8 March 2013 | 17 pages

Equity Strategy (Citi)
Japan

Japan Equity Strategist

Abenomics gets going

- Equities

- **Japanese equities on medium-term uptrend** — If Haruhiko Kuroda, who is seen as aggressive on monetary easing, is appointed the new BoJ governor, the structures will in our view be in place to implement "bold monetary easing". With PM Abe moving to participate in the TPP negotiations, we think expectations for a growth strategy that sparks private-sector investment are mounting. We believe that the yen weakening to date will raise total demand via mechanisms such as increasing the yen-converted value of overseas earnings. We conclude that Abenomics, which aims at an exit from deflation, has ushered in a medium-term uptrend for Japanese equities.

- **Growth in total demand on yen weakness** — The yen has weakened 18% versus the dollar since November 2012. We think yen weakness will push up total demand and contribute to the escape from deflation in the following ways: 1) increasing consumption by raising the yen-denominated value of overseas earnings, 2) increasing consumption via the wealth effect, 3) increasing export volume and value, 4) reducing the volume of imports, 5) increasing capex on improvement in the economic outlook, and 6) increasing consumption via wage increases against a backdrop of economic recovery. Several of these mechanisms are already beginning to have an effect. In particular, we note that multiple companies are moving to hike wages and bonuses.

- **Abenomics to continue for three years or more** — The LDP were heavily defeated in the Upper House election six years ago, so relatively few LDP seats are up for reelection in the Upper House election coming this July. The Abe cabinet's support rate is impressively high, helped by the weak yen and stock market rally. We expect PM Abe to greatly increase the number of LDP seats in the Upper House and further cement his platform within the party. Unless he were to dissolve the Lower House, there is no election due for three years following the Upper House one. The new BoJ governor will be appointed to a five-year term. We think Abenomics is likely to continue for three or more years.

- **Still only in the first half of the weak yen/equity rally game** — The dollar/yen rate was around ¥120/$-¥130/$ in 2007. Even then, excluding food and energy, the inflation rate did not reach 2%. To reach a sustained inflation rate of 2%, we feel we need to see a dollar/yen rate at above this level. The recent yen weakening has only recovered 38% of the fall in the dollar through 2011, while the TOPIX cyclically adjusted PER (CAPE) is only at half of historical peak levels. We think we are still only in the first half of the weak yen/equity rally game. With Japanese equities on a medium-term uptrend, we set our March 2014 TOPIX target at 1,140, assuming a dollar/yen rate of ¥95/$.

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Chapter 1: Abenomics gets going

Monetary dove Kuroda set to be appointed BoJ governor

The government has proposed to the Diet Haruhiko Kuroda, head of the Asian Development Bank, as the new BoJ governor, and as the two deputy governors Gakushuin University professor Kikuo Iwata and BoJ executive director Hiroshi Nakaso. Both Mr. Kuroda and Mr. Iwata have expressed their desire to expand the BoJ's asset purchase program and to achieve a 2% inflation target within two years (Figure 1). The DPJ are looking positive about the appointment of Mr. Kuroda and Your Party is likewise looking positive about Mr. Iwata, so we see a growing likelihood that the Diet will confirm PM Abe's choices. We think the structures are being put in place for the execution of the first arrow of Abenomics, "bold monetary easing".

Figure 1. Candidates for the new BoJ governor and deputy governors

Post	Name	Age	Career	Notable statements
Governor	Haruhiko Kuroda	68	Asian Development bank head, Hitotsubashi University graduate school professor, Vice Minister of Finance	Wants to achieve a 2% inflation rate within two years. There are mountains of financial assets of every stripe in Japan, such as JGBs, corporate bonds, and a variety of structured bonds, that the BoJ could buy
Deputy governor	Kikuo Iwata	70	Professor in the Gakushuin University faculty of economics, professor in the faculty of economics, Sophia University	A 2% inflation target is achievable within two years at most. We need to push QE beyond where we have taken it to date. The BoJ Law needs to be amended to effect regime change at the BoJ
Deputy governor	Hiroshi Nakaso	59	BoJ executive director, BIS markets committee chair, BoJ financial markets department head	Implement monetary easing without being constrained by past examples

Source: Media reports, Citi Research.

