CRASH TESTING ABENOMICS

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We remain convinced that Japanese risk assets—equities and real estate—are on track for a multi-year bull market. Our conviction is based on two essential pillars. The first one is our view that Japan's private sector has begun to focus on capital efficiency as a principal driver of corporate strategic focus. The second one is that Japanese policy makers are relentlessly focused on ending deflation and creating a pro-growth domestic macro-economic backdrop. Both pillars remain firmly in place, and we expect a decisive and united policy response from "Team Abe" to the deflationary threat posed by current global and domestic developments. The Bank of Japan (BOJ) is back in play to ease on January 28/29. While Japan's corporate governance revolution is unlikely to be derailed by the current pullback in global markets, the current threat to Abenomics is very significant, in our view. Personally, I think Abenomics is now facing the most challenging "crash test" since its inception three years ago, because any national growth agenda is ultimately only as good as its success in building endogenous domestic forces strong enough to withstand a global deflationary shock. **Rising Deflation Risks** The current "crash test" consists of two major hurdles: economics and portfolio. The economics is straightforward. It is the compounding deflationary pull from: • Falling global demand in general, China in particular; • Imported deflation from both yen strength and falling commodity prices; and • Domestic demand deflation forced by the negative wealth effect from falling asset prices. Note here that on January 12 TOPIX was down 17.7% from its August 2015 peak, while the S&P 500 was down "only" 9.9% from its May 2015 peak. While it is difficult to model the exact impact of these compounding deflationary forces on Japan's inflation and growth outlook, sensitivity analysis suggests that the 5% appreciation of the yen and the fall in commodity prices alone have the power to push the Consumer Price Index (CPI) back into outright deflation (last reading of the national CPI was +0.3% year-over-year). It goes without saying that these are just the immediate first-round effects. Sustained global deflation momentum and yen appreciation would, before long, begin to cut into domestic employment and business investment plans. Clearly, downside risks to achieving any inflation target are rising. **Rising Portfolio Risks—Negative Returns for Abenomics Portfolio This Fiscal Year** The portfolio risks are even more significant, in my view. This is because the entire portfolio reallocation agenda of Abenomics—cut domestic bonds, raise domestic equities and non-yen exposure—is being undermined. Specifically, yen equities are now down 9.1% since the start of the Japanese fiscal year (April 1, 2015); in other words, we are on track for the first negative fiscal year for yen equities since 2011. It would also be the first year of yen appreciation since fiscal 2011. And to add insult to injury, the negative returns of risk assets is offset by a sharp rally in the perceived "risk-free" Japanese government bonds (JGBs), with 10-year yields falling from 40 basis points (bps) at the start of the fiscal year to 23 bps on January 12. **Asset Performance from a Japanese Perspective—Negative Abenomics Portfolio This Fiscal**

Index	12-Month Peak	% Change from Peak	% Change Since Start of Japan FY2015
TOPIX	1703 (August 2015)	-17.7	-9.1
JPY/USD	125.9 (June 2015)	-6.7	-2.2
S&P 500 (JPY)	265 (July 2015)	-14.7	-8.9
S&P 500 (USD)	2135 (May 2015)	-9.9	-7.0
JGB 10-Year (bps)	55 (June 2015)	-58.2	-42.5 (yields fall from 40bps to 23bps - strong rally)

Source: Bloomberg, as of Jan 12, 2016, Tokyo close. FY2015 ends March 31, 2016.

Year? The message is loud and clear: Portfolio rebalancing has been a key part the Abenomics strategy, with the BOJ, the [Government Pension Investment Fund (GPIF)] and Japan Post all advocating and implementing significant increases in risk assets to "lead by example" and for private asset managers and retail investors to follow suit. If these new "national model portfolios" do indeed show negative returns in the current fiscal year—which concludes March 31, 2016—there are bound to be significant negative repercussions. After all, Team Abe has often insisted that the transmission of a new virtuous cycle from portfolio rebalancing into the real economy, fiscal sustainability, corporate innovation and positive wealth for consumers remains at the core of why Abenomics will work. Failure to perform risks incurring the wrath of critics from both the conservative side and the opposition. **Policy Response Coming—BOJ in Focus on January 28/29** In short, the current threat to Abenomics is very real, in our view. The good news is that Team Abe is not complacent. A strong and unified reflation policy response is likely to come soon. A key focus falls on the BOJ. We had originally expected added easing to come at the March 14 or the April 27 policy board meeting; but given the growing sense of urgency forced by the combination of accelerating global and domestic deflation risks and growing pressure on Team Abe to renew its pro-growth credentials, added BOJ stimulus is now in the cards for as early as the January 28/29 meeting. Indeed, assuming global and domestic asset price volatility remains high, failure to act decisively and proactively now could severely endanger Team Abe's pro-growth credibility, in our view.

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DEFINITIONS

Bullish : a position that benefits when asset prices rise.

Deflation : The opposite of inflation, characterized by falling price levels.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Abenomics : Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

Tokyo Stock Price Index (TOPIX) : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Inflation : Characterized by rising price levels.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Basis point : 1/100th of 1 percent.

Government Pension Investment Fund (GPIF) : Japan's largest public pension fund.