Rising Sun, Setting Sun
Prime Minister Shinzo Abe’s “three arrows” plan to escape deflation and revive Japan’s economy ignited a rally in Japanese equities—and a big decline in the yen.

Is Abenomics another false dawn? This is no academic matter. Japan is still the world’s third-largest economy and a big weight in many foreign investor portfolios. We gathered in Tokyo to debate Japan’s uncertain future. Our main conclusions:

- We are struck by the broad support for Japan’s reform agenda. What is different this time? A national sense of urgency this is Japan’s last chance to revitalize in the face of a fast-growing rival: China.

- The first two arrows of Abenomics—monetary easing and fiscal consolidation—have driven Japan to the base camp of the mountain. Now the private sector must take the reins and embrace risk. The trek ahead looks more like Everest than Mount Fuji.

- The Bank of Japan (BoJ) appears fully committed to doing whatever it takes to hit a 2% inflation target. A weaker yen helps—but the broader economic impact of currency depreciation is limited. Japanese exporters have shifted much of their manufacturing capacity overseas.

- Wage growth is key to rekindling inflation. Recent salary hikes by big companies such as Toyota (and labor shortages in sectors such as construction) are encouraging signs. The key question? Will small- and medium-sized enterprises (which provide 70% of jobs) follow?

- Japan’s huge debt load (243% of GDP) is a worry. The BoJ’s largesse should keep a lid on Japanese yields for the time being—but without stronger economic growth (and a healthy dose of inflation), it is hard to see Japan escaping its debt trap.

- Key reforms are deregulating inefficient sectors such as retail and agriculture, improving corporate governance and cutting corporate taxes. Plans to designate (parts of) Tokyo and other major cities as “special economic zones” could help revitalize corporate Japan. Entrepreneurs welcome!

- A proposal to cut the bond allocation of Japan’s $1.2 trillion Government Pension Investment Fund (GPIF) could herald a broader shift by Japanese investors into equities and alternatives (including foreign assets).

- A rise in Japan’s consumption tax from April could slow growth in the near term (as it did the last time Japan raised the tax in 1997). Monetary policy combats deflation, but is unlikely in itself to boost economic activity.

**SO WHAT DO I DO WITH MY MONEY?®**

- **Stock up on Stocks:** Improving earnings should support Japanese equities. Focus on shareholder-friendly companies.

- **1980s Redux:** Consider Tokyo real estate. Ample liquidity and cheap financing are boosting condo prices. Falling vacancies point to rising commercial rents.

- **Beware of Bonds:** BoJ buying will support JGBs for the time being—but the risk of yield spikes looms in the longer term given Japan’s debt load.

- **One-Way Street:** Further yen declines are likely given BoJ largesse—but beware crowded trades. (The yen could rise if China’s economy crashed, for example.)
JAPAN’S LAST CHANCE

Abe has unfolded a “three arrow” plan to reverse two decades of sluggish growth and deflation. This moniker comes from an ancient Japanese proverb that says one arrow can be easily broken, but three bound together cannot. The three arrows are monetary easing, fiscal consolidation in the medium term and structural reform (deregulation).

Previous bouts of optimism on Japan petered out as many promised reforms were thwarted by vested interests. Why should we believe this time is different? A few reasons:

- Territorial spats with China have strengthened a sense of urgency that Japan must get its act together—or risk becoming a second-rate economy at the mercy of its larger neighbor. The policy elite and some business leaders view this as a last chance for Japan to reform.

- Abe’s strong approval rating (near 60%, recent polls show) means there is a good chance he will have three to four years in power to see through reforms. Japan had six different prime ministers in five years before Abe took power in 2012.

- Japan is the only major country in the world today with fully aligned monetary, fiscal and reform strategies. Its ability to execute is another matter.

Markets have welcomed Abe’s agenda. Japanese equities have risen sharply, Tokyo condo prices are climbing again and the yen has sharply declined. See the charts above. Land prices in Japan’s largest cities rose for the first time in six years in 2013. A weaker yen has historically given a boost to Japanese equities, but its impact could be waning. Japan’s manufacturers have shifted much of their production overseas. Nissan, for example, only makes around 20% of its cars in Japan.

