ABE REFOCUSES ON ECONOMY: A DISCUSSION WITH JESPER KOLL

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Last week I chatted with Jesper Koll, CEO of WisdomTree Japan, who has spent over 30 years in Japan leading investment strategy at various firms. The discussion was particularly timely following his appearance at the Japan Finance Forum hosted by Bloomberg on September 29. To illustrate just how influential Jesper's research on Japan has been, I'll quote from prime minister Shinzo Abe's speech at the meeting. He opened with:

> This morning we have Jesper Koll joining us. You were the one—in fact, the only one, were you not?—who maintained that the Japanese economy had been grossly underrated.

and then closed with:

> Japan stands at the dawn of a new Golden Age, and prospects for the next five to ten years are extremely promising. This is the latest prediction made last year by Jesper Koll, who so confidently predicted Japan's resurgence three years ago.[1]

Abe's Laser Focus: Economy Abe made it clear at the forum that his top three priorities are economics, economics and economics. Jesper underscored the importance of this focus, given Japan's weaker-than-expected domestic demand. He noted that while Abe took unpopular but necessary decisions on the defense front, his political capital remains quite strong. Not only does Abe have a two-thirds majority in Parliament, he has also been reelected to lead his party for another three years—in a race that was completely uncontested. In contrast, over the past 30 years, only two prime ministers have served terms longer than 1.5 years. Abe's staying power is crucial in ensuring policy continuity and implementation. **Pro-business Government with Policy Continuity and Certainty** Jesper reminded us that policy continuity is key for entrepreneurs looking to commit long-term capital. In addition, the government is also committed to deregulating Japan's economy and pushing privatization that is supportive of economic growth. In fact, his commitment to cut the corporate tax rate from 33% to 29% in 2016 is a clear illustration of his pro-capitalist agenda. **Policy Coordination Key** Jesper invoked Abe's three-arrow policies, which do not stand to be fired individually but, rather, are to be held together, making them harder to break. It is this emphasis on policy coordination across Abe's government and the central bank that is key. Consequently, Jesper thinks that an increase in quantitative easing (QE) from the Bank of Japan (BOJ) would occur only if coordinated with expansionary fiscal policies —e.g., building out social infrastructure—where the BOJ will stand ready to underwrite these projects via QE. The BOJ, in Jesper's view, does not want to monetize a blank check or open budget deficit, but it is happy to fund specific projects. **One-Two Punch—Monetary and Fiscal Easing** The BOJ's focus is primarily on growing the economy by increasing aggregate demand. Jesper anticipates that the government will be introducing an expansionary fiscal policy—to the tune of 1% of gross domestic product (GDP) that will ultimately be funded by the BOJ through expanded QE—over the next 4 to 6 weeks, i.e., at either the late October or November BOJ policy meeting. **Standout Country Implementing Structural Reform** Investors should recognize that Japan is the only advanced economy undertaking deep-rooted structural reforms. Jesper details a few pro-business examples: 1) **Energy** – The government has broken the power generation and transmission monopoly and allowed private suppliers to now feed power to the grid. 2)

Health Care – Japan is committed to making progress in the areas of medical devices, pharmaceuticals and regenerative medicine. While it has historically taken 13 years, on average, for a drug to be accepted in Japan for retesting on Japanese citizens, more recently we have seen 18 drugs from multinational companies which went to market in Japan first. 3) **Immigration** – While not openly discussed as an emotional issue, Japan is pragmatic with respect to immigration, in Jesper's view. To wit: the foreign population in the greater Tokyo area that has gone from 3.1% about five years ago to 5.4% as recently as last year. Additionally, in 1985, when Jesper arrived to Japan on a student visa, foreign students were allowed to work only 12 hours per week. Today, they are allowed 38 hours—three hours more than the regular working week in France.[2] **Multiyear Bull Market Percolating** Japan's real strength is that corporations have continued to invest in innovation and forward-looking technology. Jesper states that 3.6% of Japanese GDP is spent on research and development (R&D), while the U.S. spends only 2.6% of GDP on R&D. Innovation is driven primarily by private corporations, which account for over 80% of Japanese R&D expenditure. They are focused on a broad spectrum of innovation power: steel manufacturing, ship building, car manufacturing, basic materials and robotics. While Japan has not been as aggressive in monetizing this innovation over the past 20 years, more corporations are urgently looking for means to do so. From a valuation perspective, Japan also happens to be the only developed market where earnings have grown more than prices. Despite strong equity performance since 2012, multiples have in fact contracted in Japan.[3] **What about the Yen?** Jesper expects that the yen will continue to weaken. He suggested not fighting the BOJ by betting on higher bond yields, but he believes the yen is ultimately going to be a weak currency on a structural basis. Even on a short-term basis, given Jesper's view that the BOJ will likely expand its QE program, there are also likely to be short-term pressures on the yen, perhaps sending it as high as 130 to the dollar and beyond. [1]Source: Shinzo Abe, Japan Finance Forum, 09/29/2015. [2]Source: Statistics Bureau of Japan, 2015. [3]Source: Bloomberg, as of 9/30/15.

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DEFINITIONS

Three-Arrow Policies : This refers to three pointed economic policy of Shinzo Abe consisting of fiscal stimulus, monetary easing, and structural reforms.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Bond yield : Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.