July 2010

Outlook for **Japan**

Like the game software developers looking to recycle old titles for Nintendo's new 3D format, Japan's Democratic Party (DPJ) is hoping to reset its political momentum with a newly chosen Prime Minister and cabinet. That this comes a few weeks ahead of an election for the Upper House of parliament could well prove to be fortuitous for both the party and its Prime Minister Kan. When the last long-serving leader of Japan, Junichiro Koizumi, obtained a mandate, it was in very similar circumstances to the current situation. That is, a deeply unpopular party chooses a new leader just ahead of an election, and the electorate gives him a sweeping victory that solidifies his ability to take relatively bold reforms over the objections of entrenched political factions. Prime Minister Kan could find himself in a position where he has somewhat of a free hand to pass policies and extend his tenure as Prime Minister well beyond the woeful nine months of his predecessor.

The initiatives he has highlighted leading up to the election include changes to the tax policy, which will likely bring two benefits. First, by lowering corporate tax rates, doing business in Japan becomes more economically feasible. Second, hiking the consumption tax could improve government finances and reduce the burden of bond issuance. While Japan's nominal corporate and individual tax rates are relatively high by international standards, the actual fiscal take is low, as avoidance schemes through corporate perks reduce taxes paid. We believe a consumption tax hike makes economic sense, and the adverse impact on individuals is relatively easily mitigated due to the ongoing deflationary pressures on the economy.

If Prime Minister Kan and the DPJ win the elections in July and pass the aforementioned tax reform, the stage could be set for Japan's domestic dynamic to become even more interesting over the remainder of the year. Already there is evidence of a modest recovery in domestic demand. Housing starts, auto sales, and consumer discretionary expenditures have flattened or begun to rise reasonably well in recent months. Regional initiatives have been initiated to improve tourism and direct investment, including zones for operating casinos and promotional campaigns directed overseas.

Meanwhile, the ongoing concern over budgetary deficits and the potential for global economic growth to slow in the second half of the year continues to hang over sentiment, leading to a fair amount of caution among corporations with large overseas businesses. While consensus expectations are calling for a further large upturn in earnings in this group, management is decidedly more downbeat. The potential for negative first-half earnings surprises from the automotive and consumer electronics sectors looks to be relatively high.

The most favorable valuation play in the market is represented by a spread of domestic-oriented companies, including financials, telecoms, construction and retailers. The average return on capital for this group of companies is currently higher than the TOPIX Index. Dividend yields are also higher, while price-to-book-ratio and price-to-earnings-ratio valuations are lower. Investor sentiment on the domestic economic environment remains very negative, which has led to an unprecedented valuation gap between these companies and the more globally focused firms.

As the DPJ moves to reset its political agenda and possibly gain some reformist zeal, the spotlight in the second half of the year is likely to turn towards the real conditions in the domestic economy. That Japan is holding up relatively better than many other parts of the world may come as a surprise, and cheaply valued domestic firms may lead investors to reset their portfolios to reflect this contrary and interesting opportunity set.

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NOTES:

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