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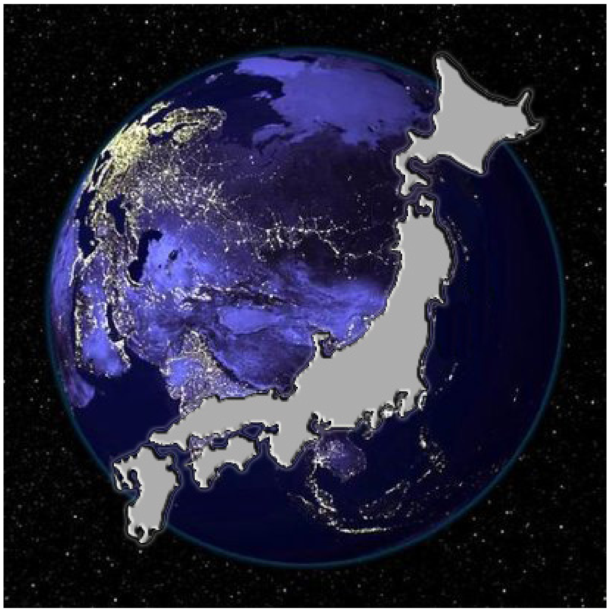
Economics/Rates/Equities
Japan

Japanese Elections: Political, Economic and Market Impact

A Multi-Asset Investment Perspective

- ***In this report, Citi's political analysts, economists and strategists present a multidisciplinary take on the upcoming December 16th general election and its implications for economic/monetary policies, FX, rates and equities.***
- **New election to bring change of government** — Based upon current data, our base-case scenario is a return to power for the LDP, but likely in a coalition, with considerable scope for policy shifts. Possible areas of impact include taxation, monetary policy, nuclear power, and participation in the Trans-Pacific Partnership (TPP) trade agreement. With LDP leader Shinzo Abe poised to return as Prime Minister, concerns about nationalism, particularly with regard to recent tensions with China, could increase.
- **Positive on risk assets in coming months…** — Mr. Abe's statements on monetary policy have moved FX and equity markets significantly over the past few weeks. While we believe that most of his statements are political rhetoric rather than real policy proposals, the BoJ's words and deeds will likely change under its new leadership, to be appointed by the incoming government. As a result, we expect a further depreciation of the JPY, to ¥85 against the USD.
- **…but skeptical that Mr. Abe will change the economy immediately** — We expect economic policies under an Abe administration to mark a return to the traditional LDP approach. If, as we anticipate, BoJ policy turns out to be realistic rather than out-of-the-box, medium-term JPY weakness may be limited.



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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Japanese Elections: Polls, Policies and Potential Implications

Tina M Fordham

A change of government from the ruling DPJ to the LDP is likely, with policy shifts including taxation, monetary policy, nuclear power, and the Trans-Pacific Partnership trade agreement

Japan will hold early elections on December 16th, for the first time in three years, with a change of government from the ruling DPJ to a coalition including the opposition LDP likely, an outcome that would be broadly in line with the current trends in developed market politics: anti-incumbent sentiment leading to frequent changes of government, generally to a mainstream opposition party, but with increased scope for "NEAPs"—New, Extreme or Alternative Parties—to enter government, possibly as coalition partners.

With many voters undecided and approval ratings for both parties low, polls could move in the weeks ahead. Based upon current data, our base-case scenario is a return to power for the LDP, which ruled Japan for more than 50 years prior to the 2009 DPJ takeover, but likely in coalition, with scope for policy shifts considerable. Possible areas of impact include taxation, monetary policy, nuclear power, and the potential ratification of the Trans-Pacific Partnership trade agreement.

With party leader Shinzo Abe, regarded by some as hawkish on foreign policy, poised to resume the leadership, concerns about nationalism, particularly with regard to Japan's stance on recent tensions with China over the territorial dispute in the East China Sea, could increase. With regional political dynamics changing in Asia, between the Chinese leadership transition, South Korean elections on December 19, the potential revival of six-party talks with the DPRK in the Obama administration's second term, and the ongoing shift toward the so-called "Asia Pivot" in US foreign policy, we see the risk of rising nationalism across the region as significant, possibly increasing geopolitical risks.

1. Election Outlook: LDP and New Komeito Likely to Get Majority

Kiichi Murashima

Eiji Dohke

We consider three scenarios for the results of the election: an LDP victory (with 90% probability), a DPJ victory (5% probability), and a "third force" victory (5% probability).

The election campaign will be officially launched on December 4 and parties are now selecting candidates. We had expected the focus of the coming election to be the pros and cons of a change in administration from the DPJ to the LDP. However, around the time that the integrated tax and social security package bills, with their consumption tax hike centerpiece, were passed in August, the DPJ disintegrated; this will therefore be a very unusual election, with more than 10 political parties jostling for position (See Figure 1). The ruling DPJ lost its majority not only in the Upper House but in the Lower House, too, and became unable to run the administration, resulting in a snap election.

The focal points of debate in the election were initially the consumption tax hike, participation in Trans-Pacific Partnership (TPP) trade negotiations[1], and an end to dependence on nuclear power, but of late the monetary policy of the Bank of Japan has also emerged as an issue. Other issues include diplomacy/security and education reforms, so topics in this election are proving to be quite diverse. In divining the impact the election will have on the macroeconomy and financial markets, it is possible to see it as revolving around the question of whether there will be a policy shift from fiscal reform to an emphasis on growth. There are 480 seats up for grabs in the Lower House election, with 300 in single-seat constituencies and 180 in proportional representation constituencies. In the single-

[1] See the discussion in *2. Economic policies: what's new in the LDP's policies?* from p5.

seat constituencies in particular, a slight shift in public opinion can often translate into big changes in the number of seats won, and we cannot rule out the possibility that the general election will produce an unexpected result.

