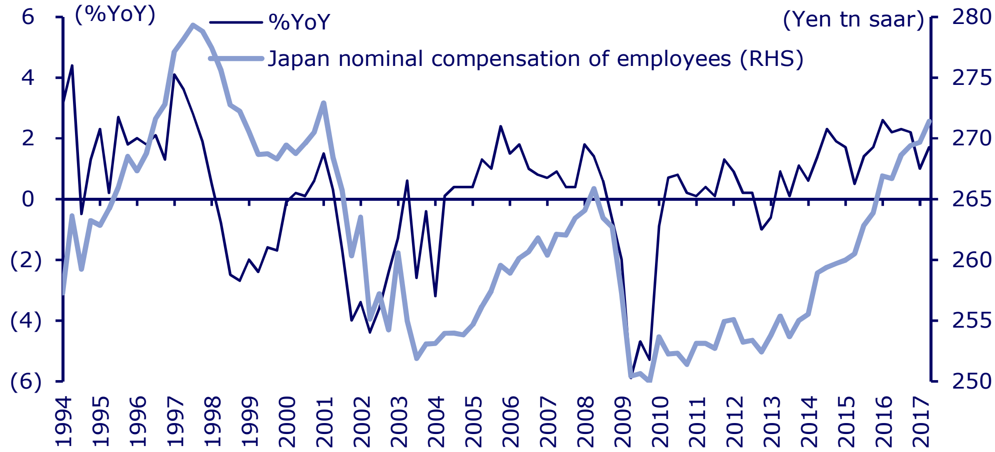
Japan and US working-age female labour participation rate



Note: Aged 15-64. Source: CLSA, Japan Statistics Bureau, US Bureau of Labour Statistics

Figure 8

Japan nominal compensation of employees



Source: Japan Cabinet Office

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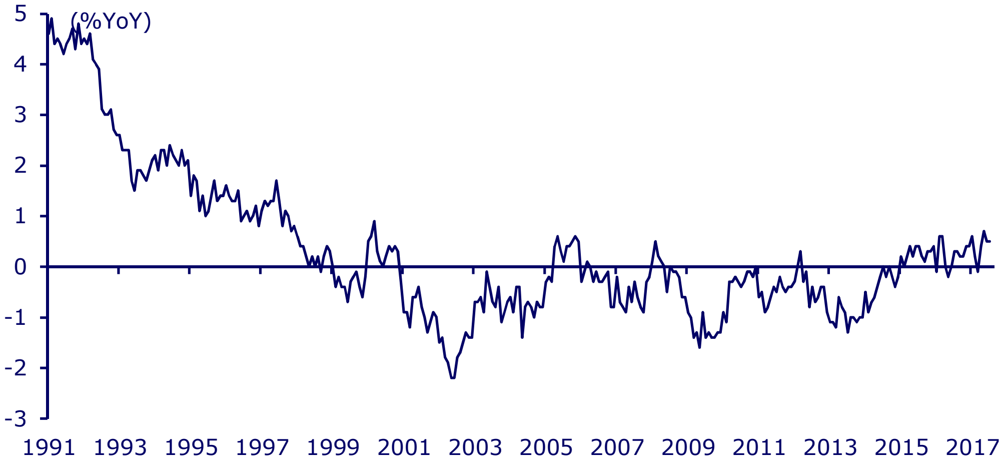
As a result, aggregate compensation is way up on the low reached back in 2009. But wage growth remains surprisingly anaemic in aggregate, just like inflation. Thus, total compensation of employees rose by 1.7% YoY in 2Q17 to an annualised ¥271.4tn, the highest level since 1Q01, and is up 8.6% since bottoming in 4Q09 (see Figure 8). While average monthly scheduled cash earnings per regular employee, excluding overtime pay and bonuses, rose by only 0.5% YoY in July (see Figure 9).

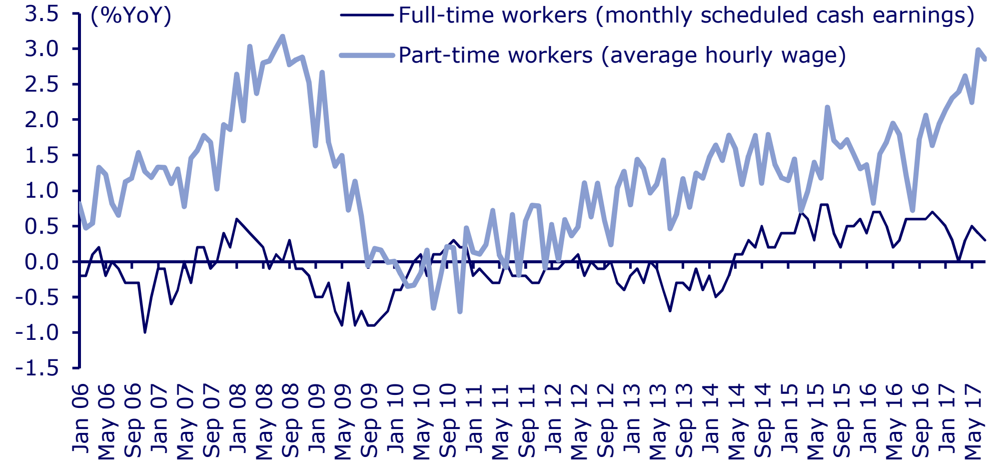
This dilemma is looked at in some detail in the July outlook published by the Bank of Japan ("*Outlook for Economic Activity and Prices*", 21 July 2017). The key reason for sticky wage growth is the perverse incentives created by Japan's schizophrenic labour market where unions representing permanent employees have little incentive to push for wage increases since their main role is to preserve the permanent status, which means not only that their members receive good benefits but also earn almost twice the level of temporary employees. As a result, average monthly scheduled cash earnings for permanent employees are only rising about 0.3% a year while hourly pay for temporary employees, where the shortage of workers is most acute, is rising by 2.9% a year (see Figure 10). Yet the permanent employees account for 60% of the workforce and earn almost double the hourly wage of the temporary employees though that gap is narrowing, albeit far too slowly. The average hourly wage for full-time workers is now 1.8x of the hourly wage for part-time workers, down from 2.1x in 2005.

