

**BAILLIE GIFFORD**

# Niagara Institutional Dialogue

**Beyond Abenomics**

**June 2014**



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# So Far 2014 Has Been a Bad Year For:

**The Scottish Rugby Team (again)**

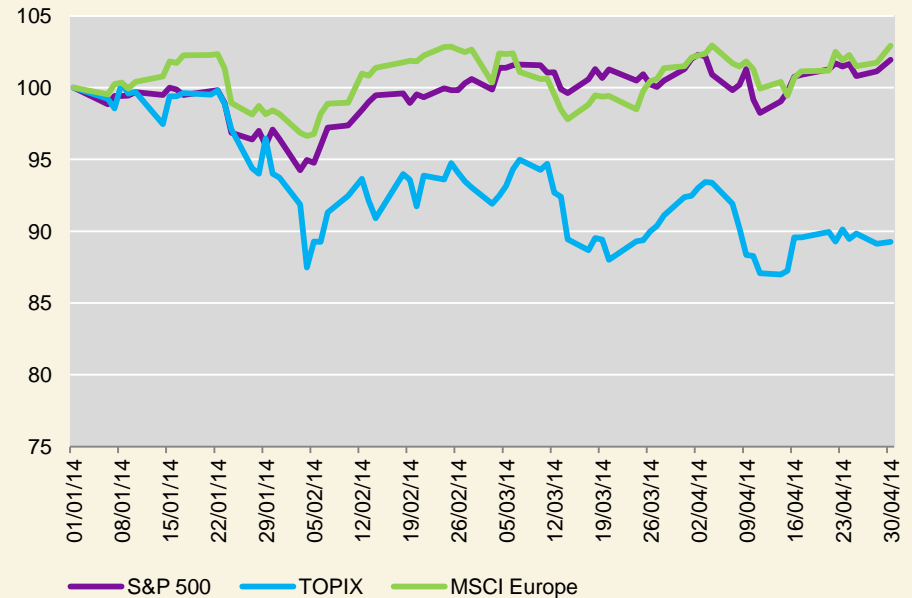
**Manchester United Football Club**

**Justin Bieber**

**Leonardo DiCaprio**

**Japanese Equities**

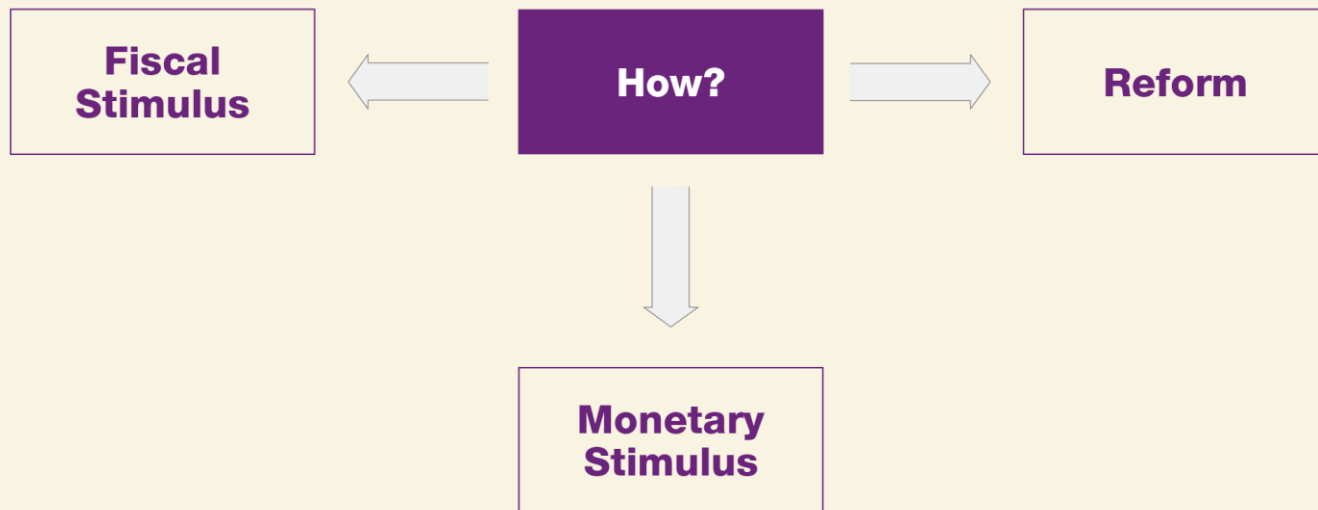
Stock Market Returns



Source : Bloomberg. Local currency basis. Rebased to 100 as at January 1, 2014

# Abe's Three Arrows

To revitalise the Japanese economy, raise the nominal growth rate, exit deflation and correct the excessive yen



