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ABE'S NEW BULL MARKET IN EQUITIES AND HOME VALUES

There is little doubt that Prime Minister Abe wants a rising stock market. Now that his term seems very likely to extend to 2021, Abe will likely work on a constitutional amendment to legitimize Japan's military forces, and hike the VAT by 2% in October 2019, but he will also continue to push for economic reforms and monetary accommodation.

Since he is now the most powerful Prime Minister in modern Japanese history, he should be able to achieve all of these goals, especially now that the main opposition party has been fractured by Ms. Koike. Indeed, Ms. Koike will almost certainly push her coalition (and all her supporters nationwide, most especially women voters) to vote for the constitutional amendment.

Rising stock markets encourage consumer spending via the "wealth effect," at least among the wealthy segment that account for the majority of any country's personal consumption. The capital gains associated with such are also a major factor in the future reduction of fiscal deficits.

But how far can equities go? Quite far actually, assuming the global economy remains sturdy and interest rates do not rise too rapidly. The S&P 500 is approximately 18 times 12-month forward earnings (though near 16.7 times if one assumes a 20% corporate tax rate), while TOPIX is only 14.7 times*.

Foreigners, who were negative on Japan for most of the past year, despite the fact that TOPIX has performed in line with the S&P 500 when measured in USD terms, are now getting quite excited about Japan again, and since foreigners are a key factor in Japan's market sentiment, it is not hard to expect a re-rating to 17.5 times in the quarters ahead.

Indeed, if global reflation leads to rising US Treasury yields, which correlate highly with a weaker Yen, which leads to higher corporate profits and increased investor and consumer optimism, then the macro hedge fund 2013 strategy of buying Yen-hedged equities could well be repeated. Assuming these valuations remain in two years' time and that EPS grows 10% per annum, the TOPIX should be approximately 2500, or nearly 44% higher than the pre-election level. Unlike prior bull markets in Japan, this one would retain reasonable valuations, especially if stock buybacks and dividend payout ratios rise substantially further. As for the secondary effects, this would theoretically equate to 174 trillion Yen of capital gains for wealth effect and capital gains purposes, and although not all of such would qualify for either purpose, a large portion of it would. No wonder Abe wants this.

Abe also wants house prices to rise. The two-decade decline in home values greatly depressed consumer sentiment until two years ago when they began to rise again in major urban centers. It is not hard to imagine, for instance, how US consumers would have behaved since 2007 if housing prices continued to decline and how this experience in Japan can explain much of the lost decades. If house prices continue to rise, then Japan's economy and fiscal situation will benefit even more than the equity considerations mentioned above, because home ownership is very widespread and an overwhelming portion of personal assets.

While it is possible to construct counterarguments to a continued dual bull market (like the ones experienced in the US, Northern Europe and most of Asia for the past several years), the positives (global reflation, improving corporate governance and rising corporate earnings) outweigh the negatives. Certainly, there may be some trembling while the constitutional amendment is passed, but with strong Diet support, it may well be deemed a fait accompli. Given the 2014 experience, a VAT hike might also be problematic, but fears of such are likely greatly overstated since: 1) it will be only a 2% hike instead of 3%, 2) the economy, both global and domestic, will likely be much more sturdy than it was in 2014 and 3) the reflationary and confidence-boosting Olympics will soon follow the hike.

Long-time watchers of the Japanese market are often jaded, but this seems like the incorrect attitude even after the market has doubled since October 2012 when Abe was chosen the head of the LDP and the market started to discover Abenomics. It now seems clear that Abenomics has many more years to run; thus, one should be wary of Japan skeptics.

* Source: Factset, 20 October 2017

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