Here we envisage a number of scenarios for the election and we forecast the impact of these on the macroeconomy and various markets. Which party will come in with the most seats? We consider three cases, based on opinion polls and the results of election forecasts: the LDP, the DPJ, and a "third force" (here we take the aggregate of the Japan Restoration Party and Your Party). In all three cases, we note, no party will have a majority in the Upper House, so without some political realignment among major parties, the issue of the "divided Diet" will remain unresolved until at least the Upper House elections in summer 2013 (see Figure 2). If a party or coalition should win a two-thirds majority in the Lower House (320 or more seats), the Lower House can force the passage of bills by means of second votes.[2] However, we think the possibility of this is remote.

Case 1: The LDP is the largest party (subjective probability of 90%)
Case (1a), the LDP/New Komeito coalition forms a majority (65%)
We think case (1a) is close to the market consensus and is the most likely outcome as of the time of writing (see Figure 3). In this case, the FY12 supplementary budget and the FY13 budget would reflect the policies of both the LDP and New Komeito. In budgetary matters, the primacy of the Lower House is well recognized. We think the size of the additional public works spending would be decided by the LDP and New Komeito coalition, with both parties being proactive on additional spending. The medium-term fiscal framework decided on by the DPJ administration would be scrapped and the administration would in our view not be constrained by the cap on JGB issuance of ¥44trn. In contrast, we think that the new administration will need to respect the three-party agreement that the LDP and New Komeito reached with the DPJ over the integrated tax and social security reforms, and specifically those that relate to pensions, medical treatment, and long-term care. We suspect that if the BoJ does not set its inflation target equal to the inflation target that the LDP is citing as a policy pledge, the LDP may seek the amendment of the BoJ Law. New Komeito is opposed to this but the "third force" is even more enthusiastic than the LDP. We put the likelihood of revisions to the BoJ Law at 30%.

Case (1b), the LDP/New Komeito coalition fails to form a majority (25%)

In case (1b), budget compilation will not be smooth unless there is an alliance between the LDP and the DPJ or the "third force". However, as an ancillary provision when the integrated tax and social security bills were passed, the DPJ agreed with the LDP and New Komeito on the need for public works for disaster prevention. We thus think that there would be additions to the public works budget, although we would not expect it to bulge to the extent it would in scenario (1a). While the DPJ is opposed to revisions to the BoJ Law, the "third force" is enthusiastic. We would see a lower probability of revisions than in (1a) but would not rule out the possibility. On fiscal consolidation, we think that if Mr. Abe were to be elected as PM he would postpone the consumption tax hike if he judged that the Japanese economy was not on its way out of deflation.

[2] The Lower House can override a decision made by the Upper House with a two-third majority vote, even if the Upper House rejects a bill approved by the Lower House.

Figure 1. Seat distribution in the Lower House (as of November 16)

Democratic Party of Japan	233
Liberal Democratic Party	118
People's Life First (including Kizuna)	45
New Komeito	21
Japanese Communist Party	9
Japan Restoration Party (including the Sunrise Party of Japan)	7
Your Party	6
Social Democratic Party	5
Tax Cut Japan	5
People's New Party	3
New Party Daichi-Shinminshu	3
Green Wind	1
New Party Japan	1
Others	22
Vacancies	1
Total	480

Source: Nikkei news, Citi Research.

Figure 2. Seat distribution in the Upper House (as of November 26)

The Democratic Party and The Shin-Ryokufukai	90
Liberal Democratic Party and Group of Independents	84
New Komeito	19
People's Life First	12
Your Party	11
Japanese Communist Party	6
Social Democratic Party	4
Green Wind	4
Japan Restoration Party (The Sunrise Party of Japan)	3
New Renaissance Party	2
New Party Daichi-Shinminshu	2
Independents	5
Vacancies	0
Total	242

Source: The House of Councilors, Citi Research.

Case 2: The DPJ is the largest party (probability 5%)

We think the DPJ will find it hard to win a standalone majority. We feel the LDP and the “third force” would be negative on participation in a coalition and that the status quo would likely be preserved. We would not hold out much hope of decisive policy steps in areas such as the economy. With the DPJ anxious to respect the medium-term fiscal framework, we would see scant chance of a large increase in the size of the budget. We think the administration would strike a cautious stance on BoJ Law revisions.

Case 3: The “third force” is the largest party (probability 5%)

With the smaller parties not having prepared thoroughly for the election in areas such as candidate selection, we think they will find it hard to win a majority. We feel a coalition with the LDP and DPJ would be tough to execute and that budget compilation would be a rocky process. The integrated tax and social security reform deal was an agreement between the DPJ, the LDP, and New Komeito, with the “third force” not involved. The “third force” has been calling for the consumption tax to be converted into a regional tax, and we would expect revisions to the current fiscal reconstruction plan, which was expected to be funded by the consumption tax hike. However, we would expect the “third force” to be proactive on revising the BoJ Law. We think this could happen, in alliance with those in the LDP and DPJ who favor revision.