Figure 9
Japan average monthly scheduled cash earnings per regular employee



Note: Excluding overtime pay and bonuses. Source: Ministry of Health, Labour and Welfare (MHLW) - Monthly Labour Survey

Figure 10
Japan wage growth for full-time and part-time workers



Source: Ministry of Health, Labour and Welfare (MHLW) - Monthly Labour Survey

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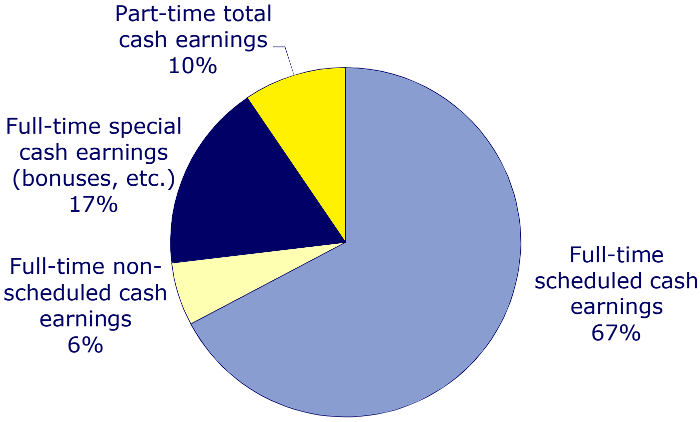
The above analysis means that only wages of part-time employees are really responding to the tight labour market conditions. Yet scheduled cash earnings of full-time employees make up 67% of total employee income (see Figure 11). This explains, as noted by the BoJ in its July report, why hourly wages at the macro level have been increasing at a much slower pace compared with the period of the Bubble Economy (1986-1990) which is the last time the job offers-to-applicants ratio was near current levels.

Figure 11

Breakdown of Japan total employee income (FY16)



Note: Figures for FY16 ended 31 March 2017, estimated by multiplying cash earnings by the number of regular employees based on the "*Monthly Labour Survey*". Source: CLSA, Ministry of Health, Labour and Welfare

Meanwhile, the Japanese central bank highlights other measures being taken to address the labour shortage apart from the obvious one of raising wages. One is to increase investment in labour-saving equipment. The most extreme example of this *GREED & fear* has seen recently was the decision by major travel agency H.I.S. to expand automated hotels following a successful experiment in one hotel in Kyushu. Another is to stop employing people in unnecessary jobs in the service sector, a practice known as *omotenashi*, of which there are many examples in Japan. Think of female lift attendants in department stores. In this respect the labour shortage is not as extreme as it looks in the short term in the service sector because of such entrenched practices. Still the demographics point in only one direction.

The theoretical hope is that reform of labour practices, be it introducing automation or ending unnecessary tasks, will increase labour productivity which in due course will lead to rising real wages. This makes sense. But in the meantime Kuroda is still BoJ governor, he is still committed to the unrealistic 2% target while it is also quite possible that he could be reappointed for another five-year term. On this particular point, there is no consensus on BoJ succession in Tokyo which suggests that the decision has not yet been made. Kuroda's age of 72 is certainly not held against him. Indeed the issue is perhaps, if asked, whether he wants another term. For the longer he is still around, the bigger the risk he has to contend with some of the fallout from his extreme monetary policy, be it a destabilised yen or a destabilised JGB market.

For now the continuing commitment to the "yield curve control" policy means, so far as *GREED & fear* is concerned, that Japan remains a hostage to the belief, or lack of it as of late, in Trumponomics. True, the current consensus of the chattering classes is that the BoJ has commenced tapering because it has bought fewer JGBs than its current ¥80tn annual net purchase target (see Figure 12). But this is of course nonsense. The reason the BoJ has bought fewer JGBs is because the US yield curve has been flattening for most of this year (see Figure

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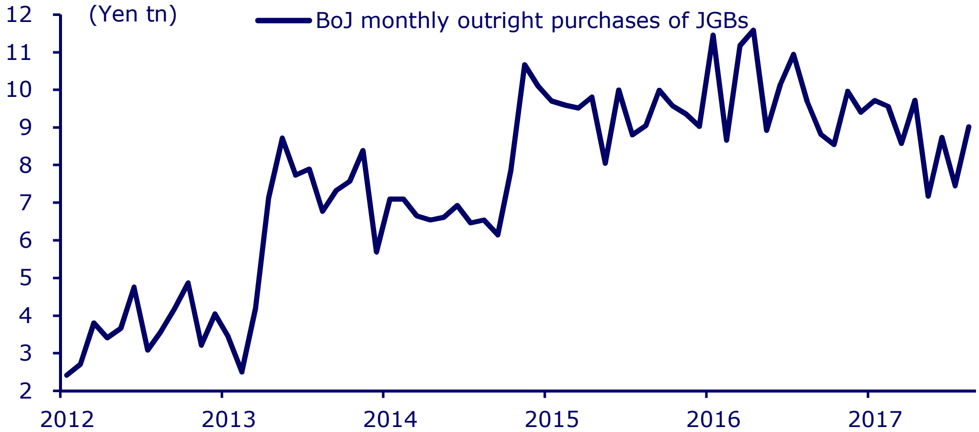
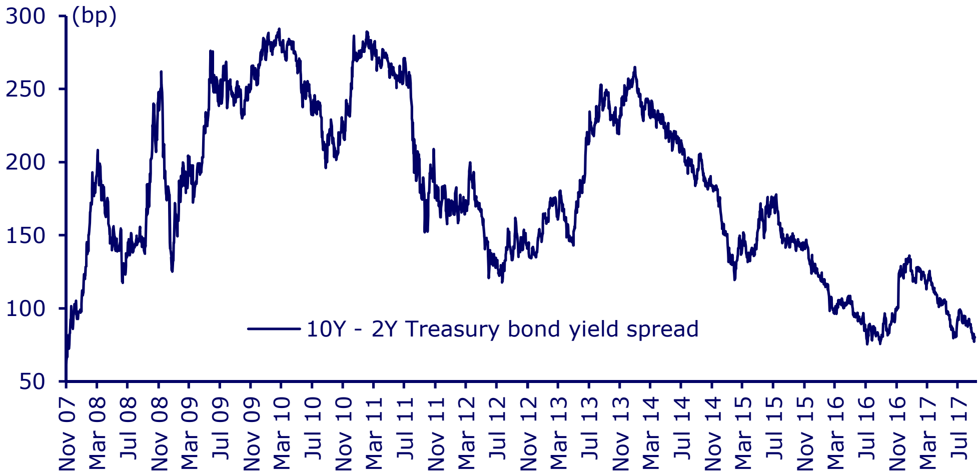
13), which means the Japanese central bank has not had to be aggressive to maintain the 10-year JGB yield at the target level of "around zero" (see Figure 14).