The BoJ is determined to break the shackles of deflation with massive monetary easing. It plans to keep expanding its balance sheet by buying Japanese government bonds (and also equity ETFs and REITs) until its 2% inflation target is hit. The central bank expects to hit this target in around two years—and has suggested it is willing to push even harder and longer (well into 2015) if the goal is not met.

The BoJ is the only major central bank in the world that still has its foot on the monetary accelerator. The size of its balance sheet is set to reach around 58% of GDP by the end of 2014, dwarfing the scale of monetary expansion by the Federal Reserve, European Central Bank (ECB) and Bank of England (BoE). See the chart below. The ECB’s balance sheet has been contracting as banks repay their long-term refinancing operations (LTROs), the Fed is already winding back its bond purchases, and the BoE is on hold.

MONETARY GODZILLA

Central Bank Balance Sheets, 2006–2015

Sources: Thomson Reuters and BlackRock Investment Institute, March 2014.
Notes: Dotted line is a BoJ projection based on a balance sheet of 290 trillion yen at end 2014.
**INFLATION, PLEASE**

The BoJ's hope? Expectations of inflation will spark a virtuous circle of spending by consumers, greater risk taking by corporate Japan and rising economic activity. The problem: Japanese are still suffering from deflation trauma. Prices (ex food and energy) have barely regained late 1990s levels, BoJ data show.

What might push inflation higher?

- Big Japanese firms, including Toyota and Panasonic, in March hiked base wages for the first time in years. The key question: Will small and medium enterprises (which make up 70% of employment) follow? This could take time.
- Japan's aging population has led to labor shortages (think construction and nursing). There are two jobs for each applicant in the construction industry, according to JPMorgan. This should lead to rising wages.
- Japan's potential growth rate is steadily declining as its working age population shrinks. Low potential GDP growth (around 0.7% according to the IMF) means even moderate economic expansion could quickly lead to rising inflation.
- Vacancy rates in the pivotal Tokyo property market are falling sharply, according to Mitsui Fudosan. This suggests rental increases are just around the corner—and rent makes up 25% of Japan's CPI.

Wage growth in Japan is still muted—and inflation is creeping toward the BoJ’s target. See the chart on the top right. A weaker yen could help. Japan’s inflation rate tends to rise 0.2 percentage points for every 10% fall in the yen, BNP Paribas estimates. Yet a dramatically weaker yen would hurt many smaller Japanese companies that rely on imports (and upset Japan’s trading partners).

**ECONOMIC SUICIDE?**

Hikes in Japan’s consumption tax could slow the economy, making it harder for the BoJ to hit its inflation target. The government plans to raise the tax to 8% from 5% in April, and again to 10% in October 2015. Some economists view the move as economic suicide. Fiscal consolidation is critical (see sidebar below)—but could snuff out a budding recovery and hurt fiscal sustainability if it comes too fast.

Policymakers expect little impact from the tax hikes. We are less confident. A supplementary budget in 2014 will make up for around two-thirds of the hit from the tax hike, but around 40% of the spending is based on (slow moving) public works projects. There are signs some consumer spending has been sucked forward ahead of April to avoid the tax hike.

**HIGH-WIRE ACT**

Japan’s public finances are on a perilous path. Years of fiscal stimulus and sluggish growth have left it with a debt-to-GDP ratio of 243% (the highest in the G7), according to the IMF. The nightmare scenario? A spike in JGB rates triggers a fiscal crisis. The BoJ is currently buying the equivalent of 152% in net monthly issuance, according to the Japan Securities Dealers Association. Its buying is concentrated in short to medium maturities. See the chart on the right. Could long-term rates spike if inflation takes off or the government loses fiscal credibility? Unlike for now (but long-term risks are huge). The BoJ would likely shift its buying to longer maturities in this case. Steady buy-and-hold investors such as life insurers and pension funds dominate these maturities. Foreign investors hold only a tiny share.
WANING POTENTIAL
The government’s 2% GDP growth target is very ambitious. Japan’s working age population is shrinking at the pace of 0.6–0.7% a year, according to the BoJ. Even with 2% productivity growth (not seen since the bubble years), Japan’s real GDP would grow at just 1.3% a year.

