

MACROCOSM

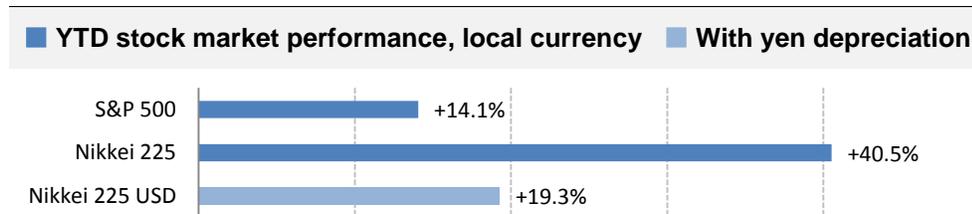
The Abe Restoration

Friday, May 10, 2013

Donald Luskin

Abenomics isn't just policy -- it's part of a Japan's cultural and geopolitical awakening.

US stocks dribble up to new all-time highs, while earnings and sales growth deteriorate. Meanwhile Japanese stocks trounce the US, driven by a powerful rebirth of growth potential (please see the chart below, and ["2013 Outlook: Think Globally, Shrink Locally"](#) January 14, 2013).



Source: Bloomberg, TrendMacro calculations

- We think Japanese stocks are reacting to a fundamental turnaround in Japan's economy. "Abenomics" is more than just "three arrows" of policy initiatives. It has become embedded as part of a transformation of a culture (please see the illustration below).



Source: [Reuters](#)

Update to strategic view

ASIA MACRO, ASIA STOCKS, BOJ, FX, US STOCKS: Japan's stock market rally handily beats that of the US, even with US stocks at new highs. To be sure, timing is tricky with Japanese stocks up 72% in less than a year. But we think this rally is durable, as it is based the fundamental economic turnaround of "Abenomics" -- from deflation to inflation, and from protectionism to liberalization. It is made possible by Prime Minister Shinzō Abe, tapping into popular demand for a war-time leader to provide bold new solutions in the aftermath of the Tōhoku earthquake, tsunami and radiation spill -- and in the face of geopolitical risks from North Korea and China, at a time when the US commitment to provide a nuclear umbrella is questionable. Abenomics will not only immediately liberate Japan's productive export champions from an over-appreciated currency. Over time, it will unlock productivity in the rest of Japan's economy -- the vast majority of it -- that is inefficient and uncompetitive.

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- The deep cultural roots of the Abenomics transformation tap into the tragedy of the Tōhoku earthquake, tsunami and radiation spill of 2011. That catastrophe awakened and energized a culture that had been in a form of managed decline for more than two decades (as we speculated at the time; see "[Meltdown in Japan](#)" March 15, 2011). Japan's new government under Prime Minister Shinzō Abe is [calling it a "rebirth."](#)
- Tōhoku was the [fourth largest earthquake](#) in recorded history, [killing more than five times as many](#) people as the terrorist attacks in the US [in 2001](#). It caused a [Chernobyl-class nuclear event](#) and [disabled 12%](#) of Japan's electrical generation capacity. The rebuilding will [cost ¥25 trillion](#) over five years.
- The catastrophe has been [regarded by some Japanese](#) as *tembatsu* -- divine punishment. Abe has become [enormously popular](#) by offering, in the aftermath, simplified moral clarity that can restore national pride and purpose. This is straight from George W. Bush's playbook after the 2001 terrorist attacks.
- Bolstering Abe's position as something of a war-time leader are a cluster of geopolitical risks now facing Japan.
- Transition in North Korea to a [third-generation despot](#) has brought about the rogue nation's worst-yet episode of [nuclear brinkmanship](#). Tokyo is [only 800 miles](#) from Pyongyang, easily within reach of a simple ballistic missile.
- At the same time, last year's power transition in China has brought about [increased saber-rattling](#) over [Japan's claims of sovereignty](#) over the [Senkaku Islands](#). Recently Chinese military vessels have [deliberately entered](#) what Japan regards as its own territorial waters around the islands.
- With these threats as a backdrop, Abe and his cabinet have [positioned themselves as militarists and nationalists](#) -- taking the daring politically incorrect steps of visiting war shrines, and breaking with the tradition of shame and apology for Japan's role in World War Two.
- More substantively, Abe intends to go forward -- [over US objections](#) -- with the start-up of the massive Rokkasho nuclear fuel reprocessing plant, capable of producing enough weapons-grade plutonium for 2,000 bombs in twelve months.
- New US Defense Secretary Charles Hagel has given [public support](#) for Japan's position on the Islands, and reiterated America's commitment to a nuclear umbrella for Japan. But then again, Abe can't fail to observe that President Obama [warned Syria](#) not to cross the "red line" of using chemical weapons -- and after it was crossed, has done nothing. Even if America were perfectly reliable, we think *realpolitik* makes it even money that Abe will have to announce his intention to build Japan's own nuclear deterrent.
- To actually carry this out would probably require amendment of Article 9 of [Japan's Constitution](#), which outlaws "the threat or use of force as means of settling international disputes" and the maintenance of "land, sea, and air forces, as well as other war potential." To amend Article 9, a first step for Abe is to [amend Article 96](#) to weaken the Constitution's requirement for a bicameral