# Abenomics Report Card

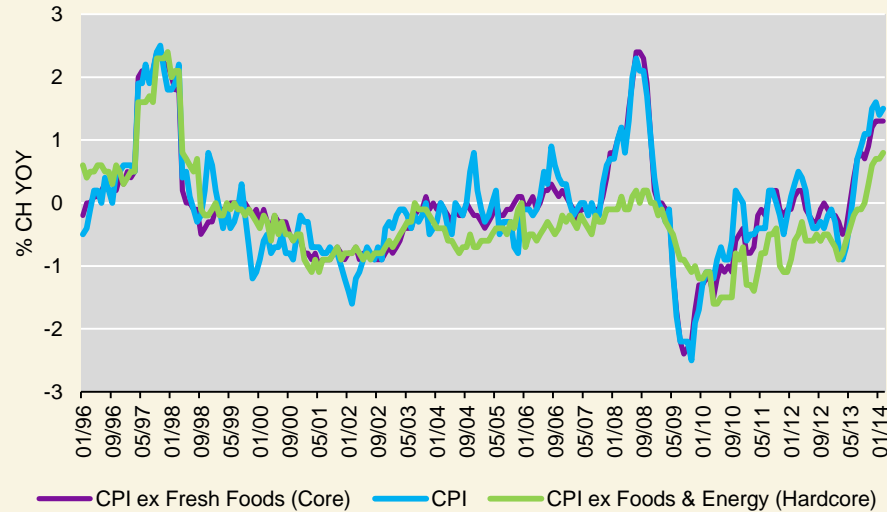
|   | Description            | Grade |
|---|------------------------|-------|
| → | Monetary Stimulus      | A     |
| ⇒ | Flexible Fiscal Policy | B     |
| ⇨ | Structural Reform      | E     |

Is this a fair reflection?

# Effects of Abenomics – Prices

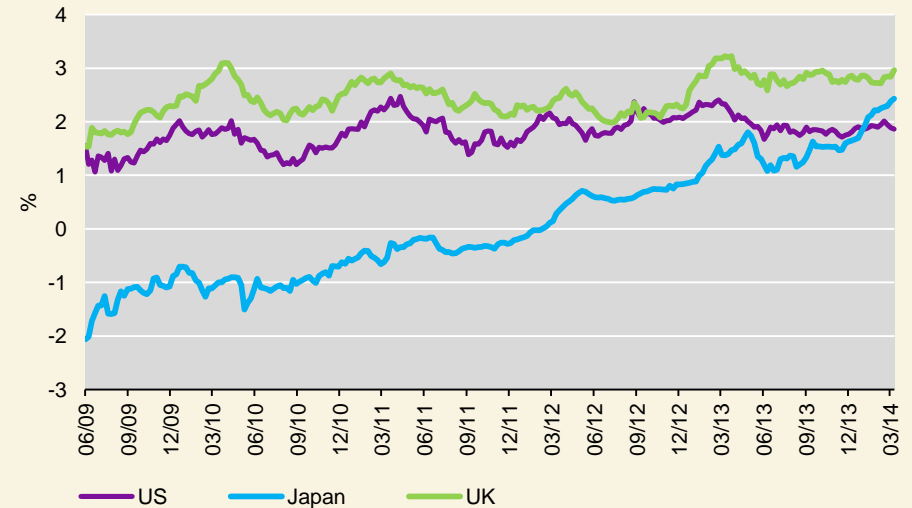
## Inflation is broadening and becoming embedded into the system

Nationwide Inflation



Source : Ministry of Internal Affairs and Communications.