Around 41% of Japan’s population will be aged over 60 in 2040, versus 17% in 1990, United Nations projections show. See the left chart above. A rise in the female participation rate could help slow the decline in the working age population. Many Japanese women are forced to choose between child-raising and continuing their careers. As a result, just 48% of Japanese women are in the labor force, versus 57% in the United States, according to the World Bank. A recent uptick in the participation rate is an encouraging trend. See the right chart above.

Which aspects of Abe’s growth strategy are investors most fixated on? Japanese investors are more concerned about inflation, while foreign investors are six times more focused on reform, our text analysis of broker research reports on Japan suggests. See the charts below.

Why does this matter? Foreign investors dominate trading in Japanese equities, with a 60% share of volume on the Tokyo Stock Exchange. The share is disproportionate—foreigners own just 26% of Japanese equities. Perceptions of progress on Abe’s third arrow will likely have a big impact on equity prices. Reforms to develop a stronger equity culture could reduce Japan’s reliance on foreign investors. Japan introduced the Nippon Individual Savings Account (NISA) in January, a tax-free investment account aimed at younger savers. Uptake has been slow so far, but we would expect this money to be sticky.
**DUAL ECONOMY**

Japan has world-class exporters in industries such as machine tools and autos—but vast swathes of its economy suffer from low productivity because of regulations that shield them from competition. This is particularly true in domestic sectors such as retail and agriculture.

Innovation itself is not the problem. Four of the top ten corporate patent owners in the United States are Japanese, according to the U.S. Patent Office. Yet many of these companies lack focus and have poor return on equity (ROE). Think sprawling conglomerates such as Sony versus focused U.S. competitors such as Apple. The average ROE of Japanese companies is around half that of their U.S. counterparts. See the chart below.

Poor corporate governance is part of the reason. Consider:

- More than 40% of Japanese shares are “cross held,” TSE data show. Banks, corporations and insurers often hold shares of their business partners. This often means little pressure is exerted on management to act in the interest of other shareholders.

- Japanese companies have few independent directors on their boards (and few appropriate candidates)—even compared with companies in emerging markets such as Brazil and India. Just 3% of Japanese corporate boards have a majority of independent directors, versus 64% of South Korean boards. See the chart on the top right.

- Banks play a much bigger role in Japan’s financing system than in the United States. This means Japanese companies are less subject to the discipline (and whims) of the capital markets. Japanese nonfinancial companies rely on bank loans for 34% of their financing, compared with less than 10% for U.S. companies, data from the BoJ and Fed show.

**MIND THE GAP**

Japan and US Return on Equity, 1975–2014

[Chart showing ROE for Japan and the United States]

Sources: MSCI and BlackRock Investment Institute, March 2014.

**CORPORATE MAKEOVER**

What are the prospects for change in corporate Japan?

- A proposed “comply or explain” rule will encourage more Japanese companies to hire independent directors. This is a welcome move—but we wonder if there is enough talent to fill the boards.

- Cross shareholding in Japan is on the decline (down from a peak of almost 70% in the mid-1980s), while foreign investors’ ownership share has risen fivefold since 1990. More foreign ownership increases pressure on Japanese management to put shareholders first. (More buybacks and dividends, anybody?)

- Private equity could help unlock “hidden jewels” on the balance sheets of large Japanese companies. The future of Japan Display (a carve-out of Sony, Hitachi and Toshiba’s LCD display divisions) will be an important test case. The company fell 15% on the day of its March IPO—not an auspicious debut.

Japan needs a breakout of entrepreneurship and risk taking. Japanese corporations have been saving to the tune of 8% of GDP a year for the past decade, according to Nomura Research Institute. And Japanese households hold 1,600 trillion yen ($15.6 trillion) in financial assets, with 54% (roughly equal to the GDP of Germany, France and UK combined) locked up in cash, according to BoJ data.