Figure 3. Recent polls of voter preference for major parties in the proportional representative seats elections (%)

Polls during Nov16-18

	Nikkei (Nov 16-18)	Yomiuri (Nov 16-17)	Asahi (Nov 17-18)	Mainichi (Nov 17-18)	Sankei (Nov 17-18)	Kyodo (Nov 17-18)
DPJ	16	13	15	12	15	11
LDP	25	26	22	17	23	23
New Komeito	3	4	4	4	4	4
The third power	18	15	8	21	26	10
Japan Restoration Party	15	13	7	17	22	8
Your Party (Watanabe's Party)	3	2	1	4	3	2
People's Life First (Ozawa's party)	2	2	0	3	3	2
Other parties	4	4	5	-	5	3
Undecided/No reply	-	35	46	-	7	43

Polls during Nov 23-25

	Nikkei	Yomiuri (Nov 23-25)	Asahi (Nov 24-25)	Mainichi	Sankei	Kyodo (Nov 24-25)
DPJ		9	13			8
LDP		27	23			19
New Komeito		4	4			4
The third power		16	12			13
Japan Restoration Party		14	9			10
Your Party (Watanabe's Party)		2	3			3
People's Life First (Ozawa's party)		2	2			2
Other parties		5	5			5
Undecided/No reply		37	20			45

Note: Answer to the question, *Which party will you vote for in the proportional representation seats? Numbers do not always add up to 100% due to differences in polling methods.*
Source: *Asahi Shimbun*, Kyodo News, *Mainichi Shimbun*, *Nikkei*, *Sankei Shimbun*, *Yomiuri Shimbun*, Citi Research.

2. Economic Policy: What's New in the LDP's Policies?

Kiichi Murashima
Naoki Iizuka

It remains to be seen whether the LDP can really make a difference to the economy if it returns to power

The LDP, which is generally anticipated to secure a victory in the upcoming general election, published its election campaign pledges on November 21, as the financial markets continued to quickly price in the LDP's policies—or more accurately, party leader Shinzo Abe's statements. While the basic thrust of economic policy will likely shift, if the LDP returns to power, to efforts to revitalize corporate Japan and away from the DPJ's approach of helping the household sector directly through various subsidies, there does not appear to be much new in the LDP's policy proposals, apart from Mr. Abe's own eye-catching statements about monetary policy. It remains to be seen whether the LDP can really make a difference in the economy if it returns to power.

The LDP's policy platform begins the economic policy section with a declaration that the LDP will seek to "create wealth through growth", clearly differentiating the party's policies from the alleged "distribution under a diminishing equilibrium" pursued by the DPJ. The LDP also sets a "nominal growth target of 3% or higher", to be achieved by "all-out efforts from bold monetary easing to tax/fiscal policies and a growth strategy". In particular, the LDP reiterated its policy to make Japan the most conducive place for corporate activities in the world through intensive reforms in the next five years. But the big question here is how?

The document says that the prospective LDP government intends to implement economic measures seamlessly by compiling a supplementary budget immediately after assuming office, followed by an initial budget for fiscal 2013. We expect a LDP government to expand public works, meaning that the supplementary budget to be submitted to the ordinary Diet session early next year would be reasonably large

(we expect at least ¥3trn). With the Upper House election approaching in the summer of 2013, we believe the bulk of these public works would likely consist of traditional projects. If so, we think financial markets could give low marks to the new government's economic policies.

Figure 4. The LDP economic policy platform for the election

Macroeconomic policy and stimulus measures
- 3% growth in nominal GDP as a medium-term growth target
- Sizable supplementary budget in January

Monetary policy
- Strengthen cooperation between the government and BoJ, including amendment of the BoJ Law
- Introduce an explicit inflation targeting framework (2%) with a policy accord
- Create a public-private fund to purchase foreign bonds

Growth strategy
- Cut the corporate tax rate significantly
- Decide whether to restart nuclear plants whose safety has been verified within three years
- Take a cautious stance on participation in TPP free-trade talks without tariff-cut escape clauses
- Encourage growth of new industries (finance, renewable energy, medical and healthcare, etc.)
- Promote deregulation

Fiscal consolidation and social security reform
- Halve the primary deficit-to-GDP ratio by FY15
- Promote social security reform in line with the three-party agreement
- Decide whether to hike the consumption tax in autumn 2013

Source: LDP, Citi Research.

Figure 5. The DPJ economic policy platform for the election

Macroeconomic policy and stimulus measures
- 3% growth in nominal GDP and 2% growth in real GDP
- Sizable supplementary budget in January

Monetary policy
- Respect the legal independence of the central bank in the BoJ Law
- Continue efforts to overcome deflation by cooperating with BoJ (a status quo approach)

Growth strategy
- Phase out nuclear energy by the 2030s
- Promote participation in TPP free trade talks and negotiate a trilateral FTA with China and Korea
- Encourage growth of new industries (renewable energy, medical and healthcare, agriculture, etc.)
- Promote deregulation

Fiscal consolidation and social security reform
- Halve the primary deficit-to-GDP ratio by FY15
- Promote social security reform in line with the three-party agreement
- Decide whether to hike the consumption tax in autumn 2013

Source: DPJ, Citi Research.

