

# Schroders TalkingPoint



## Improving data add to optimism over Abenomics

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In the first half of 2013 we witnessed a significant positive change in investors' expectations for Japan. From late May onwards this optimism has been tempered somewhat due to a perceived hiatus in policy developments, together with a decision to increase the consumption tax next year and greater uncertainty over the external environment. Nevertheless, the underlying economic conditions in Japan have continued to improve, albeit gradually. So how does the country currently fare in terms of its appeal to investors?

### What the data say

Recent data on the Consumer Price Index support the view that a sustained exit from deflation is possible, particularly if the gradual tightening of the labour market can subsequently be translated into income growth.

Importantly, there is also a fledgling recovery in capital expenditure by Japanese corporates. This has taken up some of the slack from the slower momentum in consumption, which was evident during the summer. Meanwhile, the greatest benefit from the improvements in the economy is already being seen at the corporate level, with the interim results season showing strong aggregate profit growth. This should allow the recent positive trend in earnings revisions to continue.

### Inflation – winners and losers

Although some of the immediate economic benefits – especially from a weaker currency – have already been reflected in the equity market, the broader impacts of Japan's reflation have not been fully discounted. If Japan can transition successfully from deflation to inflation this will lead the overall equity market higher but there are likely to be winners and losers. Those companies with sufficient pricing power to pass on higher costs will benefit, while those negatively impacted by a tighter labour market and higher costs will come under pressure. In contrast to the early part of 2013, the market environment in 2014 is therefore likely to see a more stock-specific approach by investors as companies refine their business models to cope with the step-change in the economic environment.



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### Abenomics: fact or fiction?

Some view Abenomics as nothing more than a convenient façade, behind which Japanese politics is quietly reverting to its usual torpor. In the worst case scenario, Prime Minister Abe's apparent reformist zeal quickly dissipates and instead becomes bogged down on issues such as constitutional change and national security, further aggravating disputes with regional neighbours. In truth, however, the real key for Japan in the next 12 months is likely to be the



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commitment of the Bank of Japan to its 2% inflation target.

If monetary policy is aggressive enough and flexible enough to adjust to external factors, we can continue to see a 'normalisation' of Japan's economy in 2014, even in the absence of other policy initiatives. We therefore remain focused on valuations and economic data, and their likely impact on corporate profits – all of these are moving in favour of Japanese equities. In this environment, we can afford to wait for some time for a real verdict on whether Abenomics actually exists.

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