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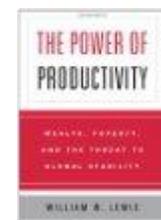
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supermajority to a mere majority for any constitutional amendments -- preserving the requirement for a popular referendum.

The point of all this is to say that what is driving Japanese stocks isn't just the pro-growth policy logic of Abenomics. It's the fact that Abenomics is powered and sustained by unique cultural and geopolitical circumstances, and a somewhat messianic leader capable of exploiting them. Without that context, it would probably be correct to dismiss Abenomics -- as indeed, many clients do when we discuss this with them -- as just another inevitable disappointment in Japan's two-and-a-half lost decades.

- But the right cultural and geopolitical context can make pro-growth economic policy transformations possible, even though they inevitably challenge powerful vested interests.
- Ronald Reagan was able to aggressively promote Reaganomics after accomplishing the release of the US hostages in Iran [simply by being inaugurated](#) (having run his campaign as a hawk).
- UK Prime Minister Margaret Thatcher cemented her moral authority as an economic reformer [in her first term](#) by aggressively protecting Britain's sovereignty over the Falkland Islands.
- George W. Bush invested the political capital he gained from what seemed then to be the successful invasion of Baghdad to ram through large tax cuts on wages, dividends and capital gains (see ["Notes from the West Wing"](#) April 3, 2003).

Make no mistake about it, it will take political capital for Abe to implement all "three arrows" of Abenomics.

- The ["first arrow"](#) -- fighting deflation and currency appreciation with aggressive monetary policy -- was relatively easy for Abe. It was just a matter of stacking the Bank of Japan with his own appointees (see ["On Kuroda and Iwata at the BOJ"](#) February 25, 2013).
- There was some doubt that Abe's BOJ appointees would really follow through, but they did -- in spades (see ["On the April BOJ Policy Meeting"](#) April 4, 2013).
- We think this monetary reform alone, if it is all that Abenomics ever accomplishes, justifies the move we've seen in Japanese stocks -- and more, once it is proven effective.