Growth strategy hopes mount

In our January 7 report, Japan Equity Strategist - Limited risk of Japanese equity correction, we described the mechanisms of Abenomics as follows: "PM Abe's reflationary policies are designed to force the expected rate of inflation higher by the setting of a high inflation rate. This then brings the yen weaker, increases aggregate demand, and forces the price of imports higher. If as a result, the actual inflation rate rises, the expected inflation rate could rise further and the yen weaken further. We interpret this virtuous cycle as being the one that PM Abe's policies—commitment to an inflation target of 2%, a joint private-sector/public-sector foreign bond fund, and unlimited asset purchases—is trying to create." (Figure 2)

Reduced likelihood of establishment of private-sector/public-sector foreign-bond purchasing fund

Our interpretation is basically unchanged, but we think that there is a reduced likelihood of the establishment of private-sector/public-sector foreign-bond purchasing fund, as criticisms from overseas have been heard about the rapid yen weakening versus the dollar since last autumn and because finance minister Taro Aso and BoJ governor candidate Haruhiko Kuroda have expressed a cautious line on purchases of foreign bonds.

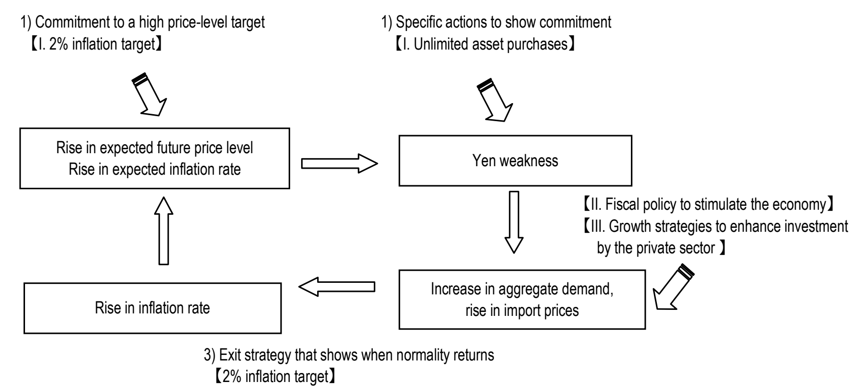
On the other hand, we think hopes are mounting about the third "arrow of Abenomics", a growth strategy to spark private-sector investment, on recognition of the speed of the policy-making decisions of the Abe administration. Following the US/Japan heads of government meeting, PM Abe has moved toward participation in the TPP negotiations (see our February 25 report, Japan Equity Strategy Flash - Implications of Japan-US summit for Japanese equities). Given that at one time it was widely forecast that clarity on participation in the TPP negotiations would only

come after the July Lower House elections, we think the speed of the Abe administration's decision-making has exceeded expectations.

With participation in the TPP negotiations now looking plausible, we think the government will push measures to boost agriculture, such as steps to expand exports of agricultural products and make farms larger. We also see a heightened possibility that the ban on the export of shale gas from the US to Japan will be lifted at an early stage. We sense that expectations are mounting about the third "arrow of Abenomics", a growth strategy to spark private-sector investment, including steps to promote regenerative medicine and drug creation using iPS cells and to push exports of "Cool Japan" products such as content and fashion.

While it may well take time, if the economic outlook improves due to the growth strategy and private-sector investment can be sparked, we think this would lead to increases in total demand and also contribute to an exit from deflation (Figure 2).