5 Year Breakeven Rates

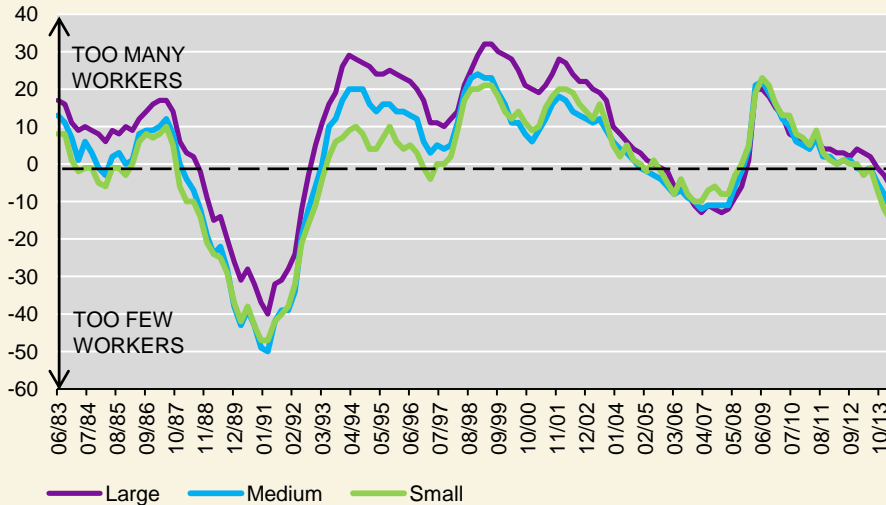


Source : Bloomberg.

# Effects of Abenomics – Wages

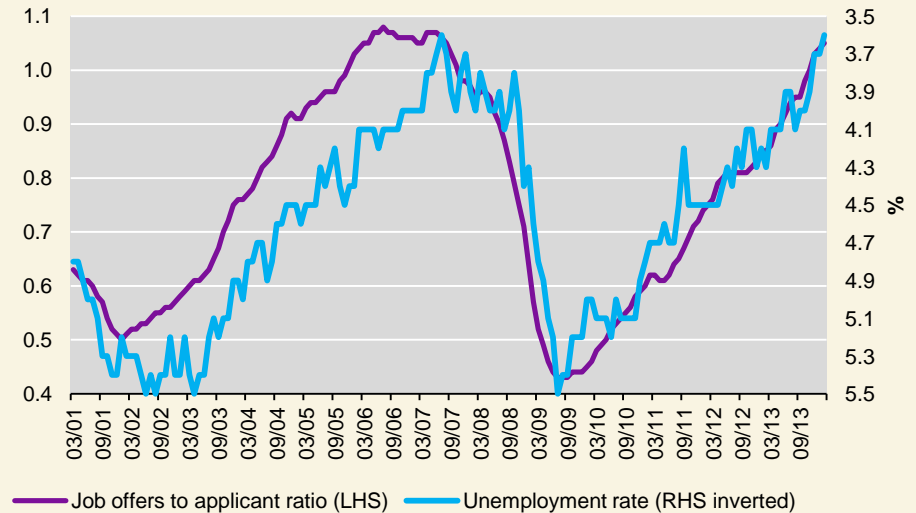
**Wages are beginning to rise and labour market tightness suggests this will continue**

Labour Conditions



Source : BoJ. Tankan Employment Diffusion indices

Offers to Applicants and Unemployment

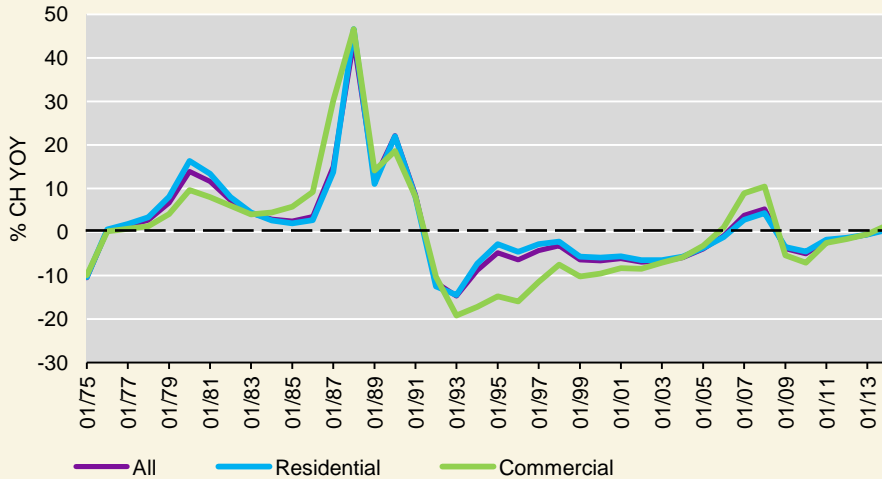


Source : Ministry of Internal Affairs and Communications.

