The Japan Trade. Heading Higher

The Japanese stock market is up some 40% year to date while the JPY has gone from 86 at the end of 2012 to 101 today. Wow. Is it too late to invest in Japan? I think not, but at the same time, it pays to be more circumspect.

The obvious trade has been in the exporters. These have rallied hard and its likely that the weak JPY impact on earnings for exporters has been efficiently priced in. It is time to look at domestic businesses as the impact of monetary and fiscal policy gain traction, in a more self sustaining recovery, than a mere export driven shot of morphine.

This time is different. Monetary policy in the past 24 years has been half hearted. Quantitative easing was always sterilized while the BoJ has been almost apologetic for their perceived irresponsibility. The independence of the BoJ and the need to maintain the semblance of independence has meant that the BoJ has never really been able to align itself with the government, even if it fundamentally agreed with it. Fiscal policy, meanwhile, will be kept loose. In the meantime, the two step increase in the consumption tax will do two things, it will front load expenditure thus compensating for some of the effects of deflation and it will raise revenues from a larger tax base. On the other hand, the cut in the corporate tax rate, more generous depreciation accounting and employment subsidies will help businesses. Beyond their material impact, the confluence of these initiatives will have a positive impact on ‘animal spirits’.

What are the risks? The obvious ones are that Japan’s fiscal position is untenable in the long run. Its demographics will result in the eventual inability to fund its debt domestically thus exposing it to international standards of credit appraisal. This can be quite far away. Less obvious is that a weak JPY is a crutch, not a cure, and it is a weak crutch. Inflation has many faces. Cost push inflation with weak demand could result, we have a word for that, its called stagflation. Also, if successful, the BoJ’s 2% inflation target could spark a sell off at the long end of the curve. A steeper term structure would raise debt costs for the government and probably require the BoJ to monetize even more debt.

In short, the prospects for a higher Nikkei are good, and I can see the market continuing for a good 12 months, maybe even more. How Japan resolves its structural issues is another question, currently unasked and unanswered.