Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

OCTOBER 1, 2014

ABENOMICS ON TRIAL

Since the reelection of Shinzo Abe in December 2012, all things Japan have been all things Abenomics. The neologism refers to the three-pronged plan set forth by the bold liberal democratic party (LDP) leader to shake double-decade deflation, dangerous fiscal deficits, and doomed demographics. Here we review the three arrows of Abenomics (monetary, fiscal and structural), consider their effects, and speculate on how the current data might impact investor portfolios.

First, some context. Scholars and market participants alike know the recent history of Japan as "the lost decades." Lost, that is, because of the massive asset bubble which popped in Japan in the early 1990s. Stock prices and property prices reached their respective apexes in June 1990 and September 1991 as breakneck economic development and a slow-to-start rate hiking cycle ended (see chart below). Since then, Japanese GDP per capita has fallen from a peak of 84% of US per capita GDP to only 69% today, despite a shrinking population. What is more, after averaging 2.2% inflation from 1981-1991, Japanese consumer price inflation has averaged only 0.23% over the past 23 years.

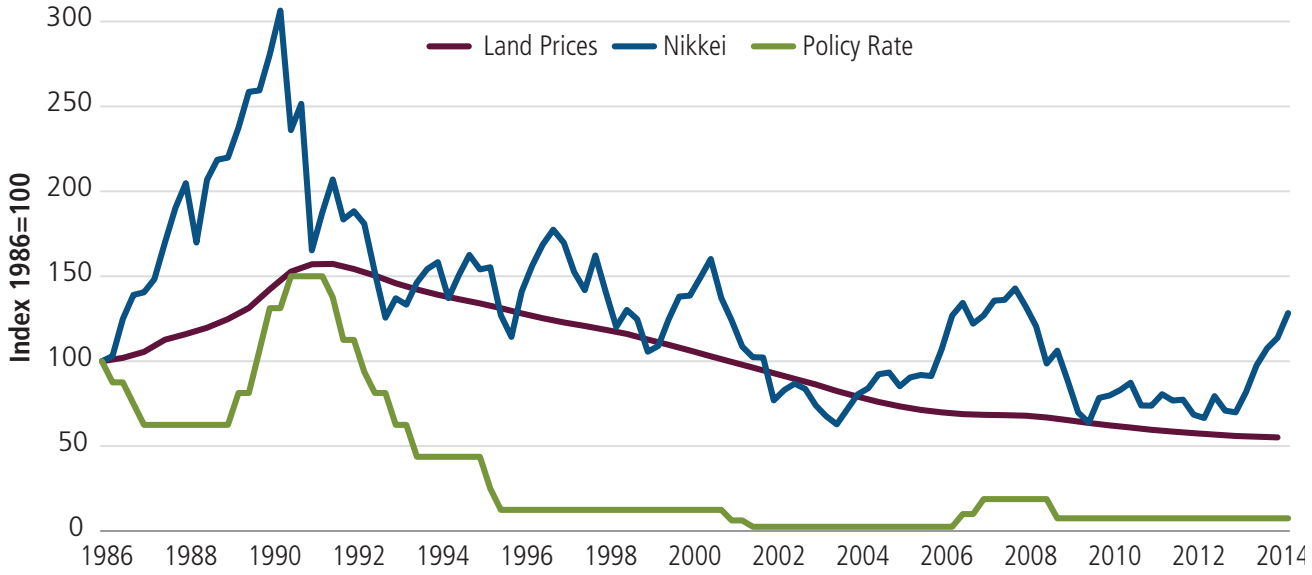
That brings us to 2012 and the much heralded reelection of Shinzo Abe (who had served as Prime Minister once before from 2006-2007). Promising to revive Japan, Abe came to office bearing three arrows of reform. The first arrow, enacted with Governor Kuroda of the Bank of Japan in January 2013, was monetary policy. Twenty years of de minimis inflation was to end as the Bank of Japan announced plans to double the monetary base, conduct open ended asset purchases and drive inflation towards a new 2% target.

Next up was fiscal policy reform: stimulus and discipline. Deploying a ¥13 trillion ($135 billion) one-time fiscal expansion, the Abe government planned to drive growth. But, in the face of 240% debt to GDP, the administration also recognized the need for fiscal discipline and committed to raising revenue through consumption tax hikes (one of which hit in Spring 2014, the second of which seems likely to hit in October 2015).

The final arrow will be a litany of "structural reforms." Meant to power potential growth higher, changes include everything from the Trans-Pacific Partnership trade agreement and industrial subsidies, to relaxed visa standards and higher female labor force participation. There is some evidence that these reforms have taken hold. Mr. Abe, in a recent editorial in the Wall Street Journal cited a 1.5x increase in the number of new entrants in utilities markets and 820,000 more women at work as the proof of progress. Some market metrics show similar signs of Mr. Abe's magic: from September 2012 (three months before his reelection) until today the yen has depreciated nearly 40% against the dollar and the Nikkei 225 rose 82%.

