

Holly MacDonald  
Chief Investment Strategist

## Highlights

- Following a rise in his popularity, Japan Prime Minister Shinzo Abe announced snap elections for October 22. A win should allow him to consolidate power in parliament.
- During his tenure, some progress has been made—in particular, a pickup in economic growth and an improved corporate environment — but the country still struggles with deflation, an aging population, and stagnant wages.
- Bessemer equity mandates are underweight Japan, but portfolio managers do have conviction around select stocks. While we do not view the snap elections as a specific catalyst to change our views on Japan, success on medium-term reforms would brighten our outlook.

We attended Japan Prime Minister Shinzo Abe's presentation at the New York Stock Exchange last week and, coincident with today's announcement of a snap election in October, thought it would be a good time to provide a more general update on our views regarding Japan. Four years or so since "Abenomics" kicked off, there have been some policy successes and failures: growth has picked up, but deflation risks have not subsided, and wages have not increased meaningfully. There have also been some structural advances in the economy, most notably in terms of corporate governance, but demographic drags are not easy to overcome.

Abe remains a perennial optimist and, in his recent speech, employed numerous American sports references (Aaron Judge, Michael Jordan, Yankees going after the Red Sox, etc.) to hit home the point that he will remain on the offensive, using "all of his political capital" to bring about reform in Japan. He acknowledges that this will require "breaking down massive walls," and the Tokyo Olympics in 2020 seem to provide extra motivation to move things along quickly. As we discuss below, he has better odds of prevailing in some areas than others.

Bessemer equity mandates retain an underweight to Japan, though there are interesting opportunities at the company level, particularly in mid-cap companies that are integral to the global supply chain. Portfolios hold exposure mainly within the Large Cap - Global portfolio in Large Cap Strategies and in some sleeves within Small and Mid Cap Strategies.

## Governance: Two Steps Forward...

In our view, Abe's most notable successes have been improving corporate governance and the corporate environment more generally. Reforms have been both within corporations and among the investor base, specifically creating a stewardship code that companies and investors have signed. For example, five years ago, only 17% of Japanese companies had at least two outside directors. Now, 88% do. There is also pressure on companies to clean up balance sheets and improve capital return, with the corporate governance code requiring that firms explain their rationale for keeping cross-held shares. We think these are important developments.

Anecdotally, we hear that the stewardship code has been so effective because companies' compliance operations also have improved to enforce it. Previously,

it was culturally difficult for portfolio managers to question corporate management since portfolio managers tend to be younger with less experience in the marketplace vis-à-vis CEOs. However, the pledges regarding governance now require portfolio managers to ask difficult questions, and compliance officials are in the room to make sure they do. Importantly, some of Japan's largest investors are backed by the government — the GPIF public pension fund for one — and thus can apply this extra pressure on management. Separately, the effective corporate tax rate in Japan has declined by seven percentage points, further supporting the corporate environment.

### Monetary and Fiscal Policy...Two Steps Back

Japan has achieved fewer wins on the monetary and fiscal front in the last four years. Most notably, negative policy interest rates have, by most accounts, been a failed experiment. The banking sector has suffered, lending did not materially increase, and saving rates have not declined.

The Bank of Japan's (BoJ) shift to control the yield curve has been more effective, but it is difficult to foresee how the end game will unfold with the central bank holding 44% of government debt (JGBs); there is no market for JGB debt in the true sense of the word. The BoJ also continues to purchase public equities through ETFs (it owns roughly 75% of the Japanese ETF market). With growth now improving (the last six quarters have seen positive growth for the first time in 11 years), it is not clear that the BoJ needs to continue with such extreme policy. However, given that inflation has not increased, it seems that policymakers are hesitant to pull back on accommodation and signal that they are satisfied with the current situation. The deflationary mindset is tough to overcome.

Meanwhile, on the fiscal side, stimulus has been lacking, and a consumption tax hike is scheduled for 2019, which Abe did not address while in New York. Tighter fiscal policy is needed to address longer-term debt overhangs and the budget deficit (currently around 5.7% of GDP). However, tightening too soon in

the recovery could risk tipping the economy back into recession. Abe is in a difficult place here.

With the monetary and fiscal situation in Japan unchanged, the driver of the Japanese yen in U.S. dollar terms has been the U.S. dollar itself, as well as some periodic flight-to-safety flows driven by regional tensions stemming from the North Korean situation.