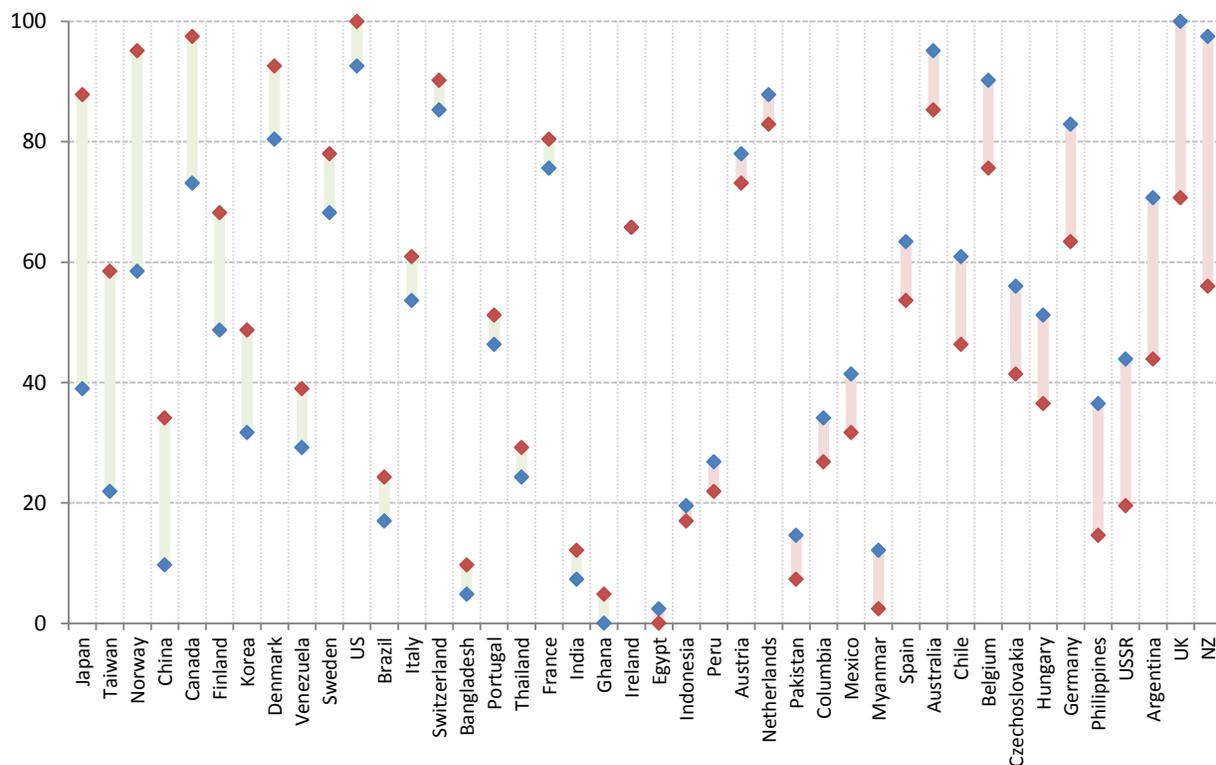
— USD per JPY



Source: Bloomberg, TrendMacro calculations

- It's working. The best high frequency indicator of success is the yen -- and yesterday at weakened to 100 to the US dollar for the first time in four years (please see the inverse chart on the previous page).
- The "[second arrow](#)" is fiscal stimulus. We won't dwell on this policy dimension -- because it is not a novel initiative for Japan, because it is not politically controversial, because much of it simply repackages Tōhoku reconstruction spending that would have occurred anyway, and because we don't believe such policies are generally impactful to begin with.
- The "third arrow" is the least well defined, and where things get really interesting -- where Abe will really have to use his political capital -- and where, if he succeeds, the potential for more gains in Japanese stocks will be enormous.
- The "third arrow" is the reform of Japan's inefficient, unproductive and protectionist labor and product markets. Such reforms will be as politically difficult in Japan as they have been in Europe (see "[Europe's Supply-Side Revolution](#)" February 17, 2012). But we think the gains in growth that can be obtained from even modest success are far greater for Japan.
- Japan has proven itself to be capable of world-class productivity growth. It is the one and only nation that moved from poor to very rich during the twentieth century (please see the chart below).

National percentile ranks, per capita GDP ◆ 1900 ◆ 2000 | **By change:** ■ Gainers ■ Losers
 0 to 20 = Very poor | 20 to 40 = Poor | 40 to 60 = Middle class | 60 to 80 = Rich | 80 to 100 = Very rich