Figure 12
Bank of Japan monthly outright purchases of JGBs



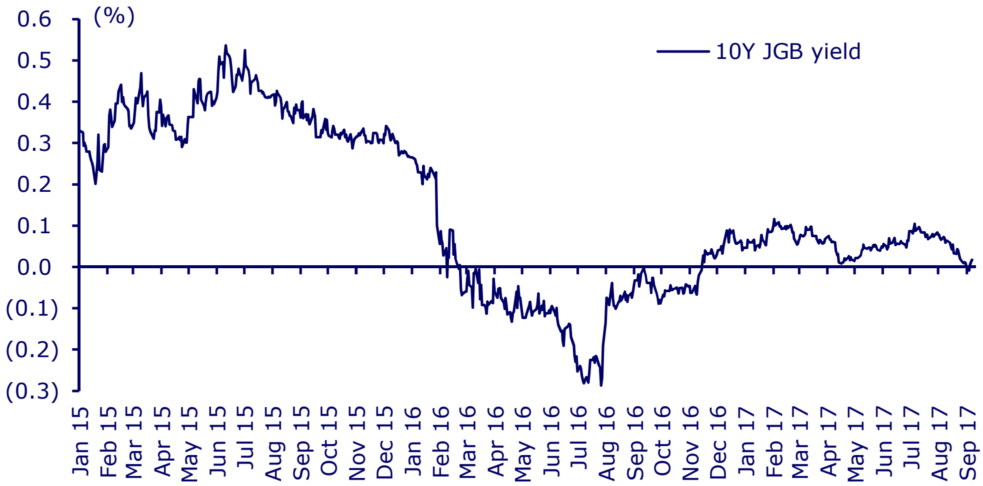
Note: Data up to August 2017. Source: Bank of Japan

Figure 13
US yield curve (10Y – 2Y Treasury bond yield)



Source: CLSA, Bloomberg

Figure 14
10-year JGB yield



Source: Bloomberg

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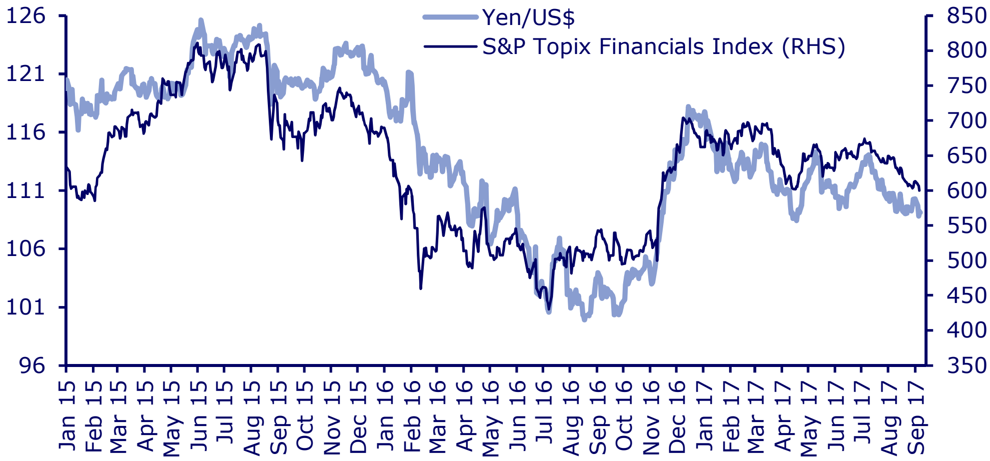
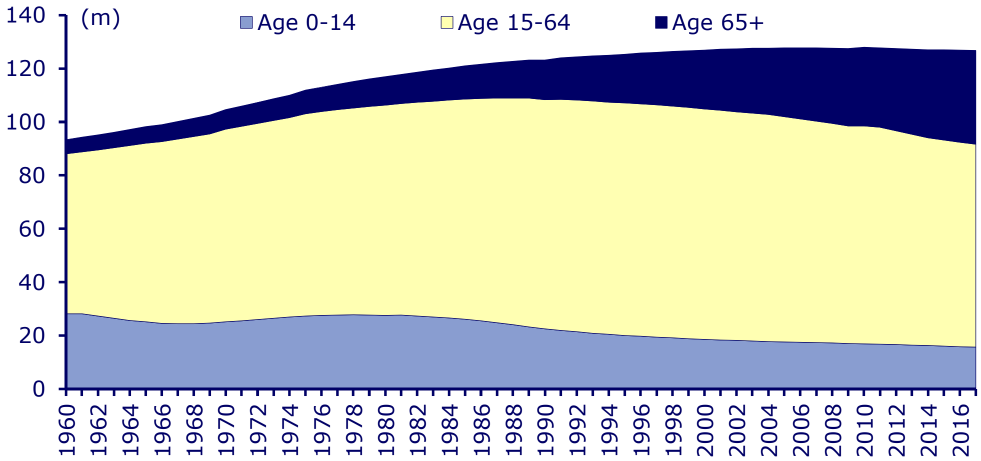
However, that benign outlook will change dramatically if the Trumponomics trade is reactivated again, say because of sudden renewed confidence that Congress will pass landmark tax reform. Then the yield curve control policy implies potentially unlimited JGB purchases by the Japanese central bank and a likely related sharp decline in the yen, as happened after Trump was elected. This is the environment where Japanese financial stocks will again outperform almost everything globally, most particularly if the currency is hedged, as was indeed the case between Trump's election and the peaking out of the 10-year Treasury bond yield at 2.64% in mid-December (see Figure 15).

Figure 15
S&P Topix Financials Index and Yen/US$



Source: CLSA, Bloomberg

Figure 16
Japan population by age group



Source: CLSA, CEIC Data, Japan Statistics Bureau

Such market action would also be viewed positively by foreign investors, given their traditional obsession with the correlation between the yen and the stock market. Still *GREED & fear* is not convinced this would be a long-term positive for the Japanese stock market. First, extreme weakening of the yen means a sharp rise in imported inflation which is a particular negative in Japan given that one-third of consumers are pensioners living on fixed incomes. This dynamic is why consumer confidence declined despite the surge in the stock market when Abenomics was launched in December 2012 and Kuroda's monetary activism drove down the yen (see Figure 17). It is also why Kuroda's negative rate policy proved so unpopular with households and, therefore, unpopular with Japanese politicians tuned in to the voters - just as it was also unpopular with banks because of the policy's further contribution to Japanese banks' long declining net interest margins (see Figure 18).