Figure 1. How Abenomics works



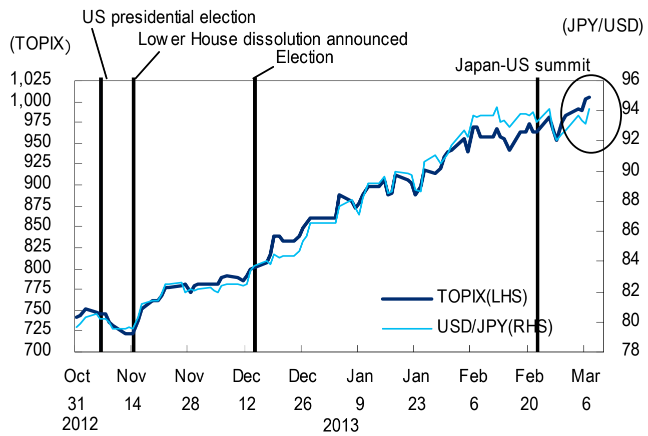
Source: Citi Research.

Equities gained, even though the yen did not weaken, after the Japan-US summit

The yen/dollar rate and TOPIX have risen hand-in-hand since November 14, 2012, when then-PM Yoshihiko Noda announced the dissolution of the Lower House (Figure 3). However, between the Japan-US summit on February 22 and March 6, Japanese equities gained even though the yen did not weaken versus the dollar. We think this is in part because they have been propelled by rising US equities, but also because of mounting expectations for the third "arrow of Abenomics", a growth strategy to spark private-sector investment, and mounting expectations for a recovery in the domestic economy thanks to the first arrow, bold monetary easing, and the second arrow, flexible fiscal policy.

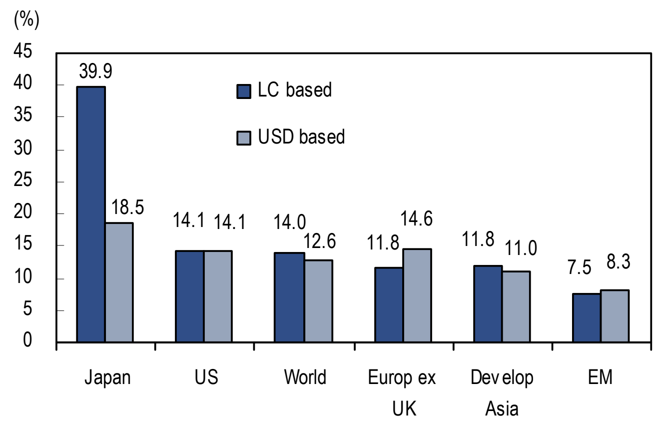
On a dollar basis, too, Japanese equities have since November 14 outperformed other regions, and this has generated good returns for dollar-based investors as well (Figure 4). If it is the case that the correlation between Japanese equities and the dollar/yen rate has, in a positive sense, weakened, thanks to rising growth strategy expectations, we think the appeal of Japanese equities to dollar-based investors would only grow.

Figure 2. TOPIX and the ¥/$ rate



Source: Datastream, Citi Research.

Figure 3. Share price performance by region



Note: November 14 to March 7. “LC” denotes “local currency”.
Source: Datastream, Citi Research.

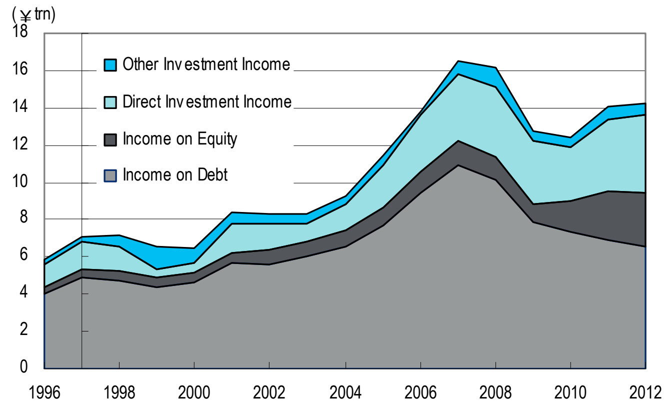
Yen weakness to have a positive impact on total demand

The yen has weakened greatly under Abenomics. It has weakened by more than 18% versus the dollar between November 14 and March 7. We think yen weakness will push up total demand and contribute to the escape from deflation in the following ways: 1) increasing consumption by raising the yen-denominated value of overseas earnings, 2) increasing consumption via the asset effect, 3) increasing export volume and value, 4) reducing the volume of imports, 5) increasing capex on improvement in the economic outlook, and 6) increasing consumption via wage increases against a backdrop of economic recovery. Several of these mechanisms are already beginning to have an effect.