# Effects of Abenomics – Property

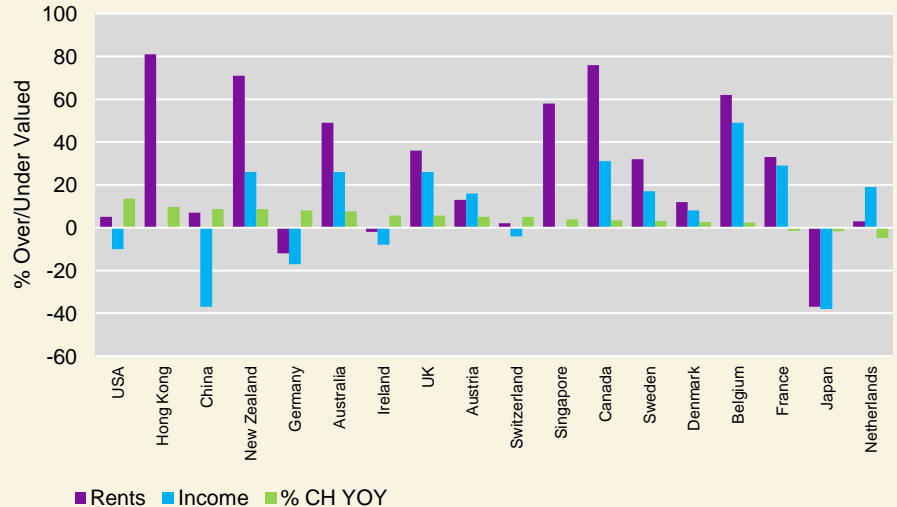
The real estate market in Japan is finally showing signs of life and valuation metrics compare favorably with other markets

Land Prices



Source: Ministry of Land, Infrastructure, Transport & Tourism. Japanese land prices in three major cities as at January 1, 2014.

Global House Price Indicators

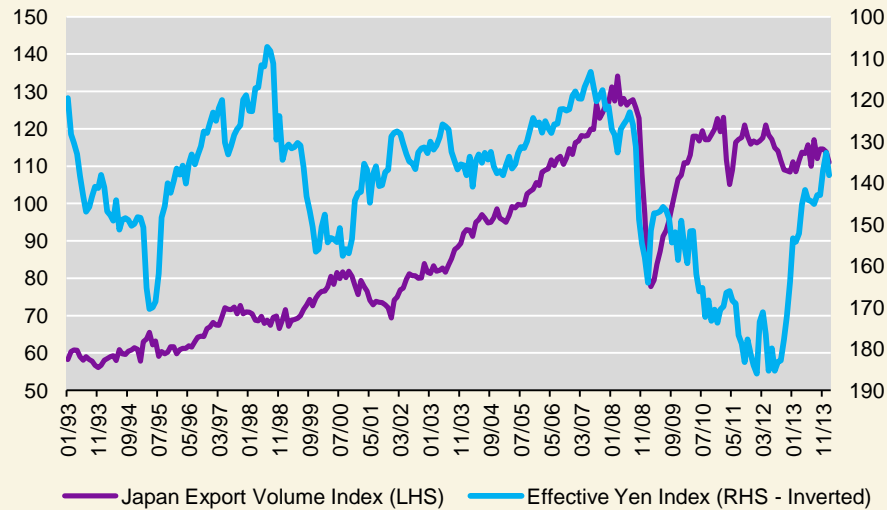


Source : The Economist, January 2014.