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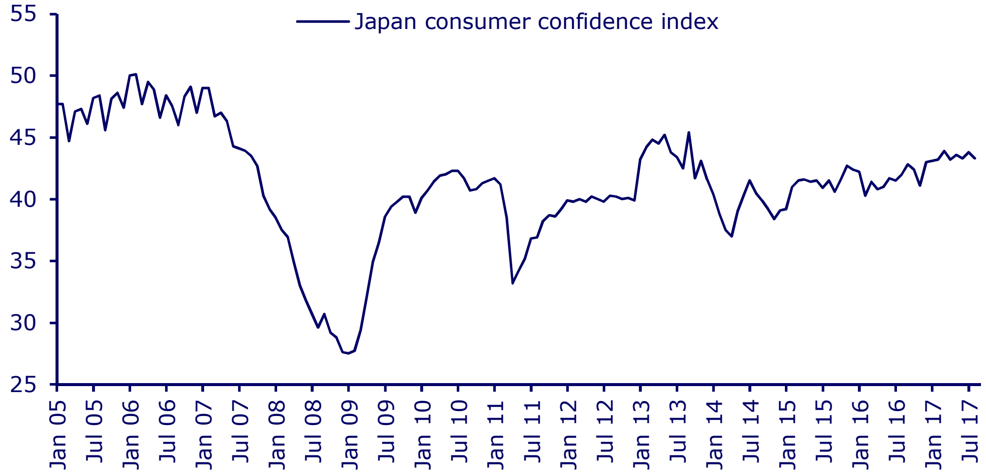
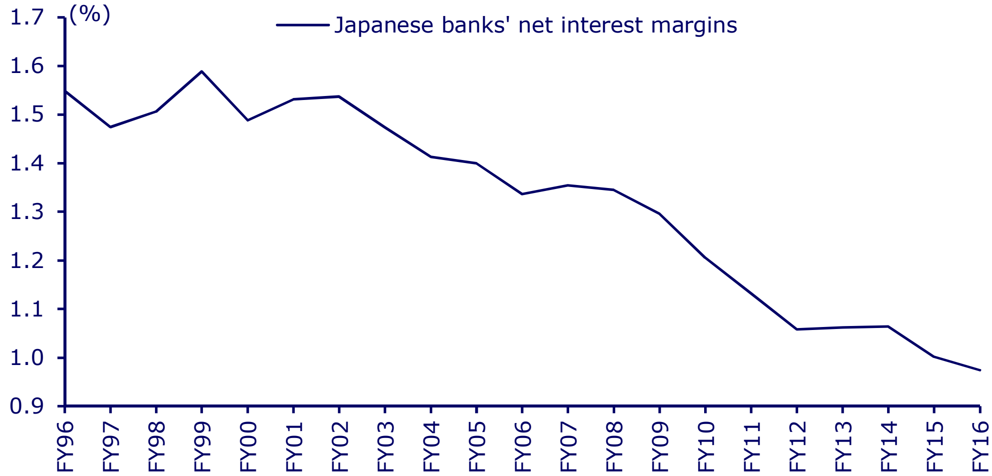
Figure 17
Japan consumer confidence index



Note: Seasonally adjusted. Source: Japan Cabinet Office

Figure 18
Japanese banks' net interest margins



Source: CLSA, CEIC Data, Japanese Bankers Association (JBA)

The other reason why the relationship between the weak yen and a positive stock market is fading is because, as has been pointed out of late by CLSA's Japan strategist Nicholas Smith, domestic companies account for a rising share of profits (see CLSA research *Benthos – ROEs and buyback potential*, 4 September 2017). Thus, non-manufacturing sector profits are now 75% larger than manufacturing profits, compared with 39% in 2007 (see Figure 19). This in part reflects the increased focus on profitability by domestic companies as a result of growing pressure to change behaviour, whereas Japan's big exporters were always much more efficient because they have had to go up against international competition. There is also from a currency standpoint the reality that much Japanese exporters' production has already been moved offshore. Japanese manufacturers' overseas production ratio has risen from 17.2% in 2011 to 21.4% in 2016 (see Figure 20).

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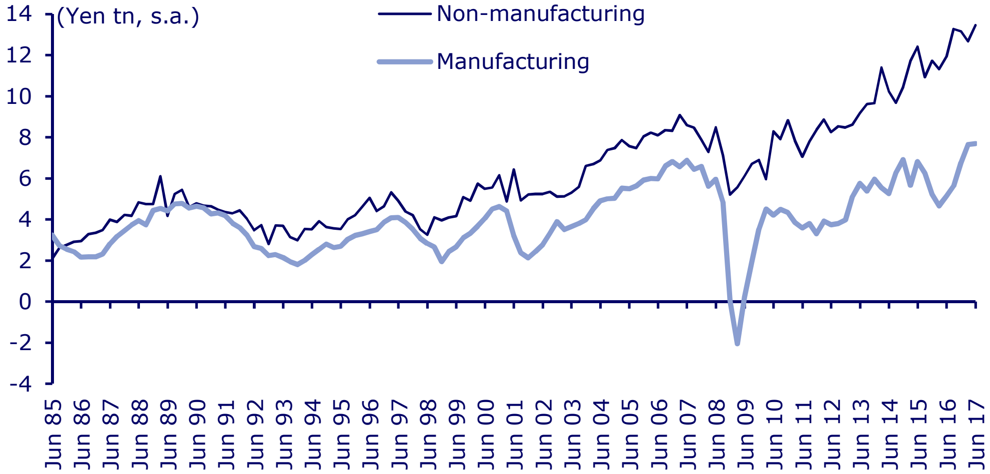
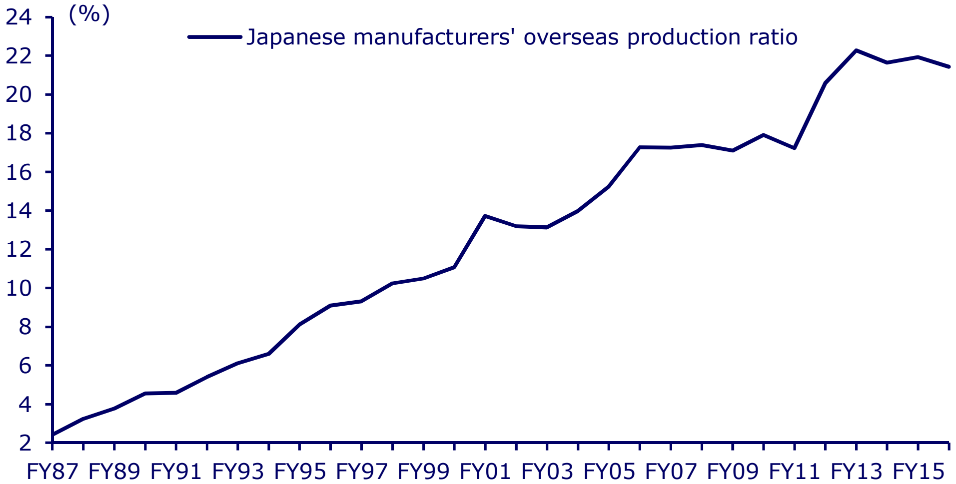
Figure 19
Japan corporate profits breakdown



