

October 2011

Outlook on Japan

The Japanese economy is not typically known for its accelerating growth, but this is exactly the trend that has begun to emerge in parts of the economy that historically have been fairly sluggish. Some of this growth is a result of the supply shock delivered by the Tohoku earthquake in March. However, the magnitude of demand recovery in housing, commercial real estate, and private consumption suggests more of a structural shift in investor behavior than merely a cyclical rebound. Meanwhile, there is little evidence that a consensus policy response is near at hand, as lawmakers remain divided. In our view, the contrast between a private sector recovery and public sector paralysis is likely to remain a key construct of the Japanese environment for some time to come.

As we see it, domestic economic demand is being driven by a combination of post-earthquake anxiety and a fundamental need to improve housing and commercial property infrastructure. The knowledge that the Tohoku earthquake was but one of several seismic events that periodically threaten Japan, has boosted demand for structurally sound property. Seismologists estimate there is a greater than 90% probability that a quake with a magnitude of 8.5 or higher will strike both the Kanto and Tokai regions (which include Tokyo and Nagoya, respectively) at some point in the next 20 years.¹ Surveys suggest that some 30% of Japan's housing and commercial property stock would be rendered unusable were such a quake to occur.² Based on these results, we estimate that half of Japan's urban centers are in dire need of a rapid reconstruction of their infrastructure. Given improvements in construction techniques in recent decades, we believe this seismic risk can be mitigated, provided that the sense of urgency is sufficient to compel the private sector to take action.

Among individual consumers, a meaningful acceleration in housing demand appears to be underway. Yet, Japan's housing stock is aging rapidly. Historically, homes in Japan were built to last only 30 years, and the last great housing boom occurred in the early 1970s. This fact, combined with the coming-of-age of Japan's second baby-boom generation, implies that there should be a structural improvement in housing construction. This development has been hastened by the fear of losing homes built prior to the establishment of modern earthquake standards. The inertia prevalent throughout Japan's weak economy, though, appears to have finally ended. Housing construction has accelerated by 30% since the quake in March, and some observers estimate that housing demand will double from its 2009 lows.³

In our view, commercial property may experience similar demand growth. Potential new tenants are including earthquake safety standards in their assessments of new-space functionality. As may be expected, rents for robustly built new properties are rising, while rents for less well-constructed buildings are declining. This economic reality has spurred landlords to consider rebuilding property or risk the loss of tenants and income. In addition, recent improvements in private-sector construction demand reflect a renewed focus on worker safety, not just in Tohoku but nationwide.

We believe the implication for real economic growth from these accelerating growth trends is stark. Japan has not experienced a robust, secular growth dynamic in more than two decades. Financial markets remain mired in the belief that deflationary forces will persist and, as global economic growth remains uncertain, many investors may continue to shun equities. However, in our view, as growth surprises persist, deflationary pressures should diminish and the scope for continued profitability improvements should rise. Thus, we see an attractive opportunity set in the Japanese market, (i.e., low valuations and low expectations) in a better prospective and rapidly-changing environment. What's more, these opportunities are being driven exclusively by private enterprise.

In contrast to the progress made by the private sector, public officials have been slow to formulate constructive policy responses to this year's tragic events. Japan's newly-elected Prime Minister Yoshihiko Noda, appears to have won over the rank and file due to his self-effacing manner, a quality that may be perceived as integral for success in this role. Nonetheless, a proactive change in policy direction seems unlikely, in our opinion, if the track record of Japan's past several prime ministers is any guide. For those investors whose opinions about Japan are influenced by the mass media, continued coverage of ongoing political paralysis is likely to keep their interest at bay.

Private enterprise is finally driving growth against a backdrop of weakening global demand and uncertain political leadership. However, it is unclear how long this positive structural shift must persist in the face of political headwinds before equity valuations improve. While it would be advantageous to see Japan meaningfully decouple from the rest of the world, it may take multiple data points and a period of time before this trend firmly emerges.

Notes

- 1 Seismological Society of Japan, May 2011
- 2 Japan Association for Earthquake Engineering, July 2011
- 3 Sekisui House, May 2011

Important Information

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