The LDP's stance on energy policy is unclear. Previously, Mr. Abe condemned the DPJ as irresponsible because it aims to eliminate nuclear power by the 2030s, leaving a large gap in their respective longer-term positions. However, the manifesto says the LDP will bring in renewable energy while implementing measures to save energy. It says the LDP will decide whether or not to resume operations at individual nuclear power stations in a timely manner and that an LDP administration will come to a conclusion about all nuclear power stations within the next three years. Over the longer-term the LDP plans to establish an optimal energy mix in 10 years' time at the latest. It seems clear that the LDP does not want to make its energy policy a key issue in the campaign because a significant proportion of voters support the DPJ's plan. In our view, a prospective change of power is unlikely to lead to major differences in this area in the immediate future, as the DPJ is also willing to approve resumption of operations at nuclear plants that pass stringent safety checks.

The LDP promises to reduce the corporate tax rate to the global norm. However, an earlier reference to cutting the corporate tax rate to 20-30% was removed from the final document. Moreover, a corporate tax cut would be at the earliest discussed as part of FY14 tax reforms toward the end of 2013. Bold cuts in the corporate tax rate in the near future appear to be difficult to implement given Japan's fiscal situation and the likely pain in the household sector caused by the consumption tax hike, slated for April 2014.

The LDP's stance on the Trans-Pacific Partnership (TPP) is also vague. While the document includes the LDP's plan to push for general economic partnership agreements (EPAs) and free trade agreements (FTAs), the LDP is opposed to the TPP if abolition of custom duties without exception is a precondition for participation. The LDP appears unlikely to make its position clear about participation in the TPP negotiations for fear of losing farmer votes ahead of elections in December and next summer. This could well make joining the negotiations difficult, in our view.

In its election pledges, the LDP says it will maintain the current government's goal of halving the primary balance deficit as a percentage of GDP in FY15 versus FY10 and achieving a primary surplus by around FY20. However, it remains to be seen whether this policy is compatible with fiscal plans in areas such as public works spending in coming years. It will also be worthwhile looking at what kind of growth assumptions an LDP administration makes in its longer-term fiscal outlook. It would not in our view be right to assume nominal growth of 3% or more, as this is a goal rather than an objective forecast.

The LDP proposes to reinforce cooperation between the government and the BoJ, with revising the BoJ Law as one possible option, but it seems highly uncertain to us that the law would be amended. Given broad-based support for the revision even among lawmakers of other parties, an amendment bill could have a strong chance of approval in the Diet. However, we are not sure whether the LDP really wants to revise the law or just to put pressure on the central bank to ease further. We expect "a clear inflation target of 2%" to be introduced eventually under the new BoJ leadership, regardless of the fate of the BoJ Law.

We doubt if the LDP would differentiate itself from the DPJ in day-to-day policy in the near term, despite its different slogans

In sum, we expect economic policies under an Abe administration would generally mark a return to the traditional LDP approach. Furthermore, we doubt if the LDP could differentiate itself from the current government in day-to-day policy in the near term, despite its different slogans and political philosophy. Efforts to ensure the support of farmers, which the LDP cannot afford to lose before the Upper House election next summer, could constrain economic policies in the near term.

When the new governor is in place, meaningful shifts in the BoJ's words and deeds may gradually change perceptions on the financial markets

We cannot dismiss the possibility that the LDP would exert heavy political pressure on the monetary authorities, beyond what is usually expected in advanced countries, although Mr. Abe has started to tone down his monetary policy rhetoric. The LDP's election pledges state that it will set a clear 2% inflation target and implement aggressive easing to achieve it by close collaboration with the BoJ, with revision of the BoJ Law a possibility. If the BoJ does not introduce an 2% inflation goal of its own accord, the LDP might seriously consider amending the BoJ Law.

BoJ Governor Shirakawa's term will come to an end on April 8, while two deputy governors will leave office on March 19. In our view, it is highly likely that an Abe administration would nominate candidates more dovish than the current leadership to these positions. In particular, someone who supports inflation goal of 2% will likely be appointed to the governor, as suggested by Mr. Abe. Given that three policy board members out of nine have dovish views on monetary policy, the sweeping change in the leadership would shift the overall balance on the policy

board to the dovish side. As of the time of writing, Toshiro Muto, an ex-MoF official who also served as a BoJ deputy governor until 2008, appears to be the most likely candidate to be the new governor.

Figure 6. BoJ policy board members: Terms in office

		Date of appointment	Term
Governor	Masaaki Shirakawa	9-Apr-08	8-Apr-13
Deputy governor	Hirohide Yamaguchi	27-Oct-08	19-Mar-13
Deputy governor	Kiyohiko Nishimura	20-Mar-08	19-Mar-13
	Ryuzo Miyao	26-Mar-10	25-Mar-15
	Yoshihisa Morimoto	1-Jul-10	30-Jun-15
	Sayuri Shirai	1-Apr-11	31-Mar-16
	Koji Ishida	30-Jun-11	29-Jun-16
	Takehiro Sato	24-Jul-12	23-Jul-17
	Takahide Kiuchi	24-Jul-12	23-Jul-17

Source: Bank of Japan, Citi Research.

The BoJ's words and deeds likely will change under the new leadership. We expect the next governor to stress that monetary policy is still effective in supporting the economy and that there remains more that the BoJ can do to eradicate deflation. Judging from his recent statements, however, Mr. Muto appears cautious about implementing out-of-the-box policy options such as BoJ purchases of foreign bonds. 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. While these measures are unlikely to have an immediate and powerful impact on the economy and prices, a meaningful shift in the BoJ's words and deeds may gradually change perceptions about the BoJ in the financial markets.