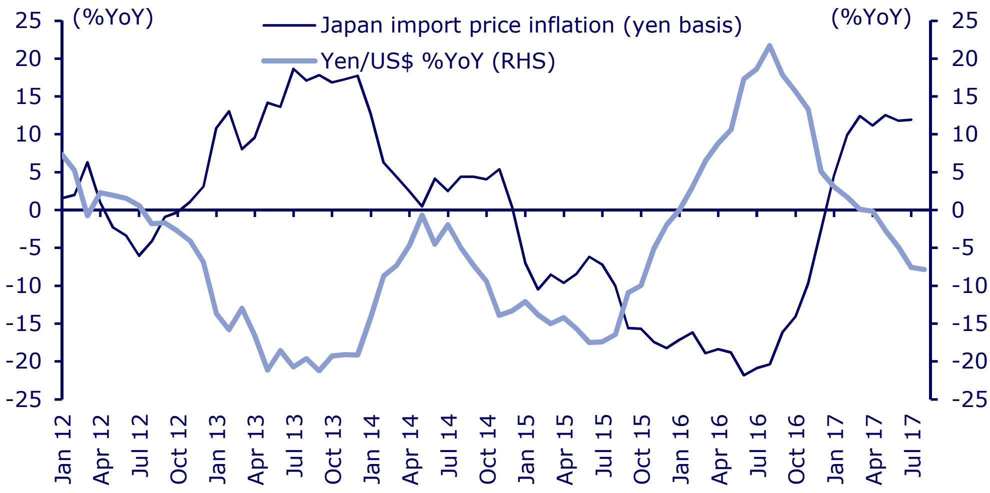
Note: Japanese non-financial corporates with capital over ¥10m. Source: Ministry of Finance - Financial Statements Statistics of Japanese Corporations

Figure 20
Japanese manufacturers' overseas production ratio



Source: Japan Cabinet Office - Annual Survey of Corporate Behaviours

Figure 21
Japan import price inflation and Yen/US$ %YoY



Source: CLSA, CEIC Data, Bank of Japan

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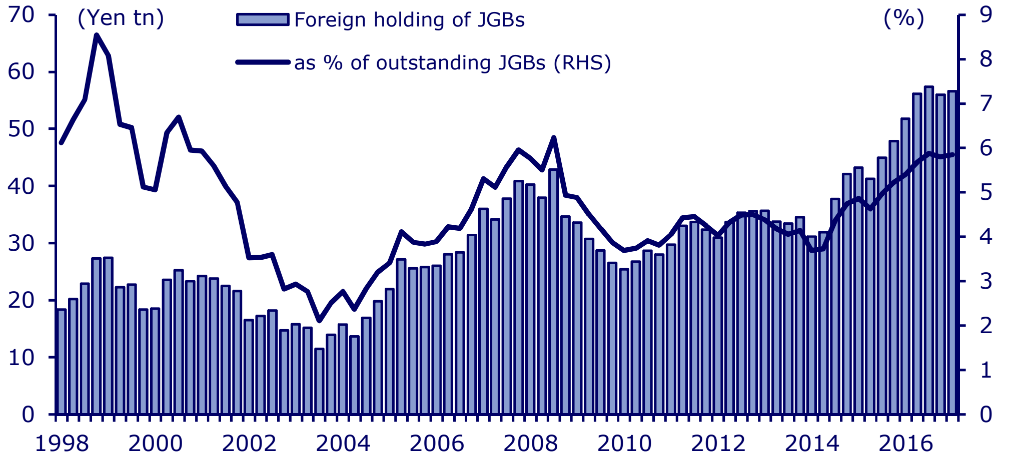
But to return to the subject of monetary policy, a sharp decline in the yen is more likely to prove a curse than a blessing given the destabilising impact on consumer confidence, most particularly if a weak yen prompted a surge in imported inflation which destabilised JGBs. While an extreme outcome, this becomes a more plausible risk the more foreign ownership of JGBs rises. Foreign holdings of JGBs have increased from ¥31tn or 3.7% of the total at the end of March 2014 to ¥57tn or 5.8% of the total at the end of March 2017 (see Figure 22).

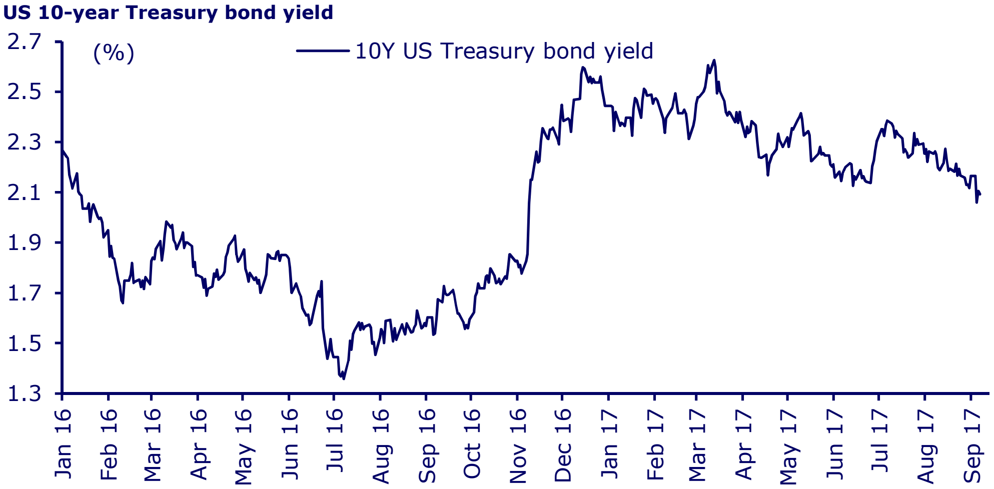
Figure 22
Foreign ownership of JGBs



Note: Central government securities and FILP bonds, not including treasury discount bills. Source: Bank of Japan – Flow of Funds Accounts

The above points are made to highlight that the Kuroda obsession with a weaker yen as a positive is outdated and quite possibly counterproductive, even if *GREED & fear* will admit that investors can make a lot of money quickly owning Japanese financials stocks on a currency hedged basis the next time there is a dramatic yield curve steepening in America. But on this point it also needs to be considered what happens if the reverse happens. For if some event leads to a sudden risk-off move in markets, and a related plunge in Treasury bond yields from current levels, the yield curve control policy will prove wholly counterproductive since BoJ purchases of JGBs will send yields even more negative. While if the BoJ refrains from purchases to maintain its JGB yield target then the pressure will be taken in a much stronger yen.

