

Post-election Reactions and Opportunities

A Multi-Asset Investment Perspective

- **With the markets having reacted positively to the LDP's landslide election victory, we follow up on our pre-election multi-asset report. Citi's economists and strategists present a multidisciplinary view on the Japanese economy, policies, and financial markets in 2013.**
- **Still positive about risk assets in coming months** — There is growing evidence that the BoJ's language and behavior will change in coming months **even before** its new leadership arrives this spring, given the LDP's electoral mandate. We continue to expect further weakening of the yen to ¥90-¥95 against the dollar, though a near-term correction would not surprise given the rapid movement so far.
- **More upside for equities through spring** — We think the equity market rally will continue through spring, with the improved corporate profit outlook set to be the driver. By sector, we like banks, which strike us as undervalued on both PER and PBR, and auto-related names, which benefit from the recovery in the US economy.
- **Yield curve to steepen** — We believe the Abe administration's anti-deflation push will be the main theme for JGBs in 2013. We envisage yield curve steepening, on increased JGB issuance to fund a big economic stimulus, inflation targets for the BoJ, and yen weakening/equity gains in response. For more on financial sector prospects, see our analyst Hironari Nozaki's January 4 report, [Financial sector outlook—Winter 2012-2013 - A 2005 rerun?](#)
- **Skeptical that "Abenomics" will result in sustained change** — The economic policies of the new administration are set to be centered on loose monetary policy and fiscal pump-priming. However, experience suggests this is unlikely to lead to a sustained revival of the Japanese economy.

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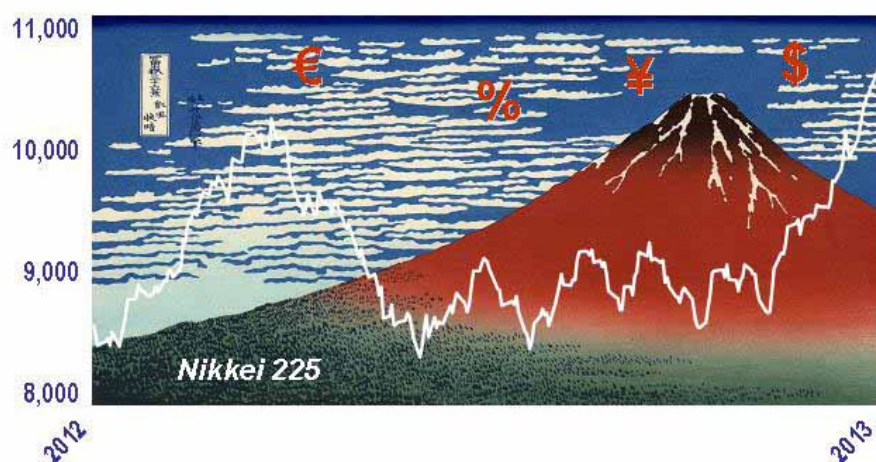
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Post-election Reactions and Opportunities

I. Policy Outlook: Fiscal pump-priming and looser monetary policy

Kiichi Murashima

Naoki Iizuka

We remain skeptical as to whether the LDP's economic policy proposals can improve the economy the way the market seems to expect

The fact that the LDP and its coalition partner New Komeito gained more than two-thirds (325 seats) of the total Lower House seats should give new PM Shinzo Abe the political power to craft and implement his economic policies, at least for the time being. The BoJ's policy decisions in December are evidence of this. We expect a continued shift at the BoJ in terms of both language and action, as unexpectedly indicated by the minutes of the November 2012 policy meeting, even before the upcoming change in the leadership in April 2013. However, we remain skeptical that the LDP's economic policy proposals can really bring the kind of improvements in the economy in 2013 and beyond implied by recent market developments.

Figure 1. Main policy schedule through next summer

		Monetary policy	Fiscal policy/politics	Foreign relations
2013 January	11th		• New administration to announce a new economic stimulus package	
	15th		• Cabinet approval of an extra budget plan for FY12 (submission to the Diet will be 31 Jan)	
	21st and 22nd	• BoJ policy meeting (Interim assessment of economic outlook report)		• Inauguration of US president Barack Obama
	23rd			• World Economic Forum (in Davos)
	24th		• LDP to announce a package of tax reform	
	28th (to be finalized)		• Ordinary session of the Diet to start (to discuss extra budget, etc.)	
	29th and 30th	• FOMC meeting		
			• Cabinet approval a budget plan for FY13 (submission to the Diet will be in February)	
February	13th and 14th	• BoJ policy meeting		
	15th			• G20 finance ministers and central bank governors meeting (in Moscow)
	24th			• Inauguration of Korean president Park Geun-hye
March	4th			• TPP meeting (in Singapore)
	5th			• China National People's Congress (inauguration of Chinese president Xi Jinping)
	6th and 7th	• BoJ policy meeting		
	19th	• Two BoJ deputy governors' term to end		
	19th and 20th	• FOMC meeting		
April	3rd and 4th	• BoJ policy meeting		
	8th	• BoJ Governor's term to end		
				• G20 finance ministers and central bank governors meeting (in Washington)
	26th	• BoJ policy meeting (updating economic outlook report)		• IMF and World Bank's annual meeting
	30th and 1st	• FOMC meeting		
May	Early in the month		• Diet approval of budget and tax reform plans for FY13	• US-China Strategic and Economic Dialogue
	21st and 22nd	• BoJ policy meeting		
June	10th and 11th	• BoJ policy meeting		
	17th			• G8 summit (in UK)
	18th and 19th	• FOMC meeting		
	26th		• End of ordinary session of the Diet	
July	10th and 11th	• BoJ policy meeting (Interim assessment of economic outlook report)		
	21st (to be finalized)		• Upper House Election	
	30th and 31st	• FOMC meeting		

Source: Bank of Japan, Federal Reserve, media reports, Citi Research.

1) Monetary policy: BoJ's language already changing

BoJ quite likely to ease monetary policy again at its January meeting

Under increasing political pressure from Mr. Abe, BoJ Governor Masaaki Shirakawa ordered BoJ staff last month to report on a possible amendment to the longer-term price stability goal at the upcoming January meeting (Figure 2). We believe the BoJ is likely to clarify its intention at that time to **eventually** pursue 2% inflation after first achieving 1%, over the longer term. The BoJ's about-face suggests that it has given consideration to Shinzo Abe's statements. We expect more monetary easing in the coming months even before the new BoJ leadership takes office in April 2013. It now seems quite likely that the BoJ will ease monetary policy again at its January meeting, by expanding the asset purchase program further. In that case, we cannot dismiss the possibility that the BoJ will extend the maximum maturity of JGBs that it purchases under the asset purchase program beyond the current three years.

Indeed, the minutes of the BoJ's policy meeting held in November indicate that policy discussions on the board had already shifted towards a more dovish tone well before the general election. While Governor Shirakawa was skeptical on Mr. Abe's statements regarding monetary policy at his press conference after the November meeting, other members showed an unexpectedly flexible stance towards policy options. Specifically, one board member suggested the BoJ should make the current accommodation, comprising the effectively zero interest rate policy and the asset purchase program, "open-ended" until 1% inflation has been achieved. Another member referred to the possibility that removal of "the rate of interest on excess reserves" (held by private financial institutions) would have an impact on the forex markets (i.e., US\$/JPY). In our view, there are compelling signs that the BoJ (or at least some board members) started to change their language of their own accord.

Leadership change will likely shift the balance on the policy board to the doves

Governor Shirakawa's term will come to an end on April 8 (with the appointment process probably completed within March), while two deputy governors will leave office on March 19 (see Figure 2). Given that three policy board members (Ryuzo Miyao, Takahide Kiuchi and Takehiro Sato) out of nine have dovish views on monetary policy, a sweeping change in the leadership will likely shift the overall balance on the policy board unambiguously to the dovish side, as the new government is most likely to pick dovish people for the positions.

Leading contenders to take over Mr. Shirakawa: Mr. Muto, Mr. Iwata and Mr. Ito

Meanwhile, the question of who will take over from Mr. Shirakawa in April 2013 appears to have become much more fluid in the wake of the Lower House election. In our impression, at least for now, the LDP's clear victory has given Mr. Abe more freedom in choosing the next governor. Before the election, we believed that Toshiro Muto, an ex-MoF official who also served as a BoJ deputy governor until 2008, was the most plausible candidate. However, after the election, the probability that other candidates not originally from the Ministry of Finance (MoF), including Kazumasa Iwata and Takatoshi Ito, could become the next BoJ governor looks to have increased (Figure 3). We think Mr. Abe now believes that his leverage over the MoF strengthened significantly as a result of the LDP victory in the Lower House election.

Figure 2. Next BoJ governor candidates

Name		Age	Current job	Former job
Toshiro	Muto	69	President, Daiwa Research Institute	Deputy governor of the BoJ, Vice minister of the MoF
Kazumasa	Iwata	66	President, Japan Center for Economic Research	President of ESRI (government research institute), Deputy governor of the BoJ, Director of the Cabinet Office
Takatoshi	Ito	62	Professor, University of Tokyo	Deputy vice minister of MoF, Professor of Hitotsubashi University
Haruhiko	Kuroda	68	President, Asian Development Bank	Professor of Hitotsubashi University, Vice Minister of the MoF
Kazuo	Ueda	61	Professor, University of Tokyo	Policy board member of the BoJ
Heizo	Takenaka	61	Professor, Keio University	Minister of Economy, Financial affairs, Internal affairs and Communications, Professor at Keio University

Source: Media reports, Citi Research

There exist big differences between the policy options that Mr. Muto supports and those that some of other candidates have so far proposed (see Figure 4). Judging from his statements, Mr. Muto appears cautious about implementing outside-the-box policy options such as BoJ purchases of foreign bonds. Instead, it is much more likely that Mr. Muto would implement the current asset purchase program more aggressively, for example by extending the maximum maturity of JGBs that the BoJ purchases and/or purchasing more risk assets. We believe that expansion of *rinban* operations accompanied by abolition of the so-called BoJ banknote rule could be another option under Mr. Muto. Meanwhile, Mr. Iwata has been proposing the BoJ purchase foreign bonds and set up new hybrid public/private funds to purchase foreign assets in order to drive yen depreciation. In short, Mr. Iwata would be likely to focus more explicitly and directly on the forex market than Mr. Muto and other candidates. PM Abe also ordered Finance Minister Taro Aso to assess the feasibility of hybrid public/private funds to purchase foreign assets (we understand Mr. Iwata has a strong ties with Mr. Aso). The latest plan to buy bonds issued by the European Stability Mechanism to help weaken the yen, referred to this week by Mr. Aso, is another policy initiative into this direction.