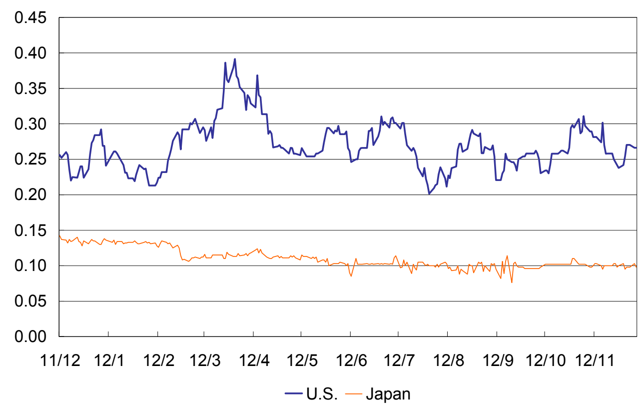
3. FX Outlook: How Long Will JPY Weakness Be Sustained?

Kiichi Murashima

We expect the yen to strengthen to ¥84/$-¥85/$ in coming months but anticipate some correction in the immediate future

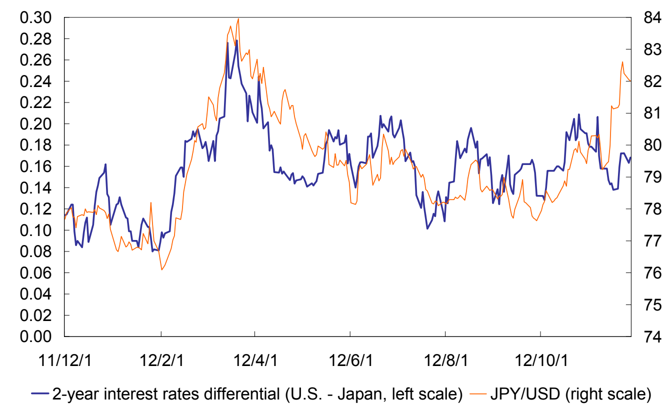
The USD/JPY has broken through its longtime trading range to the upside in recent weeks. The 2-year government bond yield differential between the US and Japan, which had been tracking the USD/JPY quite well until recently, cannot explain the latest phase of yen weakness (see Figure 7). It is clear that the market has started to price in a material change in Japan's monetary policy under the new government that will start after the upcoming general elections. Market speculation is rife that a new LDP administration will force the BoJ to take a more robustly accommodative policy stance than hitherto, via personnel changes (see discussion in Section 2).

Figure 7. 2-year Treasury yields and 2-year JGB yields (%)



Source: Bloomberg, Citi Research.

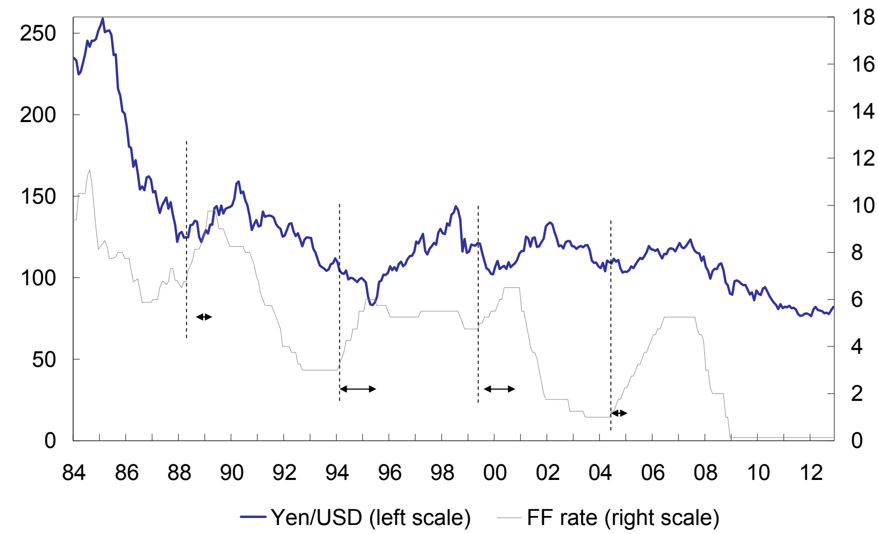
Figure 8. 2-year Yield differential and USD/JPY (left: %, right: ¥/$)



Source: Bloomberg, Citi Research.

We are skeptical that policy options to which Mr. Abe has referred in recent weeks, such as a reduction in the rate of interest on excess reserves (IOER) and so forth, will actually be implemented in the immediate future. In fact, Mr. Abe softened his rhetoric about monetary policy last weekend. However, FX market participants have thus far reacted strongly to Mr. Abe's statements. Moreover, given that he is likely to maintain a hard line against the BoJ during the election campaign over the next month and probably beyond, and that if (as we anticipate) the LDP wins, he would appoint the next BoJ governor next spring, FX market participants are likely to continue to bet on JPY weakness over the near-term. Our own assessment of Abe's policy, which we discussed in Section 2 above, does not really matter for now. And we also expect that a meaningful shift in the BoJ's words and deeds under the new leadership may gradually change the perception of the BoJ in the financial markets. As a result, we expect the yen to strengthen to ¥84/$-¥85/$ in the coming months while we expect some correction in the USD/JPY in the immediate future given that speculative positions are unambiguously skewed to JPY shorts.