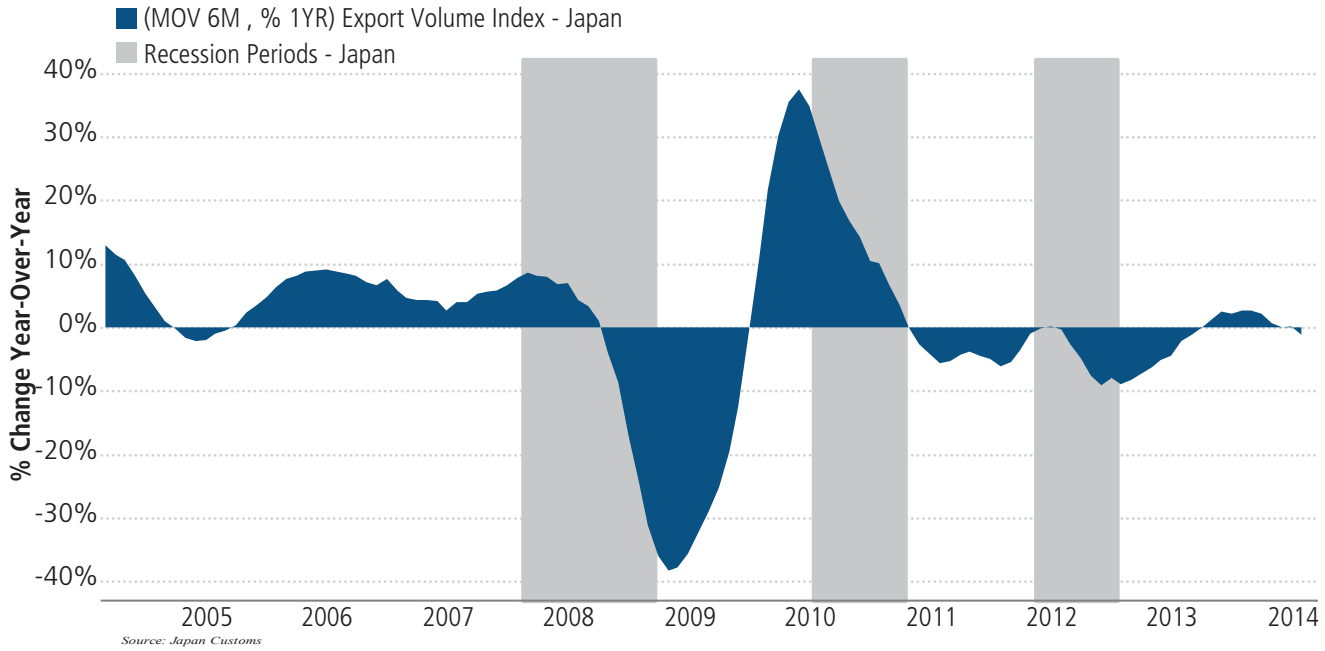
But most of the adjustment happened in 2013. This year, Japanese animal spirits met the ghostbusters. Despite the yen depreciation, exports growth has languished, and actually contracted over the last year in August (see chart at top of next page). Additionally, gross domestic product (GDP) contracted -0.1% annualized during the first half of the year, led by a -35.3% annualized quarterly drop in private housing investment in Q2—a fact not purely attributable to pay-back after the consumption tax hike boosted Q1 GDP numbers.

JAPANESE STOCK PRICES, LAND PRICES, AND INTEREST RATES HAVE YET TO RETURN TO 1990-91 HIGHS



Source: Bloomberg, Japan Real Estate Institute

LOWER YEN, MORE EXPORTS? NOT AT ALL, IN FACT EXPORTS ARE CONTRACTING YEAR-OVER-YEAR



Hopes of making the 2% inflation target by 2015 look increasingly delusional as well. If we subtract 2% from headline inflation to account for effects related to tax-related spending, headline inflation has averaged 1.5% year-over-year growth in 2014. Excluding volatile food prices, annual inflation this year has been closer to 1.3%. Despite a weaker yen, declining commodity prices (especially in 2014) have pushed inflation lower.

Most worrisome for investors, policy makers, and Japanese citizens is negative real wage growth. Real wages were lower in 2013 than they were in 1990, averaging annual declines of -0.05 % per year (see chart below). The limited success the Bank of Japan has had boosting inflation did not compel corporations to pay their employees more. In theory, real wage gains are the reward for increased productivity. When fewer workers produce more output, each marginal contribution is more valuable: they share a bigger pie with fewer people. We shouldn't be surprised to find recent empirical research suggesting that long-term growth expectations, not monetary policy, exert the most pressure on trends in Japanese basic wage growth.

For investors, the consequences of Abenomic's shortcomings are less clear. The yen is weaker versus the dollar, but perhaps this has more to do with investors' views about the US central bank than with Japan's success for Abenomics. And the Japanese government bond (JGB) market has other ideas. Since Abe assumed office in December 2012, the yield to maturity on the 10-year benchmark government bond has declined from 77 basis points to 54 basis points, and the total return for the 7-10 year part of the curve in has been + 3%. If inflation is coming to Japan to stay, bond traders are not worried.

WILL INFLATION BOOST REAL WAGES AND CONSUMPTION? IF NOT, THE BANK OF JAPAN IS GOING TO HAVE A BIG PROBLEM ON THEIR HANDS….