Figure 3. Recent remarks by BoJ governor candidates

Name	Remarks/quotations
Toshiro Muto	<ul style="list-style-type: none"> • Still remains some room for policy maneuver at the BoJ. Adoption of the inflation-targeting would be effective. Holding a central bank accountable to explain its actions increases the transparency of monetary policy • Central banks should always explore new policy frontiers (such as with the Fed newly adopting an unemployment rate as one of its policy goals) • It would be a good idea to make a clearer commitment to monetary easing, such as a commitment on purchasing assets in an open-ended way until the inflation goal is achieved • Central bank independence was discussed thoroughly when the current BoJ Law was revised in the mid-1990s. The conclusion was that both independence from and cooperation with the government are important
Kazumasa Iwata	<ul style="list-style-type: none"> • 2% inflation in CPI is appropriate as the BoJ's inflation target • There are still many things that can be done in the realm of monetary policy • "What I have advocated is the setting up of a financial crisis prevention fund managed jointly by the MoF and the BoJ. If the BoJ supplies the yen funds and the MoF purchases foreign bonds for stability of global financial markets, then the yen is likely to depreciate"
Takatoshi Ito	<ul style="list-style-type: none"> • It would be effective for the BoJ to adopt an inflation target to overcome deflation. It is important to hold the governor's to account if the bank fails to achieve the target • The BoJ was the unable to ride the international wave of quantitative easing during the global financial crisis
Haruhiko Kuroda	<ul style="list-style-type: none"> • Major central banks in Europe and the US pushed aggressive monetary easing during the global financial crisis, while the BoJ still has not done that much • There is a huge variety of assets that it would be appropriate for the BoJ to buy to further monetary easing. It is not the case that the only things to buy are foreign bonds

Source: Citi Research.

At the very first meeting under the incoming new Governor (on April 26), the BoJ will update its semiannual economic outlook report (the "Tembo" report). In the October 2012 outlook report, the central tendency (excluding maximum and minimum values) among the nine board members for core inflation projections adjusted for the consumption tax hike in fiscal 2014 was for a range of +0.4 to +1.0% with a median forecast of +0.8%, while the maximum forecast was also for +1.0%. So at least two members expected 1% core inflation for fiscal 2014 as of late October 2012. We suspect these members put 1.0% core inflation not as objective forecasts but just to be consistent with the BoJ's current longer-term price stability goal. Meanwhile, other board members, who are trying to make objective forecasts, expect much lower core inflation, with one member expecting +0.2% (the minimum value) and at least one member expecting +0.4%.

More monetary easing in April under the new governor

If the governor and two deputy governors are replaced by more dovish people, as we anticipate, they may make more objective forecasts for core inflation, instead of merely parroting the goal. In that case, the central tendency as well as the median forecast for core inflation could well edge down in April. We also expect core inflation forecasts for fiscal 2013 to be revised down meaningfully. These forecast revisions are likely to exert more pressure on the BoJ under the incoming governor to take bolder easing measures—probably more aggressive asset purchases—on April 26.

2) Fiscal policy: Abe administration plans to announce economic stimulus package this week

The new administration plans to announce a new economic stimulus package on January 11, and the FY12 supplementary budget will likely be submitted to the regular session of the Diet that starts in late January (probably on January 28). According to media reports, new government spending in the package is expected

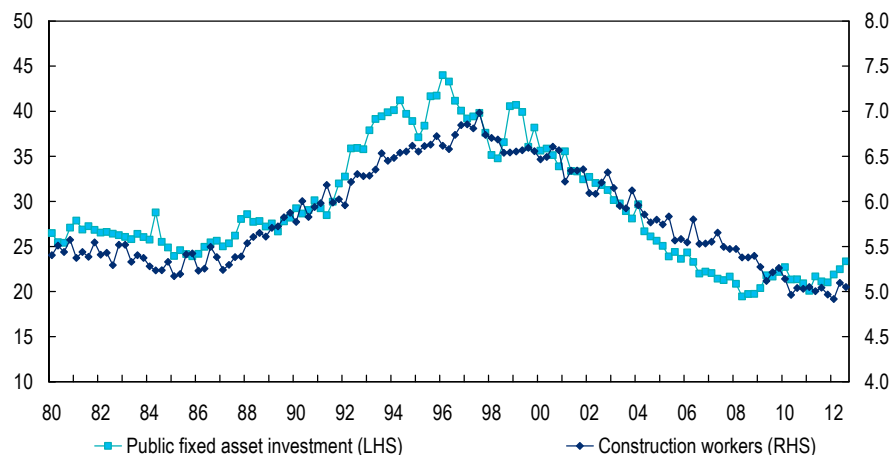
A hefty stimulus package, with real spending of some ¥10trn, will be announced soon

**Several major problems with measures
reliant on public-works spending**

to be ¥10.3trn (excluding ¥2.6trn for the state contribution to the basic national pension program), of which ¥5.2trn is for public-works spending. Public works spending is expected to be directed toward the following areas: 1) seismic retrofit works for elementary and junior high schools and for hospitals that will be key in the event of a disaster, 2) repairing aging infrastructure (roads, tunnels, and bridges), and 3) improving/upgrading old water pipes. These projects likely will push up economic activity in coming quarters, mostly in Q2 and Q3 of CY13.

However, we see several major problems with a large supplementary budget mostly reliant on public work spending. First, we believe the amount of projects which can be completed in a short period will be limited, due to constraints on labor supply. The number of construction workers in Japan decreased to 4,920,000 in the first quarter of 2012, an almost 30% decline from the peak in the third quarter of 1997 (6,980,000; see Figure 5). In this context, we doubt whether a huge volume of projects comparable to those undertaken by past LDP administrations can be implemented smoothly. Second, there may not be many appropriate projects in the first place. In an initial fiscal-year budget, public works are planned with a long-term perspective, at least to some extent, and so the budget usually has a relatively high content of meaningful projects. In contrast, as the prospective supplementary budget will be compiled hastily and most likely be a one-shot deal, it seems unlikely that truly useful projects will be found. The budget will likely generate some demand in the short run, but it will be unlikely to improve the longer-term outlook of the Japanese economy, in our view. Mr. Abe has not, either during the election campaign or after the elections, explained how fiscal pump-priming, however large it is, improves the longer-term economic outlook.

Figure 4. Public fixed-capital investment and construction industry workers (LHS: ¥trn annualized, RHS: mn people)



Source: Cabinet Office, Ministry of Internal Affairs and Communications, Citi Research.

Third, if a new administration does not compile yet another supplementary budget following the upcoming one, public works will likely decrease sharply in the second half of FY13 (October 2013–March 2014) and beyond. Declining public-works spending will probably depress economic activity significantly, especially given the planned consumption tax hike in April 2014. Simply put, government spending is set to take on a pro-cyclical nature. If it does, we would not dismiss the possibility that deflationary pressure will increase again, making the second consumption tax hike slated for October 2015 politically difficult to implement.

The splurge in fiscal spending could result in sovereign downgrades by the ratings agencies. Specifically, another substantial supplementary budget to prop up public-works spending late in 2013 or early in 2014 might lead to downgrades. Indeed, Mr. Abe has already referred to the possibility that his administration will come up with another pump-priming package next autumn. We note that the incoming government will most likely shelve for now the former administration's Medium-term Fiscal Framework, in which new issuance of JGBs is capped at ¥44trn (see Yen Rate Markets on p14 below). While not our base-case scenario, significantly higher JGB yields and/or sovereign downgrades may start to keep Mr. Abe's hands away from the fiscal pump sometime in 2013.

Moreover, there is a possibility that the LDP will introduce policy offsets to counter the negative impact from the consumption tax hike in April 2014. For example, the new administration may well reduce the indirect tax burden on autos in 2014 and also introduce new tax incentives and/or subsidies for housing so as to reduce frontloaded demand ahead of the consumption tax hike and ameliorate the reactionary decline in spending following the hike. In addition, the government may apply a reduced consumption tax rate to foodstuffs to limit the negative impact on the less well-off. In this case, however, tax revenue might not increase as much as the original plan assumed, delaying fiscal consolidation further.

Currently, S&P has Japan's sovereign rating (AA-) on a negative outlook, while Moody's has its rating (Aa3) on a stable outlook. While we expect Japan's sovereign ratings to be unchanged over the next nine months (see our October 24 report, [Sovereign Ratings Outlook - October 2012](#), for details), the possibility of a downgrade has probably increased somewhat following the inauguration of the Abe administration.

3) Growth strategy: Still abstract

Mr. Abe emphasizes the importance of a growth strategy but proposals still lack specifics

Right after he was elected as the new Prime Minister, Mr. Abe emphasized the importance of a growth strategy as one of three pillars of his economic policies, in addition to aggressive monetary easing and flexible fiscal pump-priming. At least so far, however, the LDP's growth strategy proposals are in our view generally fragmentary and abstract. This is probably in part because the LDP is concerned about a possible negative impact on its public support rates if the administration decides to take measures that may hurt vested interests.

As a case in point, the LDP's stance regarding the Trans-Pacific Economic Partnership Agreement (TPP) appears lukewarm. Officially the LDP is opposed to participating in the TPP negotiation if the abolition of custom duties without exception is a precondition for participation. The LDP currently appears likely to delay the decision to participate in the TPP negotiations until after the Upper House election, for fear of losing farmers' support for the party. In this case, Japan may not be able to join discussions to form a TPP framework. Instead, it may be forced to decide on whether or not to participate in the TPP after the framework has been already set by other participating countries. For the same reason, bold deregulation steps seem unlikely to be taken until after the Upper House election.

Meanwhile, any discussion about corporate tax rate cuts, to levels consistent with global norms, will likely be delayed until the end of this year (November/December) when the LDP tax panel finalizes its tax reform proposals for 2014. But even then, it may be difficult to cut the corporate tax rate when the government is asking households to pay a higher consumption tax rate in April 2014. According to the December 31 *Nikkei*, the government is also mulling the establishment of a new public/private fund to purchase old capital stock (factories and facilities) from

manufacturers in order to increase cash available for these companies to make new investments. However, it remains to be seen whether this would revitalize Japan's beleaguered manufacturing sector or just keep zombie companies alive.

The government plans to finalize its growth strategy in June.

4) Foreign policy: moderate approach likely for now

PM Abe will likely take a pragmatic approach, at least before the Upper House election

Contrary to expectations among some observers before the December election, the Abe administration now appears very likely to take a moderate and realistic approach in foreign policy until the Upper House election this summer (likely to be held on July 21, see Figure 2). More specifically, PM Abe is unlikely to take a hard line against South Korea and China in the island disputes Japan has with both nations, so as to prioritize economic issues. Mr. Abe sent Fukushiro Nukaga, a former Finance Minister, to South Korea to meet with incoming President Park Geun-hye early this month. He is also contemplating sending LDP deputy leader Masahiko Komura to China this year in order to improve China-Japan relations. While we do not believe PM Abe has fundamentally changed his long-held views on Japan's neighbors, in our view he will try to keep a low profile regarding these issues, at least until after the Upper House election this summer. However, if the LDP regains an absolute majority in the Upper House, PM Abe's nationalist streak may resurface and complicate Japan's relationship with China and South Korea.