U.S. households hold just 13% in cash, Fed data show. If Japanese investors were to raise their equity allocations (currently 8.5% versus 33% for U.S. savers) by just three percentage points, it would triple the (record) amount of Japanese equities bought by foreign investors last year.
THIRD ARROW
The third arrow is key to revitalizing corporate Japan and lifting the country’s growth potential, we believe. See the table below for key dishes on Abe’s reform menu (in descending order of likelihood). Previous Japanese attempts at deregulation have run aground after strong opposition from powerful lobbies. Agriculture and immigration are particularly sensitive, given Japan’s history of isolation and protection of rice farmers.

One promising plan: special economic zones. The Abe government hopes the zones (likely including Tokyo) will become test beds for deregulation of agriculture, healthcare and labor markets. The idea has been used successfully in China and more recently Dubai. The key question: Will Japanese businesses take the reins and start taking risks again?

MISSION IMPOSSIBLE
Reform of Japan’s $1.2 trillion GPIF is important—and may actually happen. The fund has a 55% allocation to JGBs (as of December) versus 30-40% bond allocations for pension funds in other countries. The fund’s real return target of around 4% looks an impossible mission given JGBs yielding a nominal 0.6%. An advisory panel recommends a shift into equities and alternatives (including foreign assets). If other big Japanese funds follow, this has big implications for asset prices (good for Japanese equities; bad for the yen).

We are cautiously optimistic the GPIF reforms will go ahead. Other items on the government’s reform agenda will move slowly—or not at all. The important thing is to keep an eye on the overall trajectory. The announcement of special economic zones and a detailed reform plan in June will be key signposts.

KAISEKI REFORM MENU
Key Third Arrow Reform Proposals

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<td>Energy Policy Reforms</td>
<td>• Implement new nuclear safety standards and restart reactors. &lt;br&gt;• Electricity deregulation establishes national power grid and allows retail consumers to choose their provider.</td>
<td>How quickly can Japan restart its nuclear reactors (and improve its trade balance)?</td>
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<td>Special Economic Zones</td>
<td>• Major cities including Tokyo to be designated “special economic zones.” &lt;br&gt;• Zones will deregulate by stealth in areas such as agriculture and medical care.</td>
<td>The government can lead, but will entrepreneurs follow?</td>
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<td>GPIF Reform</td>
<td>• The $1.2 trillion pension fund has a 60% benchmark allocation to JGBs. &lt;br&gt;• Reform panel recommends a shift into equities, infrastructure and other assets.</td>
<td>How quickly will GPIF shift into risk assets—and can the JGB market absorb its selling?</td>
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<td>Corporate Governance</td>
<td>• Company Act recommends at least one independent director. &lt;br&gt;• Stewardship Code urges disclosure of proxy votes and conflicts of interest. &lt;br&gt;• New JPX Nikkei 400 Index created to track high ROE companies.</td>
<td>Is there enough talent to fill boards—and will corporate behavior really change?</td>
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<td>Corporate Tax Cuts</td>
<td>• Abe has proposed a cut in corporate taxes. &lt;br&gt;• Japan’s rate of 35.6% (from April) is well above OECD average of 25%.</td>
<td>Will risk-averse corporations just hoard any benefits from a tax cut?</td>
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<td>Labor Market Reforms</td>
<td>• Proposals include easing regulations on working hours and allowing the rolling over of temporary contracts indefinitely.</td>
<td>Can Japan reform its “lifetime employment” system and make it easier to hire and fire?</td>
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<td>Agricultural Reforms</td>
<td>• Proposals include allowing corporations to buy farmland (currently prohibited). &lt;br&gt;• Abolish “gentan” system that pays farmers to reduce rice crops. &lt;br&gt;• Trans Pacific Partnership (TPP) would force slashing of tariffs protecting farmers.</td>
<td>Will the U.S. Congress block the TPP, slowing efforts to pry open Japanese agriculture?</td>
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<td>Immigration Reform</td>
<td>• Reformers propose intake of 200,000 immigrants a year to slow population decline and ease labor shortages. &lt;br&gt;• Reform expected to focus on construction workers, nurses and caregivers.</td>
<td>Japan has a long history of isolation. Will anti-immigrant sentiment prevail?</td>
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