- Increasing consumption by raising the yen-denominated value of overseas earnings

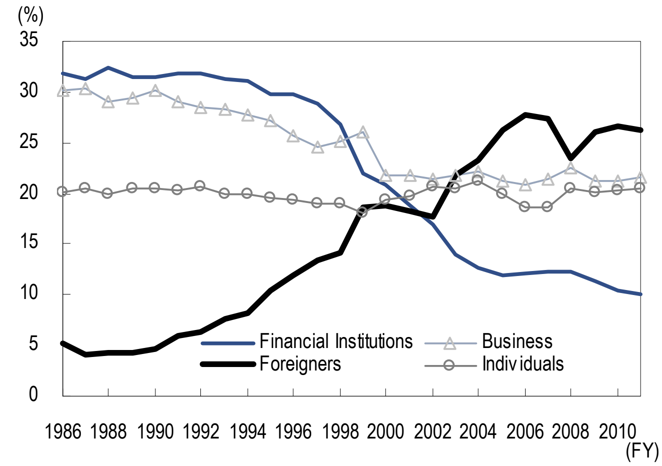
The 2012 Japan income balance was in the black to the tune of approximately ¥14trn (Figure 5). If the yen weakens, the value of income from overseas converted into yen rises. We think the increases in household budgets in interest and dividend income on foreign assets will stimulate consumption. Yen weakness will also improve the earnings of corporates that have overseas subsidiaries and assets and should in our view push up their share prices. Even ignoring pension assets, some 20% of Japanese equities are owned by retail investors and we expect consumption to increase thanks to rising share prices and the wealth effect (Figure 6).

Figure 4. Income balance



Note: Excluding compensation of employees.
Source: MoF, Citi Research.

Figure 5. Japan equity holdings

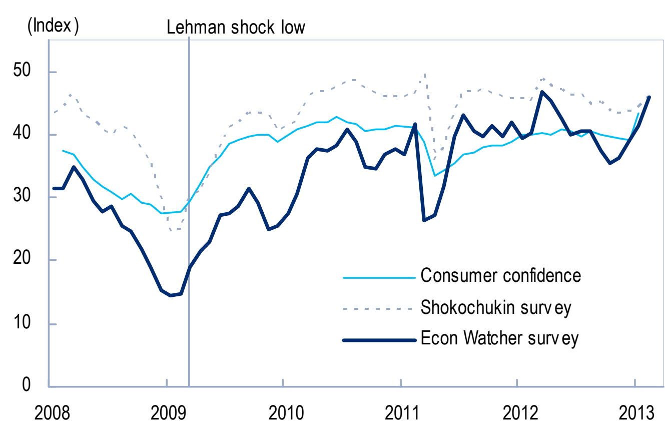


Source: Tokyo Stock Exchange, Citi Research.

Already some bright consumption signs

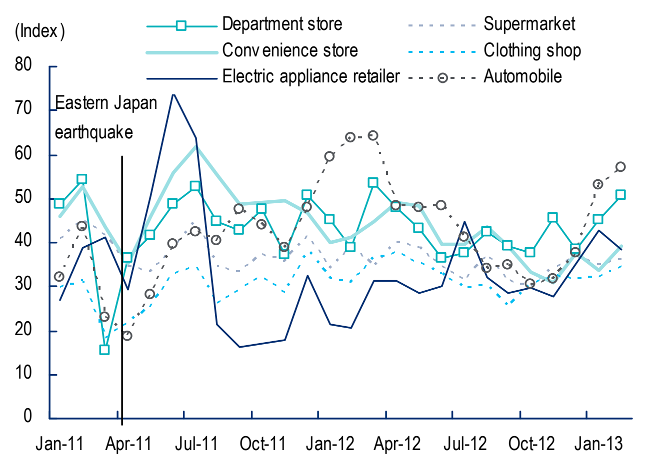
We are already beginning to see some bright signs in consumption, with improvement in consumer sentiment indexes and in the sentiment of retailers such as department stores and auto dealers in the Economy Watchers' Survey (Figures 7 and 8).