Figure 23
US 10-year Treasury bond yield



Source: Bloomberg

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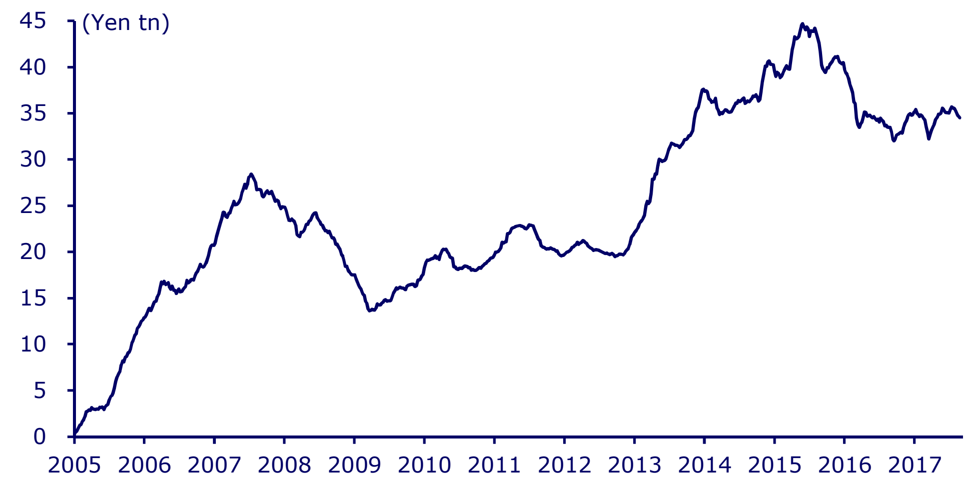
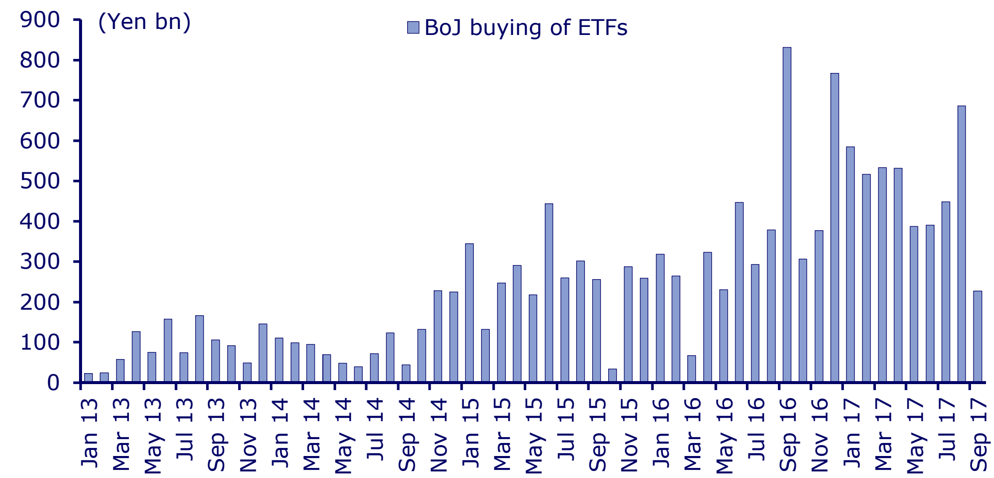
This is a context where Kuroda would be forced to abandon yield curve control because the policy will be seen to have exacerbated deflationary pressures, just as he was also forced in effect to abandon the negative rate policy in September 2016 for similar reasons. But for now the US yield levels are at neither extreme (ie, the US 10-year Treasury bond yield is not above 3% or below 1.5%) which means a relatively quiet life for now for the BoJ Governor. In this respect he might well be advised to step down next April assuming if, and it is an assumption perhaps unlikely to be complemented by reality, the 10-year Treasury yield remains in the same trading range of 37bp it has been in during the past five months (see Figure 23).

Figure 24
Cumulative foreign net buying of Japanese stocks



Note: Data up to the week ended 2 September 2017. Source: Ministry of Finance

Figure 25
BoJ buying of ETFs



Note: Data up to 6 September 2017. Source: Bank of Japan

The above analysis may seem overly focused on monetary policy given other positives in Japanese equities, such as rising profits and improving corporate governance. In this respect, *GREED & fear* will admit to surprise that foreigners have remained net sellers of Japanese shares year to date despite the significant growth in reported earnings. Thus, foreigners have sold a net ¥311bn worth of Japanese equities so far this year, after selling a net ¥5.7tn in 2016 (see Figure 24). One explanation is better stories elsewhere, such as the emerging markets and the Eurozone. Another could be the lack of credibility of a stock market where the central bank feels it is necessary to buy ¥6tn stocks a year (see Figure 25). This inevitably prompts concerns about what will happen when the BoJ sells its equity holdings, current totalling ¥21tn. Another

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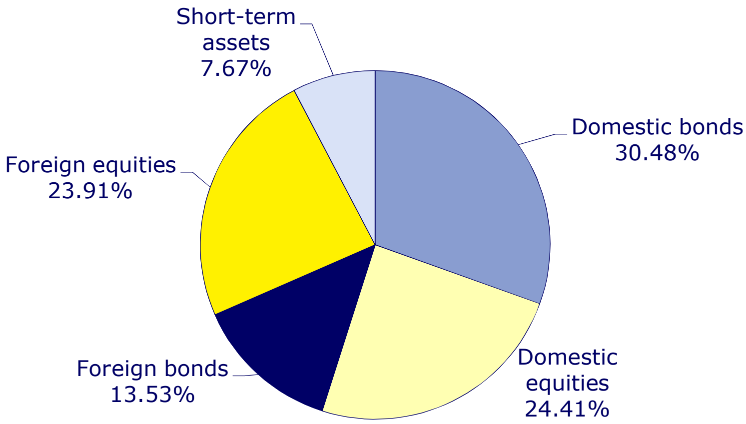
problem, courtesy of Kuroda, remains that the high beta nature of the monetary policy makes the market at the top-down level very sensitive to inflection points in such policy.