Figure 9. Federal funds rate and USD/JPY (Left: ¥/$, Right: %)



Source: Federal Reserve, Bloomberg, Citi Research.

There may be a certain limit to JPY weakness over the medium term

Meanwhile, we figure that there is a certain limit to JPY weakness over the medium term. First, as discussed above, we are skeptical that policy options proposed by Mr. Abe over recent weeks will actually be implemented in the immediate future. Rather, it appears likely that the next BoJ governor will 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. These measures are unlikely to have an immediate and powerful impact on the economy or prices, in our view. Secondly, even if the LDP's policy proposals were to be implemented in a timely manner, which seems unlikely, they would not be enough to eradicate deflation or deflationary expectations and to push down Japan's real interest rates. Thirdly and most importantly, history tells that as long as the short-end of the US yield curve has remained stable, any depreciation of the JPY against the USD has been quite modest and/or short-lived. As a result, we expect the USD/JPY rate to level out next spring. However, if (as we anticipate) the US economy accelerates to 3% growth in the second half, this should provide upside potential for the USD/JPY regardless of the BoJ's policy.

The general perception among FX market participants is that BoJ has historically been very cautious on QE balance-sheet expansion while the Fed has been much more aggressive. Indeed, the ratio of Japanese to US base money has fallen sharply in recent years. Based on current policy programs in the US and Japan, we estimate that the ratio will be roughly stable to end-2013. In the absence of additional intervention, the USD/JPY rate could fall back. Meanwhile, if the BoJ changes its tune materially, the ratio may retrace, serving to push up the USD/JPY.

Figure 10. Citi FX and interest rate forecasts (period-end except where stated, November 26)

		2013				2014	
		1Q	2Q	3Q	4Q	1Q	2Q
US	FF rates	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
	10-year treasury yield (period average)	1.75	1.95	2.20	2.50	2.65	2.90
Euro area	USD/EUR	1.23	1.22	1.21	1.20	1.20	1.20
	JPY/EUR	103	104	103	101	101	100
	Repo rate	0.50	0.25	0.25	0.25	0.25	0.25
	10-year bund yield (period average)	1.50	1.75	1.75	1.50	1.25	1.50
Japan	JPY/USD	84	85	85	84	84	83
	Overnight call rate	0-0.10	0-0.10	0-0.10	0-0.10	0-0.10	0-0.10
	10-year JGB yield (period average)	0.85	1.00	0.90	1.10	1.10	1.00

Source: Citi Research.

4. Yen Rates Market: A Tug of War between Fiscal Deterioration and Easing Expectations

Eiji Dohke
Maki Shimizu

The impact of the election on interest rate markets is best considered in four stages

Based on the base-case scenario (1-a in the earlier section), we believe the impact of the election on interest rate markets is best considered in four stages:

1) the period up to the vote on December 16;

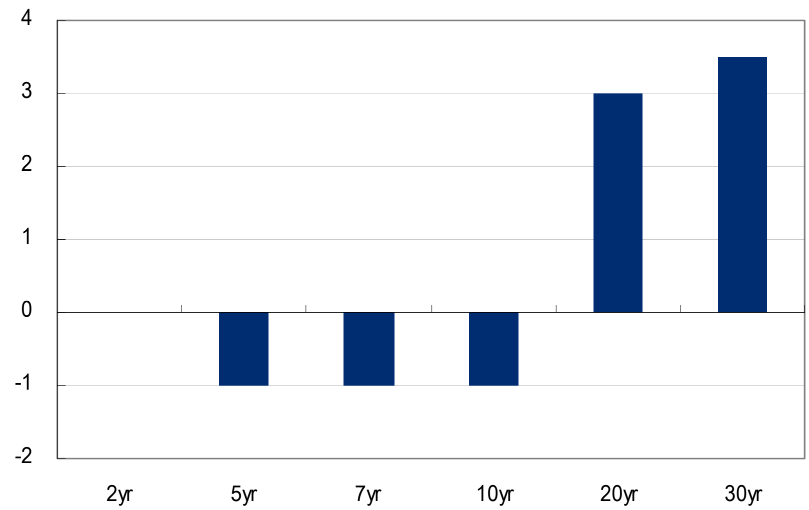
2) the period up to the drafting of the FY12 supplementary budget and the FY13 budget after new economic ministers are appointed (essentially the period up to the convening of the next regular session of the Diet in January next year);

3) the period up to the appointment of the new BoJ governor in April next year;

4) and the period up to the Upper House election in summer next year and the cabinet decision in October 2013 on whether to go ahead with the consumption-tax hike currently scheduled for April 2014.

We are currently in the initial stage, in which both FX and equity markets have been much influenced by “Abe trades”, following PM Noda’s mid-November comment that an election was likely before the end of the year. By contrast, the impact of this news on the JGB market has thus far been very modest indeed. The very short end of the yield curve has richened slightly, with the 2yr sector remaining very stable, while the long end has witnessed a modest bear-steepening move (Figure 9). As shown, the aggregate moves have been very muted to date. We believe that this is likely to remain the case unless there are further sharp moves in equities or the currency, neither of which we expect. In our view, the yen rates market is likely to continue to operate in a narrow trading range as it has been the case throughout this fiscal year. But if the yen were to depreciate further, and sharply, then we would expect this eventually to be reflected in higher long-term JGB yields.