II. Luck on PM Abe's side?

A 10% depreciation of the yen only pushes up CPI inflation by around 0.1%

We remain skeptical that the LDP's economic policy proposals to date will really bring the kind of improvements in economic activity and prices in coming years implied by recent market developments. Specifically, 1% inflation, let alone 2%, is unlikely in our opinion to be achieved by a combination of more aggressive monetary easing and a stop-go fiscal policy driven by fiscal pump-priming and consumption tax hikes.

PM Abe appears to intend to eradicate deflation at least partly by driving the yen down. Indeed, the yen has already weakened significantly against the dollar, reflecting Mr. Abe's statements about monetary policy over the past two months, to levels we do not believe can be justified by the recent relationship between US-Japan interest-rate differentials and the forex rate (see Forex Outlook on p12 below).

Figure 5. Impact of 10% yen depreciation versus the dollar on GDP and prices (%)

		Real GDP	GDP deflator	Consumption deflator
1st year	1Q	0.16	0.06	0.16
	2Q	0.17	0.02	0.12
	3Q	0.18	-0.04	0.11
	4Q	0.24	-0.06	0.11
2nd year	1Q	0.27	-0.08	0.13
	2Q	0.35	-0.05	0.15
	3Q	0.42	-0.06	0.19
	4Q	0.46	-0.01	0.24
3rd year	1Q	0.53	0.03	0.29
	2Q	0.56	0.05	0.35
	3Q	0.61	0.07	0.42
	4Q	0.63	0.05	0.49
1st year		0.19	0.00	0.12
2nd year		0.38	-0.05	0.18
3rd year		0.58	0.05	0.39

Source: Cabinet Office, Citi Research.

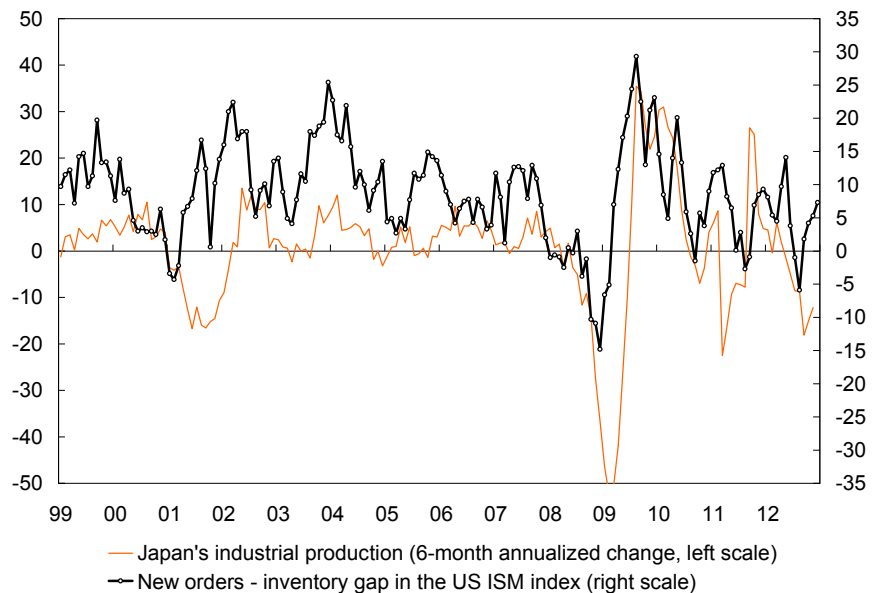
In our opinion, however, moderate yen depreciation alone is unlikely to bring about meaningful inflation on a sustainable basis, let alone 2% inflation. We estimate that a 10% depreciation of the yen against the dollar pushes up the CPI, excluding food and energy, by 0.09% in the first year and 0.14% in the second year. Moreover, macroeconomic simulations done by the Cabinet Office indicate that a 10% depreciation of the yen pushes up the private consumption deflator, including food and energy, by 0.12% in the first year and 0.18% in the second year (Figure 6).

Of course, we cannot rule out the possibility that higher imports, driven by fossil fuels, in the wake of the eastern Japan earthquake somewhat increased the sensitivity of inflation to yen movements, but we feel the impact on inflation of forex volatility is likely to be relatively small and also very short-lived. In order to induce meaningfully positive and sustainable inflation, the yen would probably need to depreciate to levels that would cause pains to the overall economy and in particular to Japanese consumers.

However, PM Abe appears to have the good luck of benefiting from a cyclical recovery. We are now starting to see increasing signs of a cyclical pickup in economic activity. While industrial production in November fell, the production projection index, based upon corporate plans, point to a 6.7% MoM gain in December and another 2.4% gain in January. We believe that production will rebound from a likely bottom in November. Our view is based on the global manufacturing cycle, which is picking up.

In the past, Japan's industrial production has closely correlated with the order/inventory gap (new orders minus inventory) in the ISM manufacturing index of the US, with the latter leading the former (Figure 7). Based on the historical relationship, the order/inventory gap, which has rebounded from a bottom in August last year, seems to signal that domestic production is also bottoming. Furthermore, we expect the weaker yen against the dollar and the expansion in public works under the new government to gradually support production in the coming months. Industrial production and GDP will likely return to a positive growth track in CY13 Q1. So far, financial markets have been focusing mostly on PM Abe's economic policies but we expect them to start to price in the cyclical recovery and its impact on corporate profits in the months to come (see Equity Market section on p17).

Figure 6. Order/inventory gap in the ISM manufacturing index and Japan's industrial production (LHS: six-month annualized percentage change, RHS: ppt)



Sources: US Institute for Supply Management, METI, Citi Research.

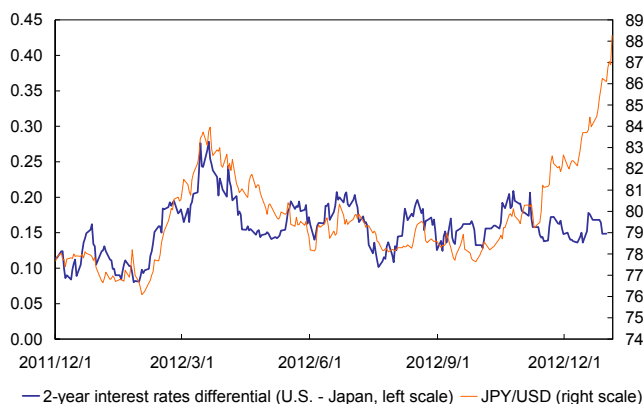
III. Forex Outlook: Yen to weaken further

Kiichi Murashima

The two-year yield differential is not likely to be the dominant factor in determining the direction of US\$/JPY

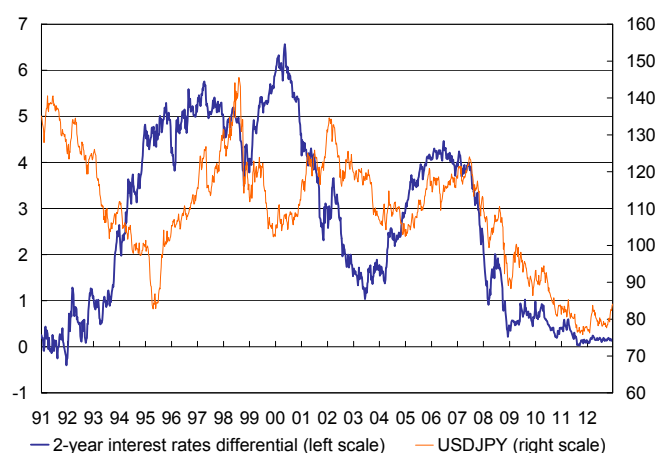
The yen has continued to depreciate against the dollar since we published our first multi-asset report on Japan's elections in late November. The yen depreciation over this period has been greater than can be explained by the relationship of the yen/dollar rate with the two-year government bond yield differential between the US and Japan over the past year or so (Figure 8). In short, based on the differential alone, the yen is oversold (although the wider spreads on 10-year bond yields may in part explain the recent movements in US\$/JPY). However, the relationship between interest rate differentials and the yen/dollar rate has been much looser over a longer-term perspective (Figure 9). Moreover, we believe that this year the short end of the yield curve is unlikely to move much either in the US or in Japan and as a result, the two-year interest rate differential will likely move sideways. As a result, we doubt that the two-year yield differential between the two countries will continue to determine the direction in US\$/JPY.

Figure 7. Two-year yield differential and US\$/JPY over the short term



Source: Bloomberg, Citi Research.

Figure 8. Two-year yield differential and US\$/JPY over the long term



Source: Bloomberg, Citi Research.

Markets pay attention to relative size of central bank balance sheets

Which metric will drive the yen/dollar rate going forward is far from certain, but at this point, to the extent that forex market participants pay attention to the relative size of the central banks' balance sheets in predicting forex market direction, the ratio of the size of the BoJ's balance sheet to the Fed's may drive US\$/JPY this year. Figure 10 shows the ratio of the Fed's balance sheet to the BoJ's (Fed/BoJ) and US\$/JPY over the past 13 years. Since early 2012, the BoJ's balance sheet has been expanding at a faster pace than the Fed's and the yen eventually started to weaken against the dollar last autumn, with the proximate trigger Mr. Abe's statements about monetary policy.

