**FLASH**

# Japanese stocks retain their appeal

Pictet Asset Management

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- Japanese stocks look set to build on 2013's strong gains as business and consumer spending picks up.
- Prime minister Shinzo Abe's reform programme should serve to reinforce the positive economic trends already in evidence in 2012.
- Japanese stocks are also likely to get a boost from the introduction of new tax-efficient investment schemes.

After a year in which Japanese stocks have climbed more than 50 per cent, investors might be forgiven for wanting to cash in their chips in a market that has often flattered to deceive. Certainly, from our perspective, it would appear that most investors are of the gloomy view that this strong run will be no different from the ephemeral bull markets (mayfly markets?) of the last 15 years.

So why do we think – to use the four most dangerous words in investment – this time is different?

Although investors have focused on Prime Minister Shinzo Abe and his eponymous Abe-nomics, a policy mix that combines quantitative easing, fiscal stimulus and structural reform, we do not think these measures have greatly changed the case for Japan. The truth is the investment thesis for Japanese stocks was strengthening well before Abe came into office.

That's not to say Abe hasn't done some very positive things. His programme prudently focuses on ending deflation in the Japanese economy, and to a lesser extent introducing structural reform to promote continued growth. Indeed, he is to be praised for appointing Haruhiko Kuroda as governor of the Bank of Japan and Kikuo Iwata as his deputy. Under these two men the BoJ has implemented an aggressive strategy of monetary easing. What is more, Abe has also helped secure Japan a position in the negotiations for the Trans-Pacific Partnership free trade area.

But Abe has also been lucky enough to return to office at a time when Japan was already turning the corner.

His first piece of good fortune was that he became prime minister just as Masaaki Shirakawa's tenure as BoJ governor was coming to an end, removing an obstacle to the adoption of the radical policy of "quantitative and qualitative easing" to end deflation.

Most importantly from an investor's perspective, Abe's electoral success coincided with a positive shift in the inflation landscape.

By the middle of 2012 we were beginning to see the first signs that the deflationary tide was ebbing: demand for bank lending was increasing; corporations were beginning to use their massive cash piles – equivalent to 30 per cent of GDP – to carry out M&A and investment; the decline in house prices was easing as mortgage lending started to edge up. Note that these are all indicators of demand – the problem of credit supply in Japan, or the reluctance of a broken banking system to intermediate, had been resolved years ago through a series of financial sector reforms.

To turn away from deflation caused by deleveraging requires a desire to invest and borrow, and this is what we have been seeing for some time now. Abe and the new management at the BoJ have simply accelerated an already strong trend. Confidence in the economy has picked up sharply among large corporations, small and medium-sized enterprises and households.

Over the last year other indicators have turned positive. House and land prices have increased. Wages are also growing as, for the first time in more than a decade, every sector of the economy is showing tight employment. With house prices and wages rising, the increase in household confidence is leading to increasing consumption.

The move into inflation has profound implications for the equity market. Japanese investors, both institutional and individual, have for years maintained a low equity weighting and a high cash and bond allocation. Even with zero or near-zero returns, this strategy has made sense in a deflationary environment – investors get their real returns free of risk.

But this is now changing. Institutions are increasing their holdings of risk assets. Individual investors with a solid risk appetite have returned to the market. Tellingly, the Shikiho – the bible of Japanese investing that lists and describes every company on the market – sold out of its first 2013 edition.

Retail equity participation will increase further in the New Year as the government launches a new tax-free investment vehicle for the individual investor, the Nippon Individual Savings Account. Current estimates suggest that nearly 10 per cent of the population will invest in these vehicles, which would represent an inflow equivalent to 4 per cent of the size of the overall equity market.

This is no bubble though. Despite the rise in prices, the market remains good value. Japanese companies have been restructuring and rebuilding for years. The repair of the banking sector, the cost cutting, the improvements in margins and efficiency, the increase in dividends and buybacks – these are the fundamental supports for the market and they derive from a decade of change. Now, we also have the tailwind of monetary policy, a weak Yen with better economic conditions abroad and an improving domestic economy. This is no mayfly market – this is the time to invest in Japan.

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