

Market Commentary



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Japan Lives to Die Another Day **Drummond Brodeur, Global Investment Strategist** **March 2013**

There is a lot going on in Japan – which is a good thing as the status quo represented a slow boat to oblivion. Following a recent visit in which we met with the Ministry of Finance, the Bank of Japan, politicians, the Ministry of International Trade and Industry and other policy advisors, as well as macro-economic experts at Goldman Sachs and Merrill Lynch, our conclusion is that Japan is not yet ready to collapse.

It seems best to think of Japan in both a cyclical and a structural sense. Cyclically, Japan is headed for a strong year. Recent monetary and fiscal policy is providing a strong boost to the Japanese economy, which was already bottoming and has always been a beneficiary of an improving global economy. For the coming year, this will drive Japan's economy, earnings and market.

As for the structural improvements that are attracting much attention, this is not a done deal and skepticism remains our base case. Japan's troubles cannot be solved with a weaker yen. The country requires significant structural reforms to encourage investment and increase its growth potential. Failure to do so means that Japan will never be able to pay off its debt burden. Given Japanese demographics, debt default is the likely end game – but not yet. Nor will simply printing more money drive inflation higher. Higher inflation will require the Japanese economy to grow above its potential and to stimulate wage inflation, which leads back to the growth challenge.

The good news is that many in Japan understand this and Prime Minister Abe's economic agenda is based on the principle of "Three Arrows":

- 1) Aggressive monetary policy
- 2) Aggressive fiscal policy
- 3) Growth strategy.

The first two arrows have been launched. (While the exact details of Bank of Japan policy are not settled, the direction is known). The bigger challenge is the third arrow, as this includes tough political decisions and reforms needed to stimulate growth and a plan for fiscal consolidation and sustainability. The government hopes to release details of a plan this summer. The consensus view is that Abe's primary goal is to win a majority in the July elections and clearly, the government is attempting to kick-start the economy and expectations in advance of the vote. He should get his wish, as the 10 trillion yen supplementary budget should boost GDP by about 2%, while the weaker yen supports corporate earnings.

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After the election, attention will turn to details of the government's growth strategy and a decision about raising the consumption tax from 5% to 8% in April 2014 as currently planned. Any backtracking on this issue would be viewed as a setback and would jeopardize the Bank of Japan's more aggressive easing stance. The central bank's comments indicate it believes that aggressive easing is necessary to enable Japan to address its fiscal challenges.

By 2014/15, however, the impact of the consumption tax increase will likely drive up inflation, which is already being reflected in some indicators, and will be a drag on the economy. With consumption expected to be pulled forward into 2013, and with the expiry of the current supplementary budget, slipping back into recession is a real possibility by mid-2014 if momentum is not building from the government's structural reform agenda.

In short, a cyclical outlook is expected to drive the economy through 2013, but major structural risks loom in 2014/15. It is up to Prime Minister Abe to deliver a more positive long-term outlook.

Foreign investors are taking more interest in Japan, but the long equity/short yen positioning is a crowded trade in the hedge fund world. Many foreign institutional investors are scrambling to get back up to speed on Japan. The re-allocation of assets to the Japanese market has further to run as data and news flow should remain supportive for next six to nine months.

As for who will buy all the Japanese government bonds, it will be the Bank of Japan, of course. This is now acceptable policy and is not considered to be monetizing the debt unless the government abandons long-term fiscal consolidation as a goal. That will not be answered this year, so the music continues to play.

Finally, with respect to energy policy, government officials assured us that a number of nuclear generating stations will be restarted this year, but this may have to wait until after the election, as it is a sensitive topic with many voters.

Our view on Japan is to consider investments that will benefit from a weak yen, economic deflation and the global recovery. However, investors should sit near the exits. Japan remains a shorter-term trade until the government shows some spine to make the tough decisions.

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