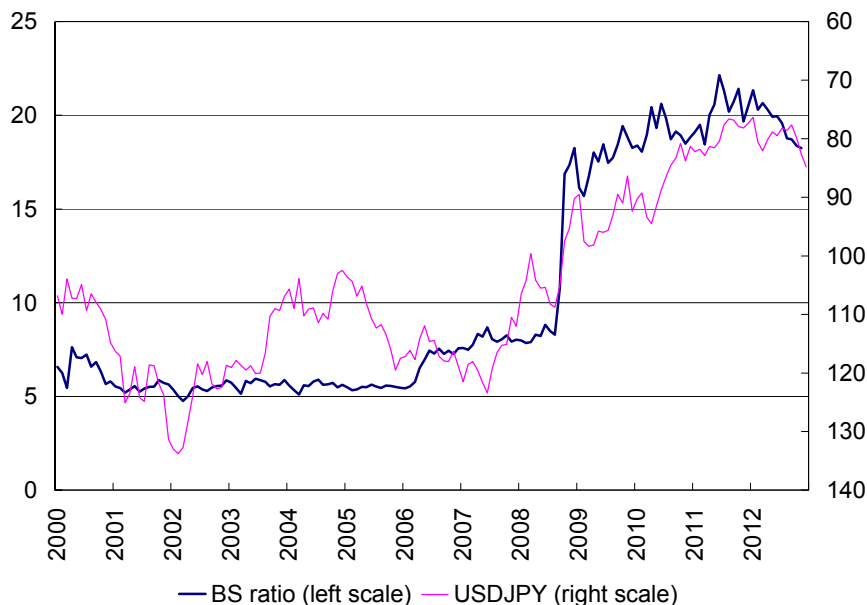
We expect the balance sheet ratio (Fed/BoJ) to stay flat or fall moderately in 2013

We expect the balance sheet ratio (Fed/BoJ) to stay flat or fall moderately in 2013. The Fed plans to continue to purchase \$85bn in longer-term securities (MBSs and US treasuries) per month and if these purchases do continue, the Fed's balance sheet will expand by around 36% in the course of 2013. Meanwhile, Mr. Shirakawa stated at a press conference after the December policy meeting that the BoJ would provide liquidity amounting to more than ¥50trn—consisting of ¥36trn in asset purchases and ¥15trn in multi-year funding operations—over the next year or so. If, as we anticipate, the BoJ adds another ¥10trn or so to the asset purchase program for 2013 in January and/or April, the BoJ's balance sheet will expand by about 38% this year. So further moderate depreciation of the yen against the dollar seems likely in 2013, based upon this metric. Even if the next BoJ governor remains cautious about referring directly to the forex market, given that he will be appointed by the Abe cabinet, we think he is quite likely to put more weight on inducing yen depreciation than his predecessor. However, there is uncertainty over whether the moderate decline in the balance sheet ratio we anticipate is enough for the yen to depreciate significantly from here, given the rapid movement over the past two months and large speculative short positions in the yen.

External factors also point to further dollar strength against the yen. The risk of the US fiscal cliff has been averted, although the deal is far from a long-term solution to the nation's fiscal problem. We estimate that the fiscal drag on the economy in 2013 will be around 1.25% of GDP. We feel this is unlikely to derail the ongoing economic recovery. We expect the US economy to accelerate gradually into CY13 H2, which should be positive for the dollar, especially if US bond yields rise further. Also, tail

risk in Europe has retreated for now and this retreat is likely to be generally negative for the yen.

Figure 9. Balance sheet ratio (Fed/BoJ) and US\$/JPY (LHS: x, RHS: ¥/\$)



Note: The balance sheet ratio is the Fed balance sheet in US\$bn divided by the BoJ balance sheet in ¥trn.
Source: Federal Reserve, Bank of Japan, Citi Research.

The next destination for US\$/JPY may be ¥90-¥95, on the US economic recovery and capital outflows from Japan

We expect the Japanese economy to pick up moderately in 2013. In the past, a recovery in the economy and the resultant rally in the equity market generally increased risk tolerance among Japanese investors—both institutional and individual—and led to larger capital outflows from Japan, which in turn caused the yen depreciation. We figure this will also be the case in 2013. All in all, we figure the next destination for the US\$/JPY may be ¥90-¥95, although we would not be surprised to see some correction in US\$/JPY over the near-term, given the large speculative short position in the yen.

IV. Yen Rates Market: We expect a 1.1% 10-year JGB yield at year-end

In our previous report, we divided the impact of the Lower House election on the yen rates market into four stages:

1. the period up to the vote on December 16, 2012;
2. the period up to the drafting of the FY12 supplementary budget and the FY13 budget after new economic ministers are appointed (essentially the period up to the convening of the next regular session of the Diet on January 28);
3. the period up to the appointment of the new BoJ governor in April;
4. the period up to the Upper House election in summer this year and the cabinet decision in October on whether to go ahead with the consumption tax hike currently scheduled for April 2014.

Eiji Dohke
Maki Shimizu

**The first period:
Up to the vote on December 16**

In this report, we look back on (1) and offer an interpretation of (2). In period (1) there was a succession of media reports not long before the December 16 election forecasting that the LDP and New Komeito together had the momentum to win 300 seats, and the market began to move to price in an overwhelming victory for the LDP of Shinzo Abe. The 10yr JGB yield rose to around 0.75% from around 0.7% on market speculation about a resumption of the “Abe trade”.

**We are now in the second period, leading
up to the drafting of the FY12
supplementary budget and the FY13
budget**

We have now entered period (2). With market observers already aware of the possibility of a revision to the BoJ Law, BoJ governor Shirakawa said at a press conference following the December 20 BoJ monetary policy meeting that the bank would bring in revisions to its goal of longer-term price stability, set in February last year, and that in principle the goal would be subject to annual reconsideration. The bank has also recently received a request from PM Abe that it look at its price target. Given this, BoJ governor Shirakawa said that at the next policy meeting (scheduled for January 21-22), the bank would look at the price stability at which it aims over the longer run in the context of monetary policy management. On the JGB market, it is becoming the consensus that the bank will bring in an inflation **target**, as opposed to an inflation **goal**, at the next monetary policy meeting.

**PM Abe seems to think both monetary
policy and government spending are
needed to raise inflation expectations**

PM Abe seems to think it will take two to three years to raise inflation expectations through monetary policy alone and that the government needs to stimulate investment and consumption via spending in the meantime. The new administration took office on December 26 and ministers indicated a large supplementary budget would be put together (LDP and New Komeito leaders envisage a budget of around ¥10trn). This does not include the FY12 increase in the state contribution to the basic pension (around ¥2.6trn), even assuming the FY11 surplus of ¥1.9trn and interest expense savings driven by lower JGB yields are used and existing expenditure is reduced, so we forecast the government will only be able to secure funds of around ¥5trn.

The Noda cabinet's Medium-Term Fiscal Framework of August 2012 states that the government will do its utmost to ensure that new bond issuance in FY13 (excluding special pension bonds and other bonds with redemption funds guaranteed by specific legislation) will not exceed issuance in the initial FY12 budget (around ¥44trn). However, PM Abe has said he will not observe the ¥44trn cap and wants to push through as big a supplementary budget as possible. Akira Amari, economic revitalization minister, said on December 20 (he was then chairman of the LDP's Policy Research Council) that if fiscal management in the first one to three years of the administration is not flexible, it will not be possible to shake off deflation. While it had seemed that the FY13 budget would be formulated with the goal of fiscal restoration, this was a DPJ policy and is not one that the new administration is likely to follow.

We thus cannot rule out bond issuance in the FY13 budget exceeding ¥44trn. Like the budget, the bond issuance plan is decided in a two-stage process. The FY12 supplementary budget will be decided around January 15 and the initial FY13 budget will probably be settled in late January/early February. Even if the administration is able to make JGB market issuance on a calendar basis lower than on a budget basis after adjustment, by reducing front-loaded JGB issuance etc., the large stimulus measures in the FY12 supplementary budget and the likely sharp increase in refunding bonds in the FY13 budget has brought an increase in average monthly bond issuance of ¥1trn within sight (not taking the BoJ rollover into account).

There is a risk of large increases in JGB issuance in major tenors in light of upcoming budgets, which should keep the yield curve on a steepening bias

At the time of writing, government bond issuance plans accompanying the FY12 supplementary budget and FY13 initial budget are unclear. We forecast JGB issuance plans by maturity in Figure 11, for which the risk is on the upside in size. As issuance per auction is capped, we believe the timing of the increase will be brought forward to February from April (the start of FY13). In light of the market's capacity to absorb JGBs, we estimate the following increase in issuance per month by maturity: two-year ¥200bn, five-year ¥200bn, 10-year ¥200bn, 20-year ¥100bn. The increases in 5-year and 10-year issuance will be reflected from the February schedule while 2-year and 20-year issuance increase will be from April. The margin of increase in JGB issuance up to ¥500bn per calendar month will likely be borne by 5-year and 10-year sectors, given the risk of a deteriorating supply/demand balance for super-long tenors. That said, an increase of issuance by over ¥700bn may come into sight from April (compared to the current schedule) and we also expect 2-year and 20-year issuance to increase.

We do not rule out the risk that the ¥44trn cap of new financing bond may be breached in the initial FY3/13 budget. If it is, alternatives to the above estimates would be an increase in 20-year issuance from February and/or monthly 30-year JGB issuance, with a reduction in the size per auction (aggregate issuance of 30yr JGBs will increase by ¥400bn annually). As the *Nikkei* reported on January 7, MoF may consider resuming the issuance of inflation-linked JGBs (with a deflation floor) from next fiscal year, in the sum of around ¥2trn. Even if this is included in the issuance plan, MoF will offset the supply burden in the market by buying back existing JGB issues.

JGB investors probably want the BoJ to increase purchases and extend the length of maturities included in the JGB purchase program. BoJ governor Shirakawa has ruled out financing the fiscal debt in no uncertain terms. The increase in long-term bond purchases by the BoJ will probably be lower than the increase in bond issuance. And while the government aims to lengthen the average maturity of bonds (seven years and nine months in FY12, we picture around 8 years for the forthcoming additional issuance), there is little likelihood that the average maturity of bonds purchased by the BoJ will increase to the level the government wants. The asset purchase program only mandates the purchase of long-term bonds that have more than one year and less than three years to maturity. Even if the maturity limit is extended, we think it would only be to five years. Extending the maturity limit would apply steepening pressure on the yield curve beyond five years.

Figure 10. JGB issuance plan (¥ trn)

	JGB40	JGB30	JGB20	JGB10	JGB5	JGB2	TB1Y	TB6M	JGBi	Liquidity Supply
2012	Apr		0.7	1.2	2.3	2.5	2.7	2.5		0.6
	May	0.4		1.2	2.3	2.5	2.7	2.5		0.6
	Jun		0.7	1.2	2.3	2.5	2.7	2.5		0.6
	Jul		0.7	1.2	2.3	2.5	2.7	2.5		0.6
	Aug	0.4		1.2	2.3	2.5	2.7	2.5		0.6
	Sep		0.7	1.2	2.3	2.5	2.7	2.5	0.9	0.6
	Oct		0.7	1.2	2.3	2.5	2.7	2.5	0.0	0.6
	Nov	0.4		1.2	2.3	2.5	2.7	2.5		0.6
	Dec		0.7	1.2	2.3	2.5	2.7	2.5		0.6
	Jan		0.7	1.2	2.3	2.5	2.7	2.5		0.6
	Feb	0.4		1.2	2.5	2.7	2.7	2.5		0.6
	Mar		0.7	1.2	2.5	2.7	2.7	2.5		0.6
Total										150.5
2013	Apr		0.7	1.3	2.5	2.7	2.9	2.5		0.6
	May	0.4		1.3	2.5	2.7	2.9	2.5		0.6
	Jun		0.7	1.3	2.5	2.7	2.9	2.5		0.6
	Jul		0.7	1.3	2.5	2.7	2.9	2.5		0.6
	Aug	0.4		1.3	2.5	2.7	2.9	2.5		0.6
	Sep		0.7	1.3	2.5	2.7	2.9	2.5	0.4	0.6
	Oct		0.7	1.3	2.5	2.7	2.9	2.5	2.0	0.6
	Nov	0.4		1.3	2.5	2.7	2.9	2.5		0.6
	Dec		0.7	1.3	2.5	2.7	2.9	2.5		0.6
	Jan		0.7	1.3	2.5	2.7	2.9	2.5		0.6
	Feb	0.4		1.3	2.5	2.7	2.9	2.5		0.6
	Mar		0.7	1.3	2.5	2.7	2.9	2.5		0.6
Total										159.6

Source: MoF, Citi Research.