Meanwhile, there is no doubt that corporate governance continues to improve driven by top-down pressure from the Abe Government. The main driver of this process remains the Financial Services Agency (FSA) under its forceful leader Nobuchika Mori. The so-called "stewardship code" for institutional investors, first introduced in 2014, was revised in May while *GREED & fear* hears that discussions are now in place for a revision next year in the corporate governance code for corporates, which was launched in June 2015.

The dual approach is starting to work in the sense that growing pressure from the buy side is beginning to drive change at hitherto reluctant corporates. One aspect of this is that, following this year's revision, a growing number of institutional investors are starting for the first time this year to disclose detailed voting results at shareholder meetings. *GREED & fear* met one major institutional fund management firm this week which set up a year ago a so-called "responsible investment department". This is charged with three main functions. They are engagement with companies, administering proxy voting and integrating "environmental, social and governance" (ESG) policy into the investment process.

Figure 26

Japan GPIF asset allocation at the end of June 2017



Note: Total assets = ¥149tn at the end of June 2017. Source: GPIF

It should also be noted that the stewardship code applies to passive investors as well as active. This is important given that indexing is, unfortunately, very popular in Japan reflecting the longstanding local bias in favour of mechanical approaches to investing. Thus, the Government Pension Investment Fund (GPIF) has almost 25% of its ¥149tn of assets under management invested in Japanese equities (see Figure 26). Out of this total 90% is invested in index strategies, mostly indexed to Topix. Still not all of them are strictly passive in the sense that the index could be theme based. In a sign of the politically correct times the GPIF has just come up with three ESG indices.

Meanwhile, the change in the buy-side is spreading beyond specialist institutional investors to more conservative institutions such as trust banks and life insurance companies. The Pension Fund Association is seeking to set up a so-called collective engagement so that for example, trust companies, which manage pension funds, can exercise their votes more effectively. Some major life insurance companies, though not all, also plan to start disclosing their voting results. This is remarkable to *GREED & fear* given that these ultra conservative institutions would historically be very wary of upsetting longstanding corporate customers.

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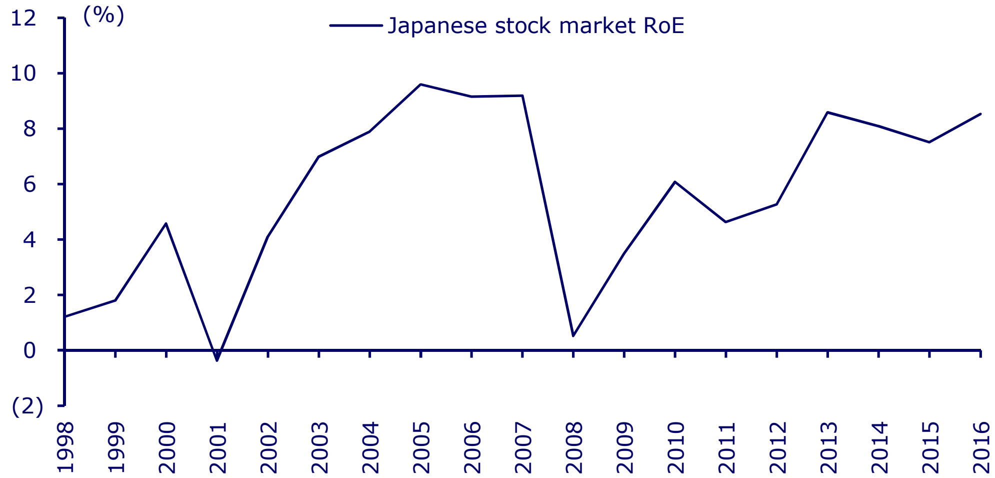
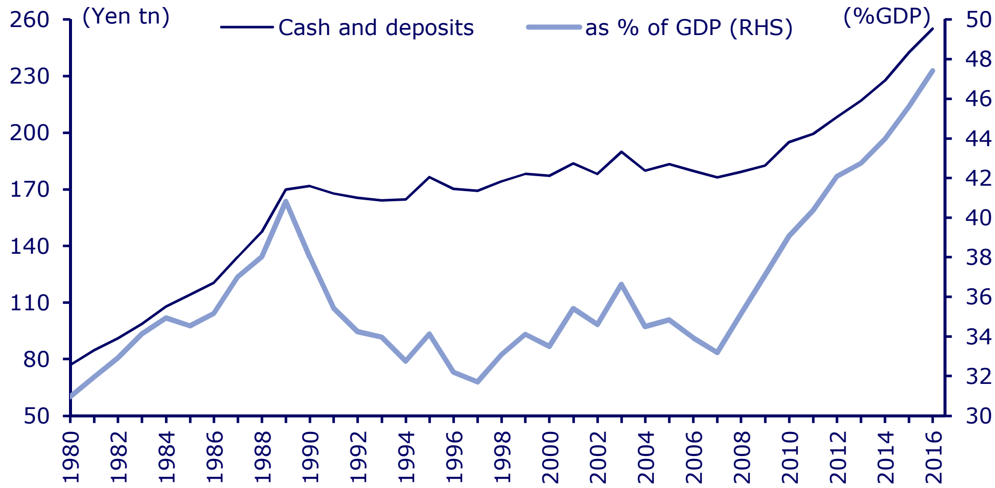
The growing pressure from the buy-side means that large corporates are much more aware than they used to be about pressure for higher dividend payouts or a higher return on equity. Still there is also a sense that the ceiling has been reached, following targets set by Professor Kunio Ito in 2014, namely a minimum 8% RoE and a 30% dividend payout ratio. This is, perhaps not coincidentally, around the current level of RoE and payout ratio in the Japanese market. Non-financial companies listed in Japan had an aggregate RoE of 8.5% in FY16 ended 31 March and a dividend payout ratio of 33% (see Figure 27). Meanwhile, for all the positive change, it is still a fact that the cash hoard of listed companies continues to grow in Japan. Private nonfinancial corporations' cash and deposits rose by 5.1% YoY to ¥255tn or 47.4% of GDP at the end of March, according to the Bank of Japan's flow of funds data (see Figure 28). This cash hoard reflects both conservatism as well as caution about business prospects.