Figure 6. Domestic sentiment indexes



Source: Cabinet Office, Citi Research.

Figure 7. Economy Watchers' Survey: Retailer current DI by retail line



Source: Cabinet Office, Citi Research.

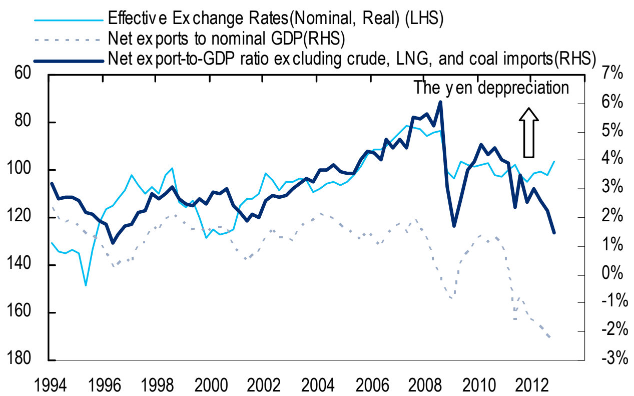
- Increasing export volume and value and reducing the volume of imports

In the Cabinet Office's macro model, three years after a 10% weakening of the yen, export volume rises 2.3% and import volume dips 0.17%. Since 1994, when the real effective exchange rate of the yen has weakened, net exports to GDP have risen (excluding crude oil, LNG, and coal imports, which are greatly affected by commodity prices) with a lag of approximately two years (Figure 9). Since the global financial crisis, it looks as though this correlation has weakened, but we ascribe this

to the impact of the eastern Japan earthquake and the deterioration in Sino-Japanese relations.

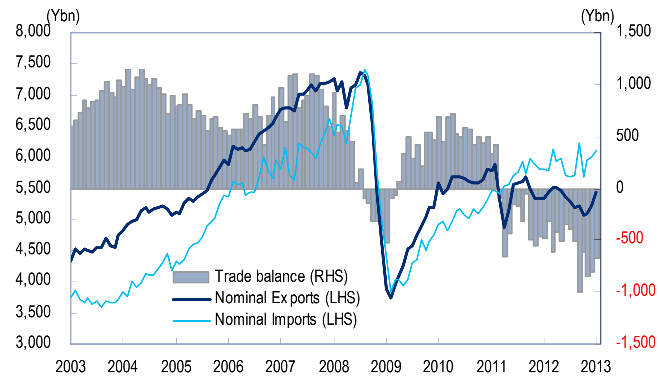
The yen-denomination weighting in trade currencies is 38% for exports and 22% for imports. If the yen weakens further, the yen-denominated value of both these exports and imports will rise. The value of exports has been on an upswing since November 2012, on yen weakness and the subsidence of the impact of deterioration in the Sino-Japanese relationship.

Figure 8. Real effective exchange rate and net export-to-GDP ratio



Source: Cabinet Office, MoF, BoJ, Citi Research.

Figure 9. Exports, imports, and the balance of trade



Source: MoF, Citi Research.

- Increasing consumption via wage increases against a backdrop of economic recovery

If via the above mechanisms consumption and exports increase, the economic outlook should improve. We have seen how capex tends to increase when firms have buoyant outlooks for GDP growth in the coming fiscal year (Figure 11). If the improvement in the economy thanks to Abenomics continues, we would expect capex to rise, too.

If the economy improves, we would expect labor supply/demand to tighten and upward pressure be applied to wages.