A paradigm shift in emphasis to growth from fiscal reconstruction, accompanied by a more reflationary policy bias, will gradually push JGB yield levels higher

We believe anti-deflation measures by the Abe administration will be the main theme for the JGB market in 2013. Our quarterly 10-year JGB yield forecasts are: January–March 0.85%, April–June 1.00%, July–September 0.90%, and October–December 1.10%. We expect a paradigm shift in emphasis, to growth from fiscal reconstruction, and a change in the direction of fiscal and monetary policy toward reflation will gradually push JGB yield levels higher. Specific catalysts include 1) a large increase in JGB issuance, 2) an increase in risk appetite, and 3) a decline in confidence in fiscal discipline. We believe an increase in issuance accompanying large economic stimulus measures, the introduction of an inflation target for the BoJ, and yen weakening and share price gains in reaction to these developments will contribute to yield curve steepening. Market sentiment weakened from the year-end into the New Year, when futures selling by foreign investors and selling of long-term bond by banks cheapened JGBs between 7-10 years to maturity, keeping the current 10yr JGB yield in the 0.8%-0.9% range.

V. Equity market: Rally through spring

Kenji Abe

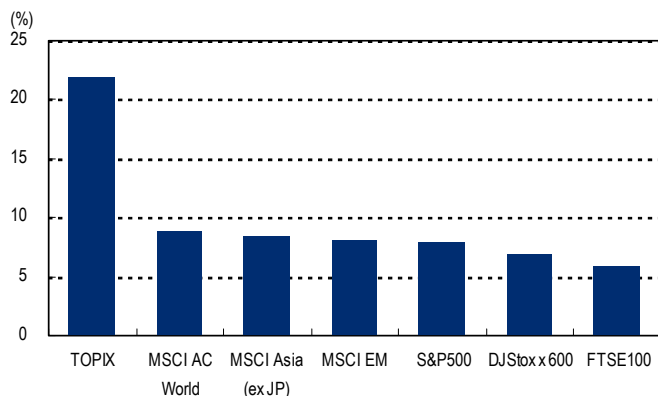
Following the dissolution of the Lower House, the yen weakened and Japanese equities surged following some decisive comments on monetary easing from PM Abe (then only LDP leader). We think the rally is likely to be maintained through spring, as the revision index improves as domestic and overseas economies pick up and on yen weakening to date. We like banks, which strike us as very undervalued on both PER and PBR, and auto-related names, which benefit from the recovery in the US economy.

Equity market in the wake of the Lower House dissolution

Japanese equities outperformed global equities in the wake of the Lower House dissolution

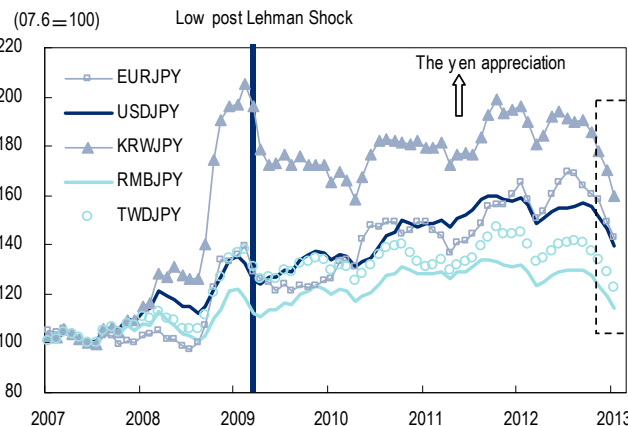
From the November 14, 2012, dissolution of the Lower House by then-PM Noda, through January 7, TOPIX added 22.0%, significantly outperforming global equities. The yen weakened following some decisive comments on monetary easing by PM Abe and foreigners increased their purchases of Japanese equities (Figures 12, 13 and 14).

Figure 11. Global equity index performance



Note: From November 14 through January 7.
Source: Datastream, Citi Research.

Figure 12. Forex rates

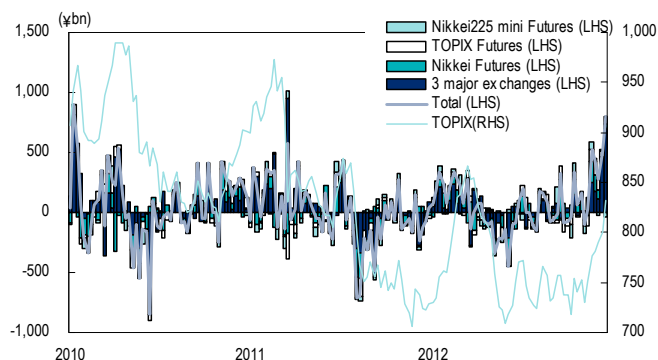


Source: Datastream, Citi Research.

Risk, size indexes rise

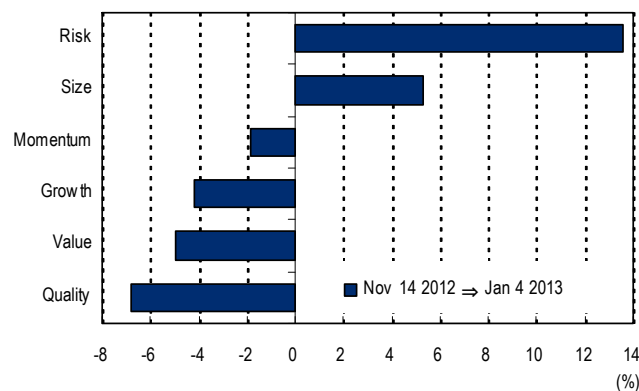
By style, stocks with high betas and high volatility and large-caps, which foreigners find easy to buy, outperformed (Figure 15). By sector, outperformance was logged by securities, which benefits from rising share prices, and transport equipment, machinery, and other sectors that benefit from the weak yen (Figure 16).

Figure 13. Foreigner buying of Japanese equities



Source: Astra Manager, Citi Research.

Figure 14. Style index performance following the Lower House dissolution



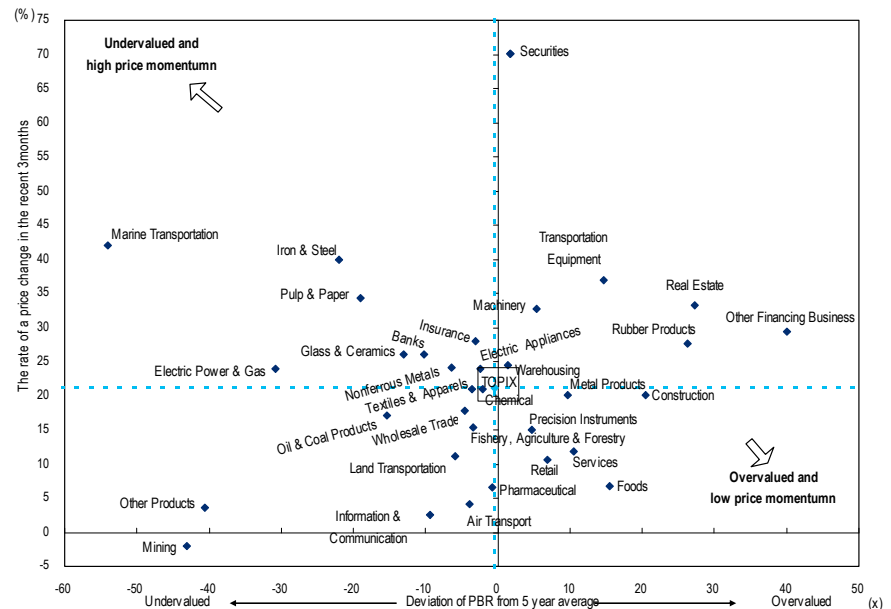
Source: Bloomberg, Citi Research.

Significant outperformance from low-PBR, high beta sectors of securities, marine transport, and steel

Transport equipment and machinery, which benefit from yen weakness, also outperform

Real estate, construction, and financials as a while outperform, as they benefit from reflationary policies

Figure 15. Value and momentum by sector



Source: Astra Manager, Citi Research.

Uptrend to continue through spring

Four reasons to be bullish

The rally has been occurring at a rapid pace, so some in the market forecast a correction for Japanese equities. However, we think the rally is likely to continue through until spring 2013, for the following four reasons.

Improvement in the revision index set to continue

First, we forecast continued improvement in the revision index, on yen weakness to date and pick-ups in domestic and overseas macroeconomies. The revision index and TOPIX have exhibited a strong correlation since 2008 (Figure 17).

Risk index on an uptrend

Second is the rise in the risk index. The risk index we calculate is one which rises when stocks with high betas and high volatility outperform and it has been a leading indicator for TOPIX. In 2012, it started to fall in February, before TOPIX started to fall in March, while it has been rising since July, before TOPIX began to shoot up in November. The risk index is maintaining its upward trajectory and this in our view suggests that TOPIX will rise up ahead (Figure 18).

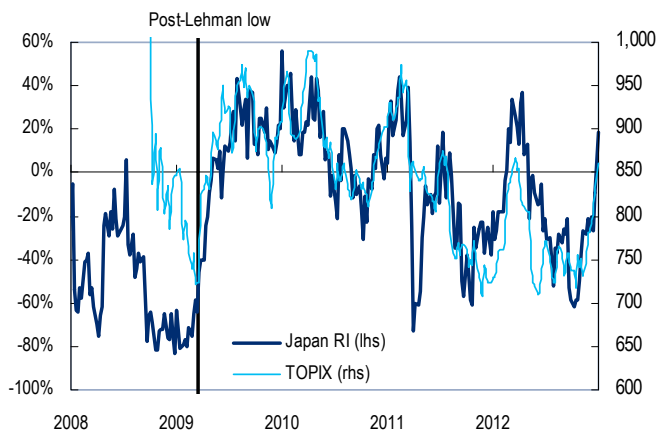
Still room for PER upside

Third is TOPIX valuations. The cyclically adjusted PER (CAPE) of TOPIX rose to 8.5x at end-December 2012. It is still well below the trend line from 1992. Even conservatively assuming that TOPIX valuations are on a downtrend, TOPIX can rise more than 15% by just returning to the trend line.

Japanese equities find it easy to make gains from winter through spring; in April comes the first monetary policy meeting under the new BoJ governor.