Figure 27
Japanese stock market RoE



Note: All non-financial stocks listed in TSE 1st, 2nd, Mothers sections and JASDAQ. Fiscal years beginning 1 April. Source: Japan Exchange Group

Figure 28
Japan private nonfinancial corporations' cash and deposits



Note: Fiscal years beginning 1 April. Source: Bank of Japan – Flow of Funds Accounts

GREED & fear would still view the high cash levels as a positive in the sense that it highlights the continuing potential for a change in corporate behaviour. It is also the case that change at the corporate level is happening but in an incremental Japanese way. True, this year the pace of share buybacks has slowed markedly. But it is hoped this will accelerate in the next four months. Topix share buybacks have declined by 34% YoY so far in 2017 to ¥3.4tn (see Figure 29).

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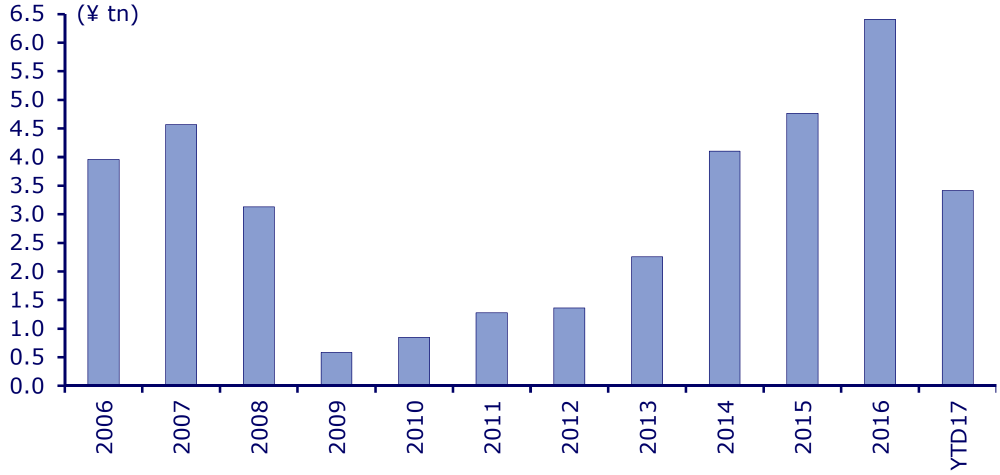
Figure 29
Topix share buyback announcements



Note: YTD17 = January-August 2017. Source: CLSA, Bloomberg

Meanwhile it is important to understand that the pressure for change is coming from the Abe Government. If for whatever reason Abe disappeared from the scene, and the Abenomics agenda with it, many corporates would instinctively prefer to go back to business as normal. Still that is not the case right now. With his popularity having, as already noted, started to recover as a result of North Korea (see Figure 1), Abe looks for now set to be in power until September 2021 assuming he is re-elected as president of the LDP next September. By then a lot of these changes should have become more entrenched. Meanwhile, at the corporate level executives should have also become more motivated by the increase in option-related pay. In this respect, one aspect of corporate governance reform is to remedy the fact that senior Japanese executives have long been severely underpaid relatively to their foreign counterparts while their pay was not linked to the share price. This is slowly changing. As of March multi-year stock option programmes had been adopted by 375 companies up from only 16 five years ago.

Finally, a change will be made in the Japan long-only thematic portfolio. The investment in Japan Airport Terminal will be removed and replaced by an investment in pharmaceutical maker Ono Pharma (see Figure 30). The investment case for Ono Pharma can be found in a recent CLSA research report by Tokyo-based healthcare analyst Stephen Barker (*Ono Pharma – King of immuno-oncology*, 20 July 2017).

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Figure 30

Japan absolute-return long-only thematic portfolio

Theme	Weight (%)	Stocks	Description	Weight (%)
Real Estate	4	Kenedix	real estate asset manager	4
Transportation	4	East Japan Railway	railway company	4
Autos	17	Isuzu Motors	truck maker	5
		Suzuki Motor	automaker	4
		Toyota Motor	automaker	4
		Toyota Industries	auto part maker & logistics	4
Machinery	18	Keyence	optical-sensor maker	5
		Fanuc	industrial robot maker	5
		Nabtesco	precision gear manufacturer	4
		Toshiba Machine	industrial machinery manufacturer	4
Consumer	18	Tsuruha Holdings	drugstore operator	6
		Seven & I	convenience-store operator	4
		Sony	consumer electronics maker	4
		Recruit Holdings	recruitment company	4
Financials	17	Dai-ichi Life	life insurer	6
		T&D Holdings	life insurer	6
		Zenkoku hosho	mortgage guarantee company	5
Construction	4	Taisei	general contractor	4
Infrastructure	6	Kyudenko	infrastructure construction	6
Gold mining	5	Sumitomo Metal Mining	gold & non-ferrous metal miner	5
Healthcare	7	Hoya	optical glass maker	4
		Ono Pharma	pharmaceutical maker	3

Source: CLSA

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Companies mentioned

Dai-ichi Life (N-R)
Fanuc (6954 JP - ¥21,100 - BUY)
HIS (9603 JP - ¥3,470 - BUY)
Hoya (7741 JP - ¥6,056 - BUY)
Isuzu Motors (N-R)
Japan Airport (9706 JP - ¥3,890 - U-PF)
JR East (N-R)
Kenedix (N-R)
Keyence (6861 JP - ¥57,140 - O-PF)
Kyudenko (N-R)
Nabtesco (6268 JP - ¥3,910 - O-PF)
Ono Pharma (4528 JP - ¥2,198 - BUY)
Recruit (6098 JP - ¥2,346 - BUY)
Seven & I (3382 JP - ¥4,267 - O-PF)
Sony (6758 JP - ¥4,258 - BUY)
Sumitomo MM (N-R)
Suzuki Motor (7269 JP - ¥5,698 - O-PF)
T&D Holdings (N-R)
Taisei (1801 JP - ¥1,138 - O-PF)
Toshiba Machine (N-R)
Toyota Industries (6201 JP - ¥5,800 - BUY)
Toyota Motor (7203 JP - ¥6,235 - BUY)
Tsuruha (N-R)
Zenkoku Hosho (7164 JP - ¥4,445 - BUY)

The above shows our fundamental ratings on these stocks.

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