Figure 11. Changes in JGB yields since announcement of Diet dissolution (Nov 14) [bps]



Source: Citi Research.

Clearly markets will struggle to price in the impact of policy risk until after the election result is unveiled (stage 2): this should clarify which parties will form a working coalition and who will assume key ministerial positions. A majority victory for the LDP and New Komeito will likely result in burgeoning market expectations for additional public works spending in forthcoming budgets (FY12 supplementary and FY13 main budgets). The key factor in gauging future JGB issuance plans will be that the medium-term fiscal framework put in place by the Noda cabinet in August may not be upheld. There is no guarantee that any administration other than a DPJ one would respect this framework, which requires “best efforts” to ensure that FY13 issuance of new financing government bonds (excluding special pension bonds and other bonds with redemption funding guaranteed by legislation) not exceed the level of FY12 (around ¥44trn). An increase in JGB issuance via the FY12 supplementary budget could be offset by reducing front-loaded issuance, so issuance this fiscal year would not increase on a calendar basis. However, there is a risk that JGB issuance next year, when there will be a significant increase in refinancing bonds, could expand by more than expected.

In the third stage, an LDP-led coalition would be likely to appoint a new BoJ governor with a more reflationary bias, supportive of inflation targeting. The timing of personnel changes in the BoJ also coincides with increasing monthly supply pressures in the bond market from April onwards, the start of the new fiscal year. So both monetary and fiscal policies could lean towards reflationary outcomes. Under such circumstances, we would become increasingly nervous about the risk of overseas selling in bond futures, particularly if the currency were to keep weakening.

The last stage will test the new government’s efforts to end deflation and the sustainability of the yen’s depreciation. There will be an Upper House election next summer. The legislation for integrated reform of social welfare and taxation, which centered on the consumption tax hike, included provisions for flexible implementation depending upon economic conditions, which included a target for average annual GDP growth over the 10 years from FY11 of 3% nominal and 2% real. Whether or not the consumption tax hike scheduled for April 2014 will go

ahead will be decided by cabinet six months prior. Economic and price trends in FY13 H1, including real GDP in April-June, will therefore be critical, in our view.

At the time of writing, the Abe-inspired rally in Japanese equities and yen weakening remain on track. Expectations for a further decline in medium-term yields have also heightened, while super-long JGBs have underperformed, reflecting mounting concerns over deteriorating fiscal discipline. The direction of benchmark 10yr JGBs, which is hemmed in between the two opposing forces, remains ambiguous. Mr. Abe is calling for the BoJ to lower rates on banks' excess reserves to zero or even negative in order to bolster bank loans. With plans to increase public works, the LDP are also likely to pressure the BoJ to use open market operations to purchase construction bonds.

Sustained momentum in the equity rally and yen depreciation will likely result in profit taking in the rich and liquid 10yr sector of the JGB market

The JGB market currently appears to be expecting a lowering of the interest paid on excess reserves as one of the next policy changes. This, along with expectations regarding maturity extension of JGBs purchased under the Asset Purchase Program (from a maximum of 3yr to possibly 5yr maturities), has encouraged increased money flow into the medium-term sector of the JGB curve. Should equity markets continue to rally while the yen weakens, we would expect to witness profit taking in the rich and liquid 10yr sector of the JGB market before long. Lifers are likely to welcome a jump in yield and would seek to switch out of long tenors into the more favored super-long sector. In this regard, we are not confident that further widening of the10yr-20yr JGB spread would be seen should yields continue on an upward track.

5. Equity market: Shift to Risk Gathers Pace

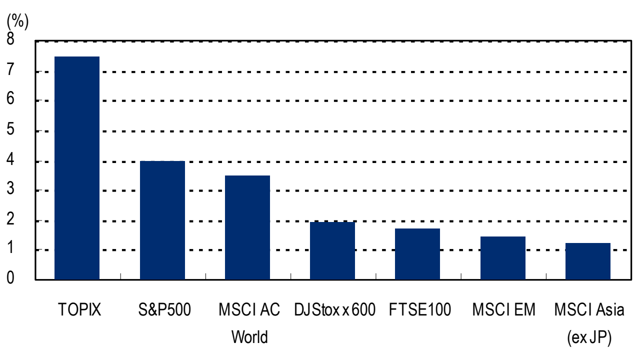
Kenji Abe

Japanese equities outperform global equities following dissolution

TOPIX added 7.5% from the announcement of the Lower House dissolution by PM Noda through November 22, outperforming global equities. We believe comments by LDP leader Shinzo Abe on monetary easing have caused the yen to weaken, and exporters, which benefit from yen weakening, have performed particularly well. As far as style is concerned, the shift from quality to risk has gathered pace.

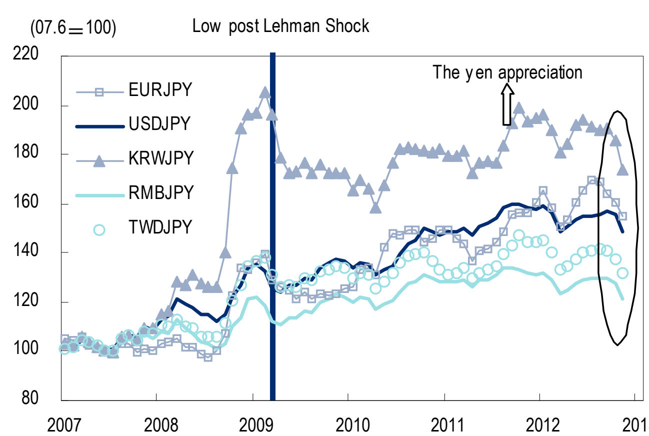
The outlook for Japanese equities depends a lot on the yen. If the yen continues to weaken on easy monetary policy by the new BoJ governor as well as on economic recovery in the US, Japanese equities are likely to make gains over the long term.