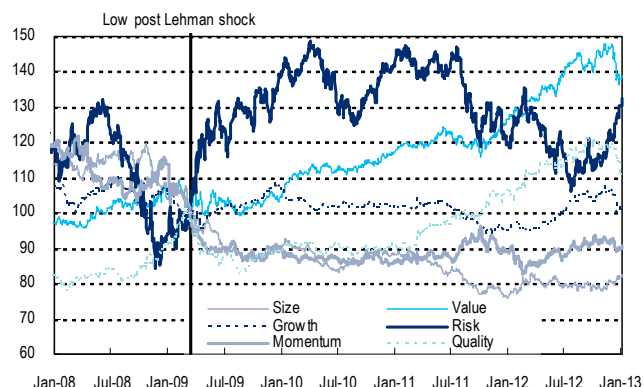
Fourth is the seasonality of Japanese equities and the appointment of a new BoJ governor. Japanese equities exhibit seasonality, in that they find it easy to make gains from winter through spring. In April comes the first monetary policy meeting under the new BoJ governor. We think that PM Abe's confidence in the monetary policy he has been propounding has grown, thanks to the crushing LDP victory in the Lower House elections and the market's reaction to date. We expect the new BoJ governor to move to execute the monetary policies that Mr. Abe has been propounding. We think policy expectations are likely to persist through April.

Figure 16. Revision index and TOPIX



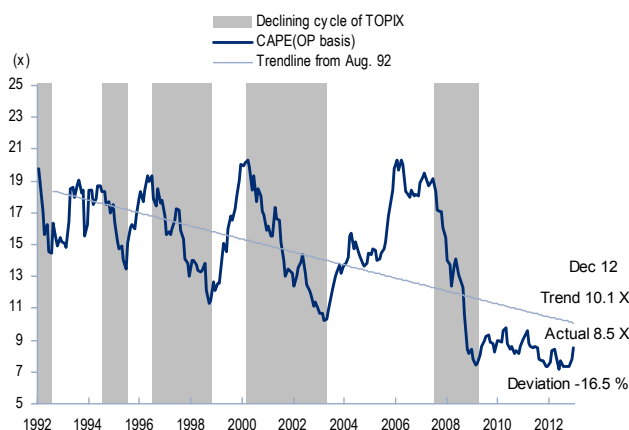
Source: Bloomberg, Citi Research.

Figure 17. Citi style index trends



Source: Citi Research.

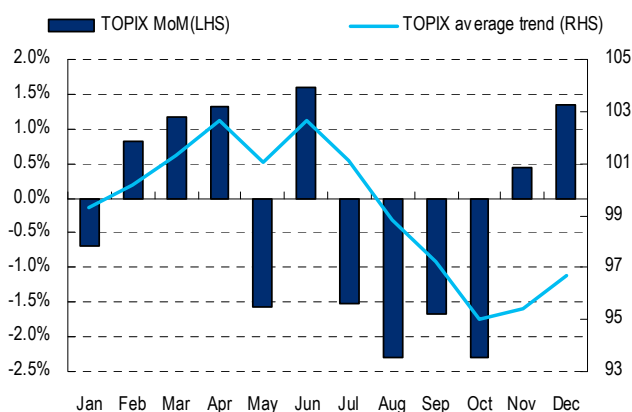
Figure 18. Cyclically adjusted PE



Note: Shaded sections denote periods of decline for TOPIX (10%+ decline over a 12-month or longer period). Deviation calculated using the natural log difference between CAPE and the trendline at end-December.

Source: Bloomberg, Citi Research.

Figure 19. Seasonality of Japanese equities



Source: Datastream, Citi Research.

We like banks and auto-related names

Thus far, the style that has outperformed has been high-risk names (i.e., ones with high beta and high volatility) and among sectors, we have seen outperformance from low-PBR, high-beta sectors such as securities, steel, and marine transport. This pattern could continue if the yen weakens at the pace it has been, but we think much of the catalyst prompted by yen weakness has been priced in. We note the likelihood that the pace of yen weakening will slow moving forward.

Sectors also undervalued on PER could outperform

We see the driver of share price outperformance shifting from yen weakness to improvement in the revision index on pickups in the domestic and overseas macroeconomies. With this, we think sectors undervalued not only on PBR but also on PER could easily outperform (See our December 12 report, [Japan Equity Strategist - Stock selection focused on value and momentum heading toward spring 2013](#), for more details). Also, we note that some sectors such as securities have lost their undervaluation on PBR.

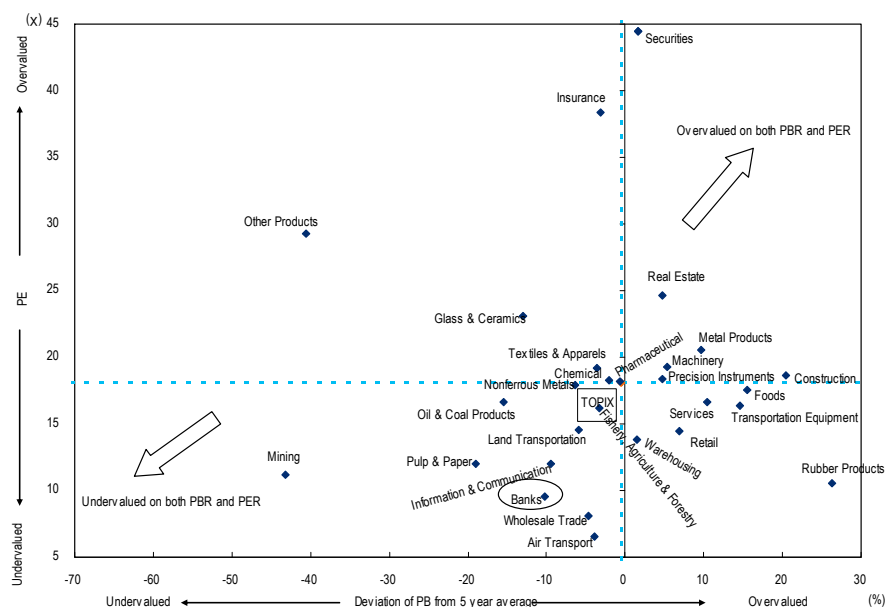
Banks look undervalued on both PER and PBR

Figure 21 shows PBRs and PERs by sector. One sector that looks undervalued on both PBR and PER metrics is banks. We like the sector on this and other factors that could lift share prices: rising long-term interest rates against a backdrop of the supplementary budget and pickups in domestic and overseas economies, and growth in banks' overseas businesses. We are also optimistic on the US economy, so we continue to favor autos and auto parts. Our current top 5 picks are shown in Figure 22.

For more ideas on stock selection, see our December 6 report, [Citi Focus List Japan - Analysts' Key Buy Ideas](#), which details 15 stocks we like.

Banks strongly undervalued on both PER and PBR

Figure 20. PERs and PBRs by sector



Source: Astra Manager, Citi Research.

Figure 21. Top five picks

Code	Company	Price	Rating	Analyst	Reasons to Buy
6902	Denso	¥3,075	1	Arifumi Yoshida	We anticipate growth in sales of fuel-saving products. Denso was swift to get to work on halving the cost of some products and we are optimistic about the prospects for growth in sales to non-Japanese automakers in emerging markets
6954	Fanuc	¥15,910	1	Graeme McDonald	The use of CNCs is spreading for machine tools in China and the use of industrial robots in global manufacturing industry is expanding
7752	Ricoh	¥917	1	Masahiro Shibano	The shares strike us as very undervalued. Moreover, restructuring benefits are beginning to emerge, so we see earnings momentum as stronger than at peers
8306	Mitsubishi UFJ Financial Group	¥476	1	Hironari Nozaki, CFA	The shares strike us as very undervalued. MUFG has greater potential to grow in overseas markets than other Japanese banks. We do not think positives such as interest rate normalization are factored in
8830	Sumitomo Realty & Development	¥2,944	1	Yoshizumi Kimura	The company has many blue-chip projects. In the wake of the eastern Japan earthquake, there has been an increase in demand for high-end projects that offer superior quake resistance. Global monetary easing is also a tailwind

Note: As of January 7. Reasons to Buy are the opinions of the fundamental analysts.
Source: Citi Research.

VI. A Political Postscript

Eiji Dohke
Maki Shimizu

The election resulted in an overwhelming victory for the LDP and New Komeito parties, with a greater than two-thirds majority

The Abe administration places top priority on the coalition obtaining a majority in the coming Upper House election this summer

PM Abe has dubbed the new cabinet a squad of crisis busters and selected key LDP members as economic and finance ministers

In our first multi-asset report, [Japanese Elections: Political, Economic and Market Impact - A Multi-Asset Investment Perspective](#) (published November 29), we envisaged a number of scenarios for the results of the Lower House election held in December and provided forecasts for the macroeconomy and financial markets. Specifically, we put the chances of the LDP emerging as the largest party at a subjective 90% while making our base-case scenario one in which the LDP and New Komeito emerged with a majority, at a probability of 65%. However, the victory of these two parties (325 seats in total) was more crushing than we had expected.

The number of seats actually won by the parties in the 480-seat Lower House was as follows: LDP 294, New Komeito 31, DPJ 57, Japan Restoration Party 54, Tomorrow Party of Japan 9, Your Party 18, Communist Party of Japan 8, Social Democratic Party 2, New Party Daichi 1, New Renaissance Party 0, New Party Nippon 0, People's New Party 1, and unaffiliated lawmakers 5. The LDP and New Komeito together took 325 seats, giving them a greater than two-thirds majority (320 seats) and allowing them to pass by a second vote bills rejected in the Upper House. The magnitude of their victory came as a surprise. The election was in many ways a referendum on the change in government three years' before. The electorate's verdict was unforgiving and the DPJ ended up with many fewer lawmakers than the 230 it had before the election. The "third forces" struggled overall, in part because they were split into three parties, the Japan Restoration Party, the Tomorrow Party, and Your Party.

The LDP/New Komeito coalition has in our view got off to a good start. However, we regard the electorate's verdict not as an expression of expectations for the LDP but of despair with the DPJ. In the Upper House, the LDP and New Komeito combined have only 102 seats (83 for the LDP and 19 for New Komeito), less than a majority (there are 242 seats in the Upper House but six are vacant, so excluding the speaker, a majority is 118). Moreover, we cannot say that the support base for PM Abe, who was named PM on December 26 at the extraordinary Diet session, within his own party is rock-solid. The party's most ardent desire for the Abe administration is probably that it wins the Upper House election this summer and puts an end to the "divided Diet". When PM Abe was last prime minister, he lost the Upper House election in summer 2007 and subsequently the LDP lost the reins of government.