# What's Missing?

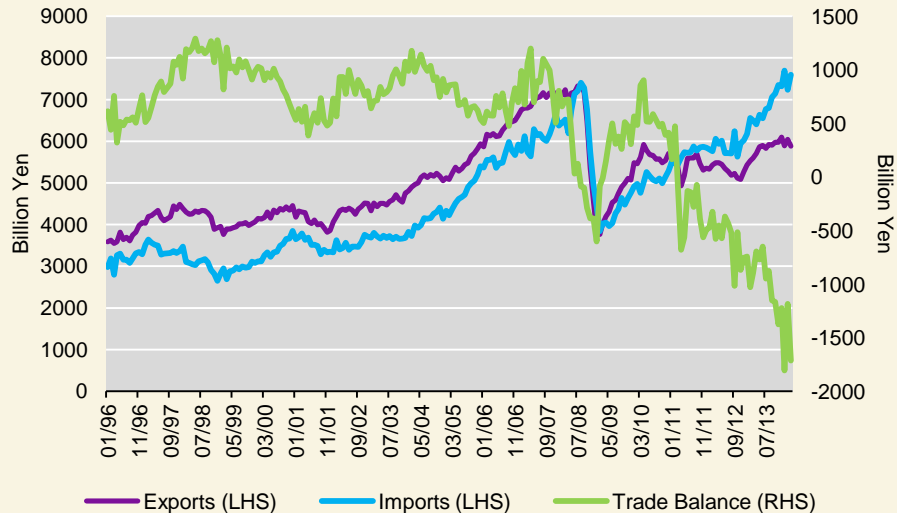
## Exports have not responded to yen weakness. Why?

Exports and the Yen



Source : BoE, CPB Nederland.

Japan's Terms of Trade



Source : MoF.



# **Abe's Third Arrow – Is it Broken?**

**What progress has been made so far?**

**What should we expect?**

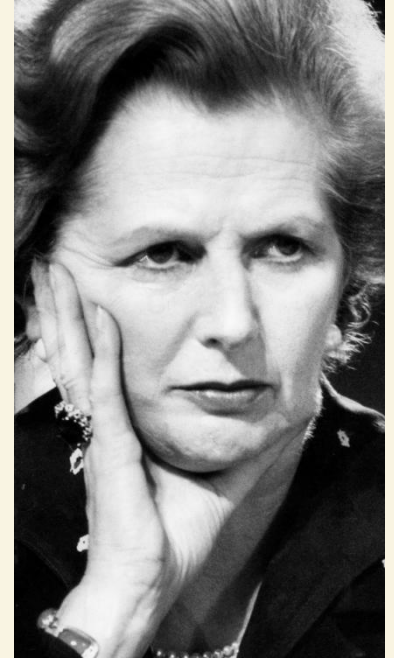
**What are the challenges?**



# A Comparison with Thatcherism

## Key policies under Thatcherism – sound familiar?

- Deregulation of the electricity industry
- Cutting corporate taxes
- Removing plot ratio rules
- Elimination of the rice production adjustment system
- Belligerence in foreign affairs



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# A Tale of Two Perspectives

## The market perspective

- The consumption tax hike will derail the economy
- Corporate earnings growth is unsustainable
- Abenomics is another false dawn
- Obsession with the currency

## The corporate perspective

- Confidence is rising and attention has shifted from cost cutting to growth
- Proceeds from yen weakness are being used for investment and higher returns to shareholders
- Pricing power is returning
- The consumption tax hike is a damp squib