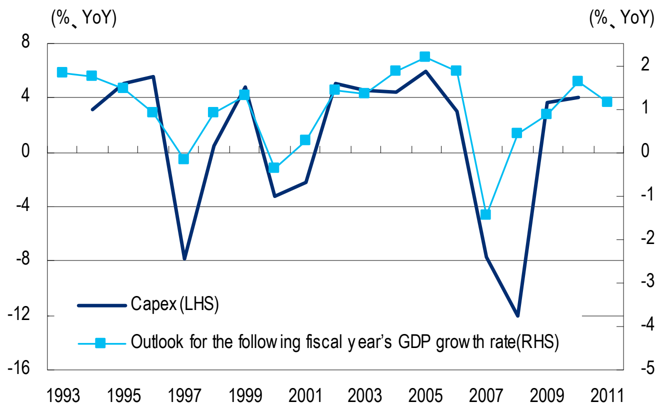
Moreover, measures are being taken to promote wage hikes. With the government and the BoJ committed to an inflation target of 2%, it is easier for labor unions to demand hikes in wages proportionate to the increase in living costs and we think it increases their bargaining power. Moreover, we sense that an environment is being gradually created in which wage hikes are regarded as socially desirable, with the government bringing in a system that cuts corporate tax for firms that increase salaries and other payments to employees and PM Abe calling on leaders of business organizations to hike wages.

Some corporations moving to hike wages and bonuses

Already, some companies are moving to hike wages and bonuses (Figure 13). We think that rising wages will be a tailwind for consumption and further improve the economy (Figure 12).

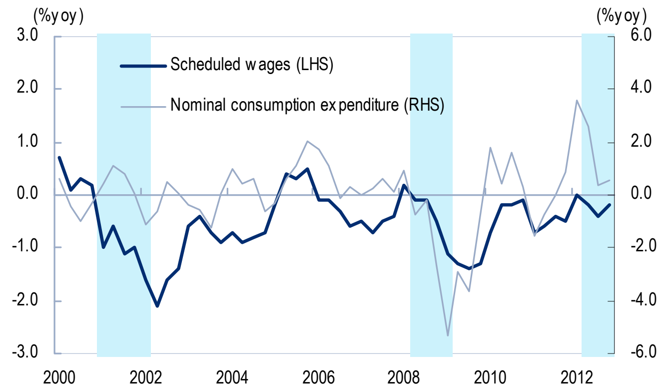
We see a mounting possibility that Japan will escape deflation with Abenomics.

Figure 10. Outlook for the following fiscal year's GDP growth rate and capex



Source: Cabinet Office, Citi Research.

Figure 11. Scheduled wages and nominal consumer spending



Note: Shaded areas show economic downturns.
Source: MHLW, Datastream, Citi Research.

Figure 12. Main companies working to boost wages and bonuses

Seven & i Holdings	Upped wages for 53,500 employees across 54 group companies. First base salary hike for Ito-Yokado in four years.
Lawson	Raised annual salary for 3,300 regular employees in their late 20s and 30s by 3% via bonuses
FamilyMart	Raised annual salaries by 2.2% on average for FY3/14. In addition to 1.5% hike for standard wages bonuses are to be hiked from FY3/13
JIN	To pay a special bonus to 1,500 regular employees. Regular employee annual salaries will be raised 6% on average.
Toyota Motor	Expects parent operating profit in FY3/13 for the first time in five years. Bonus request is ¥270,000 over last year's agreement.
Nissan, Honda, FHI	Said it will accede to union requests for bonus increase in FY3/14 salary negotiations.
Hitachi	Union has requested bonus of 5.8 months' pay, 0.52 months more than previous year and a 22-year high.

Source: Media reports, Citi Research.

Chapter 2: Japanese equities on a medium-term growth trend

Abe government could last a long time if LDP gains control of the Upper House in July

In July of this year an Upper House election will be held in Japan. The term for Upper House members is six years, and Mr. Abe was PM at the time of the 2007 Upper House election six years ago. At that time the LDP lost 27 seats, one reason for Mr. Abe's subsequent resignation.