Source: OECD, [via IMF](#), TrendMacro calculations

- But as McKinsey Global Institute's William V. Lewis explains in [The Power of Productivity](#), Japan is not as it appears in the eyes of rest of the world.
- Globally visible Japanese export giants like Toyota are the most productive and competitive companies in the world. They taught the rest of us about Total Quality Management, continuous improvement, optimization of supply chains and cut-throat global competition -- the managerial know-how that defines modern business.
- The rest of Japan -- by far the majority of its economy: agriculture, retailing, health care, food processing -- is inefficient, unproductive, uncompetitive and backward. While the export giants honed themselves in global competition, Japan's internal markets have hidden behind protectionist walls, and grown rotten.
- It is these inward-looking sectors of the Japanese economy at which the "third arrow" of Abenomics is targeted.
- The "first arrow" -- monetary reform -- will be a powerful boon for Japan's visible global champion firms, by freeing them from the deadweight of an over-appreciated currency.
- *But it is the "third arrow" that is the hidden potential of Abenomics to really move the needle on growth in Japan and the global economy. It could expose the vast majority of the world's third largest economy to the productivity gains so far enjoyed only by a small minority.*
- This fruit is sweet, but it is not low-hanging. Protected sectors are, almost by definition, politically powerful. It takes a strong reformist leader with broad public support to unlock their growth potential by exposing them to the rigors of competition. We are arguing that history is giving Abe the opportunity to be such a leader.
- When their protection is being removed, these sectors inevitably cry foul and accuse the reformist leader of "austerity" -- as protected sectors in Europe are doing now (see "[Restructuring Austerity](#)" May 9, 2013).
- With the [triennial election](#) for the [House of Councillors](#) -- the upper house of the [National Diet](#) -- coming in July, Abe is moving cautiously on the "third arrow."
- His most conspicuous move has been, [in March](#), to enter Japan into the [Trans-Pacific Partnership \(TPP\)](#). This will require Japan to remove global trade protection from its agriculture sector, which will likely force it into wholesale restructuring. Farming in Japan is patchwork of small family operations. [The average age](#) of farmers has risen to 66, and [so many have died](#) that more than 400,000 hectares of arable land have been abandoned. To compete, these family farms will have to be rolled up into a new Japanese agri-business sector -- a prospect most unpalatable to the farmers.
- Because Japan's entry into the TPP amounts to a de facto free trade agreement between the US and Japan, it must be approved by the US Congress. The Obama administration [notified Congress](#) three weeks ago, beginning a statutory 90-day ["consultation period."](#) So Japan won't be able to participate in TPP talks in any official capacity until at least late July -- *after the election*.
- Similarly, even more controversial "third arrow" policies -- most

And incidentally...

Shinzō Abe [has a history](#) with the farming sector, from the first time he was prime minister.

"After Agricultural Minister Toshikatsu Matsuoka committed suicide, Abe's approval rating remained below 30% for months according to opinion polls of Jiji Press. Abe's ruling Liberal Democratic Party suffered great losses in the upper house election. Another agricultural minister, Norihiko Akagi, who was involved in a political funding scandal, resigned after the election.

"In an attempt to revive his administration, Abe announced a new cabinet on 27 August 2007. However, the new agricultural minister Takehiko Endo, involved in a finance scandal, resigned only 7 days later."

important, making the labor market more competitive by [liberalizing](#) the ability of employers to more easily fire workers -- are completely on hold.

- But once the election has come and gone -- and especially if Abe's LDP and its coalition partners can take firm control of the upper house -- Abe will have a fairly free hand to shoot his "third arrow."
- If he hits the bulls-eye -- or even come close -- one of the world's largest economies will undergo a major growth episode.

Bottom line

Japan's stock market rally handily beats that of the US, even with US stocks at new highs. To be sure, timing is tricky with Japanese stocks up 72% in less than a year. But we think this rally is durable, as it is based the fundamental economic turnaround of "Abenomics" -- from deflation to inflation, and from protectionism to liberalization. It is made possible by Prime Minister Shinzō Abe, tapping into popular demand for a war-time leader to provide bold new solutions in the aftermath of the Tōhoku earthquake, tsunami and radiation spill -- and in the face of geopolitical risks from North Korea and China, at a time when the US commitment to provide a nuclear umbrella is questionable. Abenomics will not only immediately liberate Japan's productive export champions from an over-appreciated currency. Over time, it will unlock productivity in the rest of Japan's economy -- the vast majority of it -- that is inefficient and uncompetitive. ▶