## An Alternative View

**The Government and the BOJ are committed to reform and will do whatever it takes to achieve the necessary results**

**This is the best chance Japan has had for many years to return to a sustainable growth path**

**We are minded to pay attention to what companies are saying and doing**

*“We have readied the drilling structure to smash rock-hard regulations”*

Shinzo Abe 28<sup>th</sup> March 2014

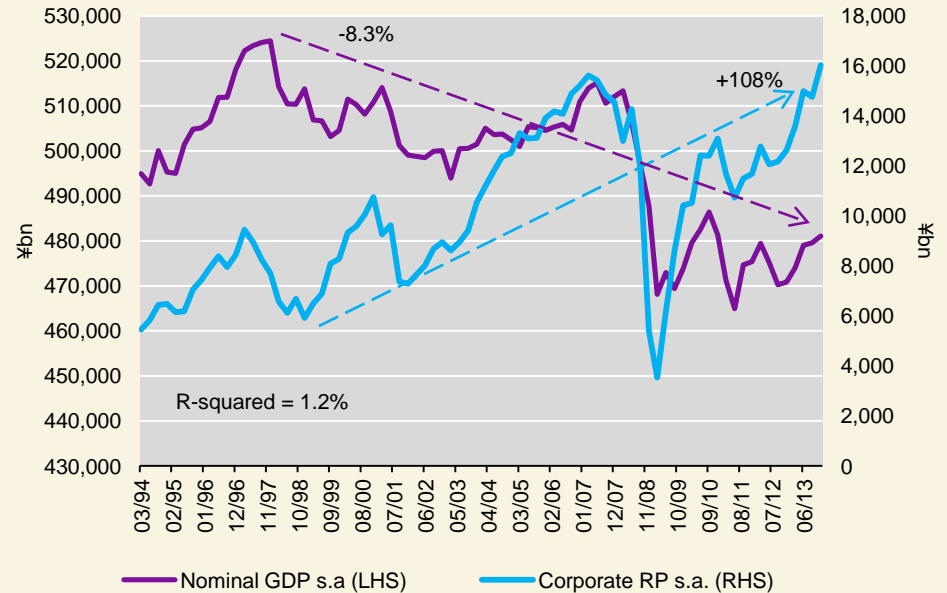
# Global Themes are an Important Driver of Earnings Growth

Japanese companies are becoming increasingly global

Secular growth opportunities exist in the following areas:

- Global Industrialisation
- Internet Everywhere
- Franchise Value Creation

Japanese Nominal GDP Against Corporate Recurring Profits



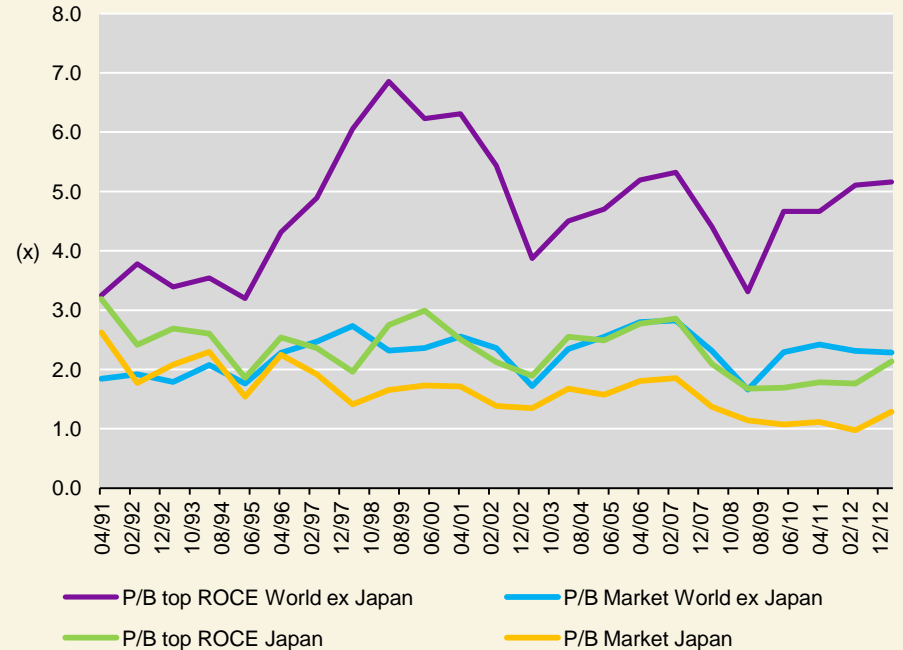
Source : CLSA.

# Is Japan Really That Different?

**In the long run share prices follow earnings and cash flows**

**In the long run quality and growth are rewarded**

**But in the short term, quality and growth often commands little or no premium**



Source : Worldscope Fundamentals/ Baillie Gifford & Co (in JPY).

## Is a Valuation Discount Justified?

**There is arguably a greater range of management attitudes in Japan than elsewhere**

**Conglomerate discounts and “keiretsu” discounts may be appropriate**

**But why are global leading businesses cheaper when they are listed in Japan?**



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# Is Japan Changing?

**It is difficult to make generalisations at the corporate level. Some companies are changing faster than others**

- Corporate governance is improving
- A more entrepreneurial culture is emerging
- Restructuring activity is increasing



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# **Conclusion**

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**The first two arrows of Abenomics have created the desired effects so far**

**Abe's third arrow is more complex and should be judged over a longer time period**

**Structural challenges remain but these can present opportunities as well as threats**

**Japan is home to a number of global leading businesses which command little or no valuation premium**

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