In a divided Diet in which parties with various ideas and policies proliferate, it is hard to get bills passed that have a substantial impact on the lives of the electorate. One option for the administration is to force through bills on a second vote in the Lower House, but we feel this would only destabilize the running of Diet affairs. However, under the constitution Lower House votes on budget bills take precedence over Upper House votes. Also the major parties have agreed that bills to authorize the issuance of deficit-financing bonds can be passed simultaneously with budget bills through FY15. We expect PM Abe to continue his "safety first" approach through to this summer's Upper House election (half of the Upper House seats expire on July 28). We see him prioritizing a boost to the economy via the three policy platforms of bold monetary easing, flexible fiscal policy, and growth strategies to kick-start private-sector investment. We expect the Abe administration to put off deliberations on bills to which opposition parties in the Upper House are unlikely to assent.

PM Abe has dubbed the new cabinet a squad of crisis busters (see Figure 1). The government will prioritize economic recovery with a view to winning the summer Upper House election and we believe the selection of ministers with economy-related portfolios was the priority in forming the new cabinet. This has given the cabinet a heavyweight, reflation-oriented look.

Akira Amari, chair of the LDP's Policy Research Council, has been appointed head of the new Headquarters for Japan's Economic Revitalization (chaired by PM Abe), which is charged with formulating microeconomic policy, and of the Council on Economic and Fiscal Policy, which is responsible for macroeconomic policy. We expect he will be involved in monetary policy decisions (Seiji Maehara, who was in charge of economic and fiscal policy in the Noda government, attended BoJ monetary policy meetings). Mr. Amari will also be responsible for unified social security insurance and tax reforms.

Former PM **Taro Aso**, who is seen as in favor of aggressive fiscal spending, will serve as deputy PM, finance minister, and minister for financial services. **Yoshihide Suga**, acting secretary general of the LDP, has been appointed chief cabinet secretary, and will hold rank over Mr. Amari in his position as the minister in charge of economic revitalization.

Figure 22. Ministers with economy-related portfolios in the Abe cabinet

Shinzo Abe	Prime Minister
Taro Aso	Deputy Prime Minister Minister of Finance Minister of State for Financial Service
Yoshitaka Shindo	Minister for Internal Affairs and Communications
Norihisa Tamura	Minister of Health, Labour and Welfare
Yoshimasa Hayashi	Minister of Agriculture, Forestry and Fisheries
Toshimitsu Motegi	Minister of Economy, Trade and Industry
Akihiro Ota (New Komeito)	Minister of Land, Infrastructure, Transport and Tourism
Yoshihide Suga	Chief Cabinet Secretary
Takumi Nemoto	Minister for Reconstruction
Keiji Furuya	Chairman of the National Public Safety Commission Minister for the Abduction Issue Minister in charge of National Infrastructure Resilience
Akira Amari	Minister in charge of Economic Revitalization Minister in charge of Social Security and Tax Reform Minister of State for Economic and Fiscal Policy
Tomomi Inada	Minister for Administrative Reform

Source: The Office of Prime Minister, Citi Research.

Government to decide on emergency economic measures and combine a substantial FY12 supplementary budget with the FY13 budget, so as to implement economic measures seamlessly

We believe the triumvirate of Mr. Aso, Mr. Suga, and Mr. Amari is close to Mr. Abe in their views on fiscal and monetary policy. The media have been reporting that the Abe administration will prepare emergency economic measures by January 11 and put them before the Cabinet for approval on January 15. A supplementary FY12 budget will be submitted to the Diet in January with a view to having it passed in mid-February. But work on the FY13 budget will start very late and the passage process will likely spill over into the next fiscal year for the first time in 19 years. We imagine a bill will be submitted to the Diet in late February and see a strong possibility that it will not be passed until around the Golden Week holidays (end of April and start of May), which means it is likely to include a provisional budget for around 50 days. To prevent pump-priming measures from falling through the temporal cracks, we believe the FY12 supplementary budget and the FY13 budget could be combined as a 15-month budget. The *J-File* 2012 LDP manifesto declared that a LDP government would decide on emergency economic measures as soon as possible after taking office and combine a substantial FY12 supplementary budget and a FY13 budget so as to implement economic measures seamlessly.

**The hefty stimulus measures and bold
monetary easing will probably determine
whether the consumption tax is hiked**

With the aim of securing a LDP victory in the summer Upper House elections, we expect the Abe administration give top priority to reflation of the economy. We believe the new government will promote more flexible economic and fiscal management that can respond to the decline in the domestic economy and international risks (the Europe crisis, slowing emerging market economies) over the next two to three years. At the same time, it plans to stand by its international commitment to restore public finances. Japan has said it will aim to halve its national and regional government primary deficit as a percentage of GDP (compared with FY10) by FY15 and return to a primary surplus by FY20. If the FY15 target is to be achieved, we believe the two phases of consumption tax hikes (to 8% from 5% in April 2014 and to 10% from 8% in October 2015) will be indispensable.

The consumption tax bill contains an economic get-out clause that requires the Cabinet to make a decision on whether a hike should be implemented as planned only after economic conditions six months beforehand have been confirmed. PM Abe has said he will give serious consideration to the April–June GDP data, which will be released in August. This is the quarter immediately before the Upper House election is scheduled to take place.

In December 2012, Akira Amari, at that time chairman of the LDP Policy Research Council, said that LDP president Shinzo Abe had told the ministry of finance that even if real GDP growth was good in April–June 2013, if it subsequently deteriorated the consumption tax hike would probably be quickly suspended. In late December, PM Abe said that fiscal consolidation without the elimination of deflation and economic growth would be impossible. The FY12 supplementary budget, incorporating hefty economic stimulus measures, the FY13 budget, and BoJ monetary policy will probably determine whether the consumption tax hikes can be implemented.

Denso

(6902.T; ¥3,040; 1)

Valuation

We use PER to set our Denso target price. We derive our PER target based on profit growth potential, profitability (RoIC, RoIC-WACC spread), historical PERs, and the market and sector PERs and global comparisons. Our ¥3,000 target price is based on a target PER of 13x and our FY3/14 EPS estimate of ¥227. We assign a PER premium of around 30% to the sector average fair value PER of 10x to derive our 13x target. We assign a significant premium, as we like Denso's potential to grow faster than auto production on the launch of fuel-saving and "half-cost" products.

Risks

We believe risks to our target price include: 1) demands for discounts from automakers; 2) forex changes (a ¥1 change affects OP by about ¥2.9bn against the dollar, ¥0.7bn against the euro); 3) production trends at Toyota, which accounts for some 50% of sales; 4) trends at the Big 3 US automakers; 5) a fall in the average price of parts supplied per vehicle as a result of model mix deterioration; 6) the prices of raw materials such as copper and aluminum; 7) the possibility extraordinary losses related to an ongoing anti-trust investigation; and 8) geopolitical risk resulting from the Japan-China territorial issue. If these factors

manifest themselves differently than we have anticipated, the share price may vary from our target price.

Fanuc

(6954.T; ¥15,860; 1)

Valuation

We set our target price for Fanuc referencing the following: 1) The average global PER for the industrial sector in CY2013 is 11.5x and as one of the world's top industrial franchises, with outstanding operating margins and positive CF generation, we feel some kind of premium is deserved. Fanuc has a 50% plus share of the worldwide market for machine tool-use CNCs/servo motors and a 20% share in industrial robots. 2) Between FY3/06-3/12, the average PER was 22x, the EV/EBITDA was 9.2x, and EV/sales was 3.5x. Median multiples for the same period were 19x, 8.6x, and 3.6x respectively. 3) Fanuc has one of the highest operating margins among global industrials. In FY3/12, the operating margin was 41.2%, though it did retreat from a new all-time high of 45.6% in Q2 FY3/12. There has been a deterioration in the OPM since then due to a shift in product mix but Fanuc continues to set the benchmark for Japanese manufacturers. 4) Between FY3/06-FY3/12 its RoE averaged 12% (with 15% generated in FY3/12).

Using FY3/14 as our base year, and applying a PER of 15x, and then adding back the estimated cash per share of c¥3,650 at end-FY3/13, we arrive at a rounded down target price of ¥14,500. Fanuc has often been criticized for its inefficient balance sheet, essentially holding too much cash. Management has bought back shares in the past, but there has been no corporate action on this front since August 2009. At present, Fanuc holds 43.7mn shares (or 18% of total shares outstanding) as treasury stock. There are no signs that management is considering canceling them or using some to carry out a share-swap type acquisition.

Risks

Factors that could cause the shares to fail to reach our target price include 1) signs of a sharp slowdown in Chinese economic activity; 2) a slowdown in machine tool demand globally; 3) a turn down in global auto capex; and 4) an increase in the value of the yen compared to the US dollar and/or the euro. If these or other factors manifest themselves to a greater extent than we have anticipated, the share price may differ from our target price. Longer-term risks would include the emergence of a credible Chinese competitor in CNCs. Also, a rapid increase in the penetration rate of electric vehicles could also be construed as a negative for the whole machine-tool industry, a key customer base for Fanuc.

Ricoh

(7752.T; ¥905; 1)

Valuation

We set our Ricoh target price at ¥1,000 (FY3/14E PBR of 0.9x). The shares have been assigned a discount of 10%-50% versus the market average since the global financial crisis, as they have been trading in a PBR range of 0.5x-1.3x. Our target price assigns a discount of around 15%, close to the level of spring 2010, when

hopes of post-global financial crisis earnings momentum improvement were high. Our target price equates to an FY3/14E PER of 11x and dividend yield of 3.3%.

Risks

We see potential downside risks as 1) rapid yen strengthening, 2) shrinking expectations for fixed cost cuts via structural reform (i.e., job cuts), 3) a clear rise in costs should the company aim for rapid sales expansion in its digital camera business or other new businesses, and 4) changes in the macroeconomic environment or customer attitudes, resulting in a larger-than-expected decline for office equipment. As for upside risks, we would envision 1) yen weakening; 2) proof of cost cutting benefits, an area where we think the company will fall short of its plans; 3) changes in the macroeconomic environment or customer attitudes, resulting in faster-than-expected growth for office equipment; and 4) should Ricoh earnings look more reassuring relative to peers as concerns about slower demand mount.

Mitsubishi UFJ Financial Group

(8306.T; ¥462; 1)

Valuation

We set our target prices using a target PER based on theoretical expected return and our FY3/14 earnings outlook. Specifically, we calculate back from historical PBRs to establish a theoretical average expected return (the level we expect will be stable over the long term) for the banking sector (5.76%, derived by adding a long-term interest rate of 2.3% to the average yield spread of 3.46%), and we take the reciprocal of this to derive a long-term PER target of 17.4x. However, the global bank average is currently below 10x, and we think it will take time for valuations to return to normal, so we think valuations will only go halfway back to normal over the next year. Accordingly, we set our target PER at 12x. We apply this to an EPS estimate adjusted for effective tax rate and round up or down to the nearest ¥10. We decide whether to round up or round down taking into account a qualitative assessment of earnings and other factors. In the case of MUFG, we round use the estimated fair value of ¥600 as our target price.