Figure 12. Global equity performance, November 14-22



Source: Datastream, Citi Research.

Figure 13. Forex rates



Source: Datastream, Citi Research.

Impressive performance from exporters in particular thanks to weak yen

Hopes of monetary easing have mounted on comments by Mr. Abe that he would set a 2%-3% inflation target and encourage unlimited monetary easing until it was achieved, and the yen has weakened against the dollar, the euro, and the won. Sectors that have delivered strong performance include transport equipment, which benefits from a weak yen, securities, which benefits from rising Japanese equities and more trading, and steel and marine transportation, with their low valuations and high betas.

On the other hand, defensive sectors that had been performing well, such as retail, pharmaceuticals, land transport, and J-REITs, have been underperforming TOPIX. By contrast, public-works related names have been doing well, on expectations for more public spending, as have electric power companies, on hopes for early nuclear plant restarts. We plan to focus on companies that benefit from yen weakness and public-works names moving forward, too.

These sector performances reflect expectation for reflationary policies by Abe's administration. If Abe's administration succeeds in implementing reflationary policies, these sector performances are likely to be repeated.

Figure 14. Performance by sector from November 14 Lower House dissolution announcement to November 22

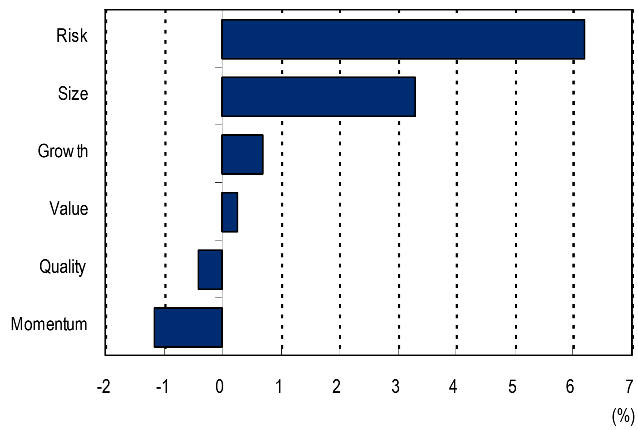
		From November 14 to 22
	TOPIX	7.5
High -tech	Electric Appliances	2.9
	Transportation Equipment	**7.6**
	Information & Communication	-3.6
	Machinery	3.3
	Precision Instruments	3.0
Cyclicals	Chemicals	0.2
	Wholesale Trade	-1.9
	Iron & Steel	**8.5**
	Nonferrous Metals	2.8
	Glass & Ceramics Products	1.9
	Textiles & Apparel	1.2
	Oil & Coal Products	-4.1
	Rubber Products	**3.6**
	Marine Transportation	**5.9**
	Pulp & Paper	-0.6
	Mining	-2.8
Domestic demand	Retail Trade	***-6.5***
	Land Transportation	***-4.8***
	Real Estate	-3.0
	REIT	***-4.8***
	Construction	-1.9
	Other Products	-3.0
	Services	-4.1
	Metal Products	-2.3
	Air Transportation	***-8.2***
	Warehousing & Harbor Transportation Services	-4.1
Financials	Banks	0.2
	Other Financing Business	-3.3
	Securities	**10.3**
	Insurance	3.3
Defensive	Pharmaceutical	***-5.9***
	Electric Power & Gas	1.5
	Foods	-4.2
	Fishery, Agriculture & Forestry	-3.9

Source: Datastream, Citi Research.

An ongoing shift from quality to risk

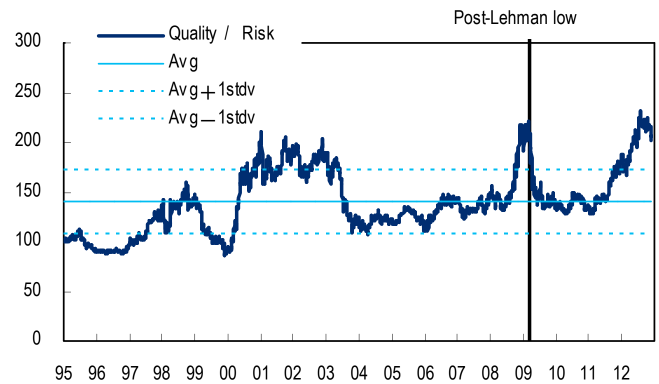
Looking at style index moves since the Lower House dissolution announcement, we note that while the risk and size indices have surged, the quality and momentum indices have fallen. The quality-risk ratio rose 54.3% from end-2010 to July 25, 2012, but fell 13.6% from then through November 22. The quality-risk ratio is still at its highest level since 1995, however, and we see plenty of room for it to fall. We think the shift from quality to risk will continue moving forward.

Figure 15. Style index performance after Lower House dissolution announced



Note: Between November 16 and November 22.
Source: Bloomberg, Citi Research.

Figure 16. Quality/risk ratio



Source: Bloomberg, Citi Research.

Appendix A-1

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