### The Next Inning: "Human Resources Development Revolution"

Abe spent considerable time in his speech, and was most animated, discussing his plans to continue to tackle Japan's demographic challenges. The labor markets have improved in recent years, but with an aging and declining population, this will remain an impediment to Japan's growth in the years to come. (Recall that GDP is effectively a function of labor, capital and productivity — less labor can create a material headwind for growth).

Cultural challenges complicate the task: women's participation in the labor force is lower than in other developed countries, and Japan has remained reluctant to embrace immigration as a way to combat these challenges. Abe declared that there will be "no limits on highly skilled workers who come to Japan." He stated that he already has reduced bureaucratic hurdles for foreigners working in Japan. There is a 10-day acceptance period for visas, and he promises a green card process that takes just one year. This sounds like good news, but it is difficult to gauge how it will work in practice and whether, even with less bureaucracy, companies will welcome immigrants given cultural biases that can run deep.

Abe would like to increase the penetration of women and the elderly in the workforce. He cited some success here, with female employment increasing three percentage points while employment of those over 60 years old also has increased three percentage points in recent years. He has pledged to reorient social security funds to target all ages rather than just seniors. These funds could help with child and elder care to free up women to work, and presumably also help with Abe's

goal of increasing the birth rate to 1.8 children per woman. For the elderly, he is pushing training and re-education programs to keep the aging population (with increasingly long life expectancies) contributing to the economy. He relayed a cute anecdote of an 81 year-old Japanese woman who received an award from Apple as the oldest developer of an app (the app gives points to users for decorating using customary Japanese fixtures and tradition), but the overall statistics in this regard are still lacking. The jury is out, but 2020 could be a bit ambitious to expect major gains in these areas.

One nuance that could help productivity, and thus growth, is that Japan is fully embracing robotics and artificial intelligence. The dialogue in Japan is much more positive in this area than in the rest of the developed world, where the conversation often shifts back to the potential loss of jobs that result from an increase in automation. Abe touted that Boeing parts are made in Japan, and he wants to use technology to make Japan's agricultural sector a major exporter.

A challenge is what he described as the biggest difference between Japan and the U.S. in the space: the entrepreneurial spirit is much more engrained in American culture than it is in Japanese culture, where more prestige has been associated with climbing the ranks of large corporate ladders. There are some things the government can do to encourage entrepreneurs, such as limiting personal liability for business loans as Abe mentioned his government has done. However, it is hard to see how these incremental steps and "sending people to Silicon Valley for training" — which he also mentioned — can really move the needle. There can be bright spots in the Japanese economy, and companies that offer long-term investors value (such as those that Ken Sasaki and Michael Crawford and team continue to identify), but we are not holding our breath anticipating a wholesale shift in Japan's entrepreneurial thrust.

## North Korea: "Not a Time for Dialogue"

The escalating tensions with North Korea have put Japan in the spotlight geopolitically, and Abe's response has boosted his popularity. His approval

ratings fell as low as 20% earlier this year, but are now over 50% following a cabinet reshuffle and the North Korea developments. He has been strong on the issue and reinforced that stance on Wednesday. He stated that North Korea "without a doubt" has perfected the technology to deploy a bomb 10 times as strong as the one dropped on Hiroshima, and that they eventually will be able to reach the East Coast of the U.S. He said sternly that dialogue for dialogue's sake is meaningless. He believes the North Koreans continue to betray Japan and its allies and that it is time to put more actual pressure (presumably in the form of more stringent sanctions) to make them commit to abandoning the technology. Abe was meeting with foreign leaders on the sidelines of the United Nations meetings (he mentioned leaders from the U.S., France and Israel, among others) to make sure all are united in conveying the idea that "there is no future for North Korea if they continue down this path."

## Abe's Second Wind

Apparently not one to let a good crisis go to waste, Abe called a snap election for this fall. With the recent jump in his approval ratings and lack of credible alternatives, this should be a good opportunity for him to consolidate power in Parliament. It seems likely that he then could comfortably stay in power through the 2020 Olympics and give himself a shot to take advantage of his second wind.

The election itself does not seem an obvious catalyst for Japanese equities to catch up to global peers from a valuation perspective. More success on medium-term reforms would definitely brighten our outlook toward Japanese equities. In the near term, however, we believe that a broad local rally would be more likely should the U.S. dollar bounce, weakening the yen and lifting sentiment toward Japanese exporters (assuming of course that economic growth in Japan, as well as for key trading partners, remains on track). Until we have higher conviction around that view, we are comfortable focusing instead on having portfolio management teams scour the market for selective opportunities.

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