Risks

Risks to our target price include the following. Potential downside risks include renewed NPL problems due to inadequate distribution of credit risk, concerns regarding exposure to market risk through shareholdings, worsened operating conditions for US subsidiary Union Bank due to a slowdown in the US economy, and capital strategies that neglect shareholder interest. Conversely, the share price could exceed our target price significantly on major improvements in macroeconomic conditions accompanying interest rate hikes or greater-than-expected integration benefits.

Sumitomo Realty & Development

(8830.T; ¥2,828; 1)

Valuation

Our target price is based on FY3/12 NAV at ¥2,400, and balances earnings momentum against other valuation metrics. Our target price also corresponds to an FY3/13E PER of 19x (excluding extraordinary items) and EV/EBITDA of 21.8x.

Risks

Risks to investing in Sumitomo Realty and Development are 1) changes in fundamentals, e.g., a decline in earnings due to sluggishness for the rental office and condominium markets, and 2) its tendency toward short-term valuation fluctuation via volatility in the financial markets.

If the impact of these factors diverges from our forecasts, the share price could diverge from our target price.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Denso (6902)

Ratings and Target Price History Fundamental Research

Analyst: Arifumi Yoshida



	Date	Rating	Target Price	Closing Price
1	26-Feb-10	1M	*2,800	2,408
2	2-Sep-10	1M	*2,700	2,340
3	4-Jan-11	1M	*3,600	2,841
4	8-Jun-11	*1H	*3,900	2,824

* Indicates change

	Date	Rating	Target Price	Closing Price
5	30-Sep-11	1H	*3,400	2,511
6	7-Oct-11	Stock rating system changed		
7	7-Oct-11	*1	3,400	2,249
8	18-Jan-12	1	*3,000	2,136

	Date	Rating	Target Price	Closing Price
9	16-May-12	1	*3,200	2,440
10	23-Oct-12	1	*3,000	2,561

Rating/target price changes above reflect Eastern Standard Time

Denso (6902)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Arifumi Yoshida



	Date	Rating	Target Price	Closing Price
1	27-Jan-11	*ADD MP	-	3,035
2	30-Jun-11	*REM MP	-	2,982

* Indicates change

	Date	Rating	Target Price	Closing Price
3	29-Dec-11	*ADD MP	-	2,096
4	18-Jul-12	*REM MP	-	2,462

Rating/target price changes above reflect Eastern Standard Time

Fanuc (6954)

Ratings and Target Price History Fundamental Research

Analyst: Graeme McDonald
Covered since January 28 2010



	Date	Rating	Target Price	Closing Price
1	28-Jan-10	1M	*10,000	8,510
2	1-Feb-10	1M	*11,000	9,040
3	27-Apr-10	1M	*13,500	11,670
4	26-Jul-10	1M	*12,500	10,490
5	29-Oct-10	1M	*15,000	11,650

* Indicates change

	Date	Rating	Target Price	Closing Price
6	27-Jul-11	1M	*17,000	14,730
7	7-Oct-11	Stock rating system changed		
8	7-Oct-11	*1	17,000	10,980
9	31-Jan-12	1	*14,500	12,810
10	16-Mar-12	1	*17,500	15,200

	Date	Rating	Target Price	Closing Price
11	1-May-12	1	*16,800	13,550
12	20-Jun-12	1	*15,300	12,960
13	26-Jul-12	1	*15,100	12,680
14	19-Oct-12	1	*15,000	13,290
15	29-Oct-12	1	*14,500	12,630

Rating/target price changes above reflect Eastern Standard Time

Fanuc (6954)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Graeme McDonald
Covered since January 28 2010



	Date	Rating	Target Price	Closing Price
1	27-Jan-11	*ADD MP	-	13,250

* Indicates change

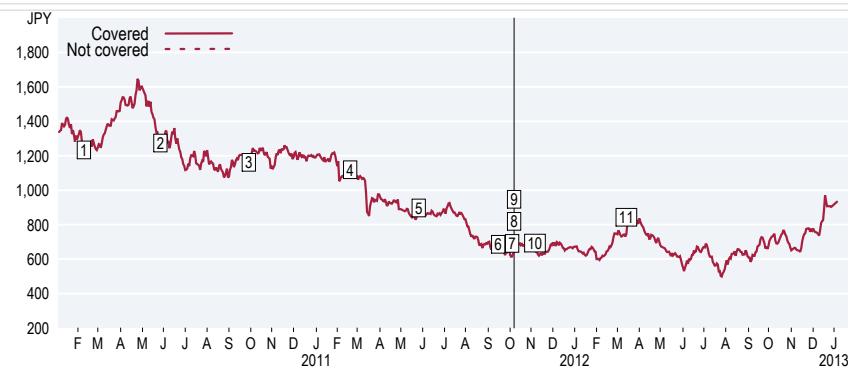
	Date	Rating	Target Price	Closing Price
2	11-Oct-12	*REM MP	-	12,120

Rating/target price changes above reflect Eastern Standard Time

Ricoh (7752)

Ratings and Target Price History Fundamental Research

Analyst: Masahiro Shibano



	Date	Rating	Target Price	Closing Price
1	9-Feb-10	2M	*1,300	1,266
2	27-May-10	2M	*1,400	1,306
3	29-Sep-10	2M	*1,300	1,200
4	18-Feb-11	2M	*1,250	1,113

* Indicates change

	Date	Rating	Target Price	Closing Price
5	26-May-11	2M	*980	885
6	15-Sep-11	2M	*700	662
7	5-Oct-11	2M	*670	615
8	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
9	7-Oct-11	*2	670	638
10	7-Nov-11	2	*700	660
11	14-Mar-12	*1	*1,000	746

Rating/target price changes above reflect Eastern Standard Time

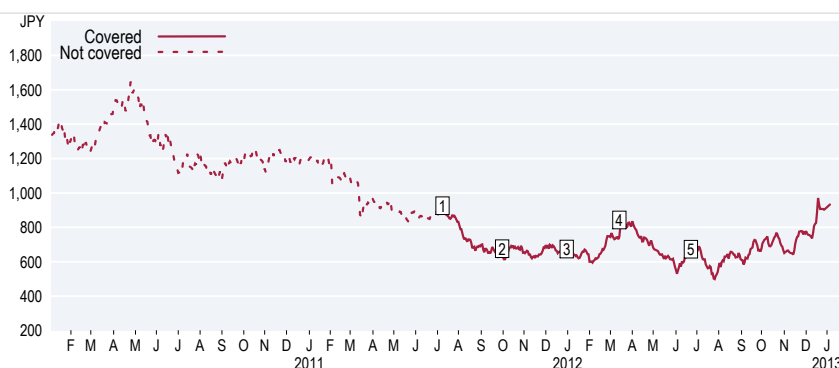
Ricoh (7752)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Masahiro Shibano



	Date	Rating	Target Price	Closing Price
1	8-Jul-11	*ADD LP	-	926
2	30-Sep-11	*REM LP	-	654

	Date	Rating	Target Price	Closing Price
3	30-Dec-11	*ADD LP	-	671
4	14-Mar-12	*REM LP	-	746

	Date	Rating	Target Price	Closing Price
5	22-Jun-12	*ADD MP	-	670

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Mitsubishi UFJ Financial Group (8306)

Ratings and Target Price History

Fundamental Research

Analyst: Hironari Nozaki, CFA



	Date	Rating	Target Price	Closing Price
1	21-Jun-10	1H	*600	428

	Date	Rating	Target Price	Closing Price
2	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
3	7-Oct-11	*1	600	328

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

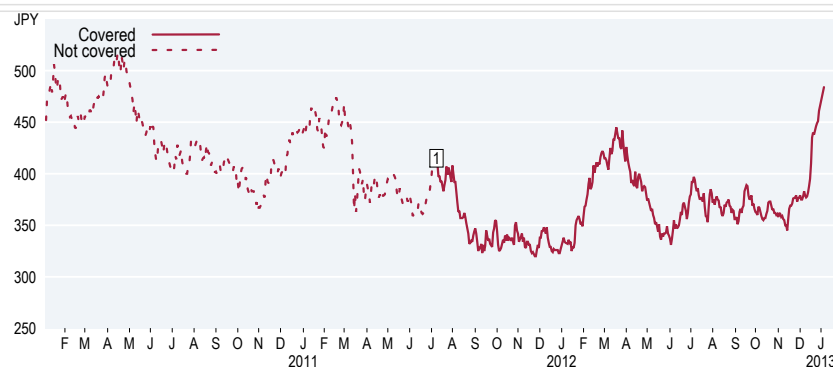
Mitsubishi UFJ Financial Group (8306)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Hironari Nozaki, CFA



	Date	Rating	Target Price	Closing Price
1	8-Jul-11	*ADD MP	-	415

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Sumitomo Realty & Development (8830)

Ratings and Target Price History Fundamental Research

Analyst: Yoshizumi Kimura



	Date	Rating	Target Price	Closing Price
1	9-Jun-10	1M	*2,300	1,528
2	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
3	7-Oct-11	*1	2,300	1,471
4	28-Feb-12	1	*2,400	1,901

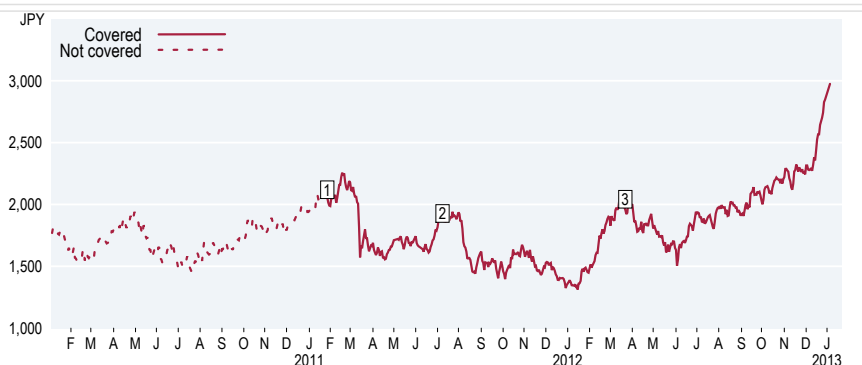
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Sumitomo Realty & Development (8830)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Yoshizumi Kimura



	Date	Rating	Target Price	Closing Price
1	27-Jan-11	*ADD MP	-	2,057

	Date	Rating	Target Price	Closing Price
2	8-Jul-11	*REM MP	-	1,907

	Date	Rating	Target Price	Closing Price
3	22-Mar-12	*ADD MP	-	1,956

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Citi Research Equity Ratings Distribution

Data current as of 31 Dec 2012

Citi Research Global Fundamental Coverage

12 Month Rating			Relative Rating		
Buy	Hold	Sell	Buy	Hold	Sell
49%	38%	12%	7%	86%	7%

% of companies in each rating category that are investment banking clients 53% 49% 45% 60% 49% 55%

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Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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