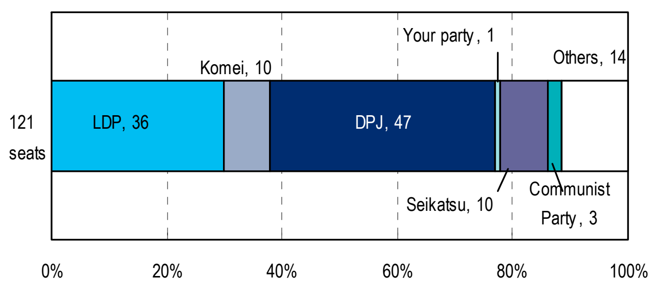
LDP seats likely to increase given the small number of seats up for reelection and the Abe government's strong support

In the upcoming July Upper House election 36 LDP seats are up for reelection while 51 seats are not (Figure 14, 15). At the time of the Upper House election six years ago the Abe cabinet approval rating was just 38% (in July 2007), but in February of this year approval was 64% (Figure 16). Given that Abenomics has started to bear fruit we think the Abe cabinet will likely still have a high approval rating in July. In our view the LDP is likely to significantly increase its Upper House seats with help from PM Abe, further solidifying his party base.

Abenomics could last three or more years: no elections scheduled for three years after Upper House election, BoJ governor term is 5 years:

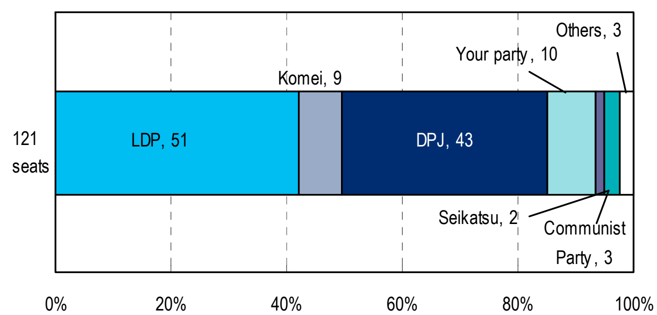
Assuming PM Abe does not decide to dissolve the Lower House, no further elections are scheduled for three years until the next Upper House election. It would seem quite possible that the Abe government will last for a long time. The term of a BoJ governor is five years. We thus believe Abenomics will be in place for at least three years.

Figure 13. Number of Upper House members with terms ending July 28, 2013



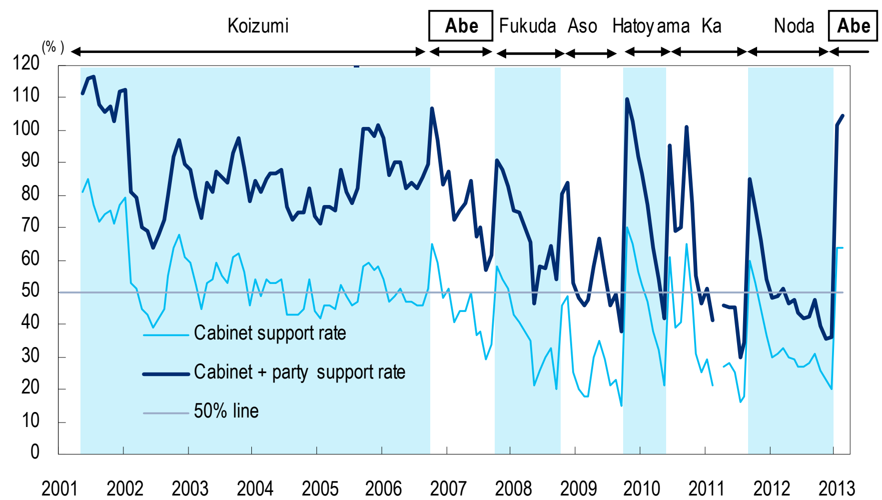
Source: Upper House, Citi Research.

Figure 14. Number of Upper House members with terms ending July 25, 2016



Source: Upper House, Citi Research.

Figure 15. Cabinet and party approval rates



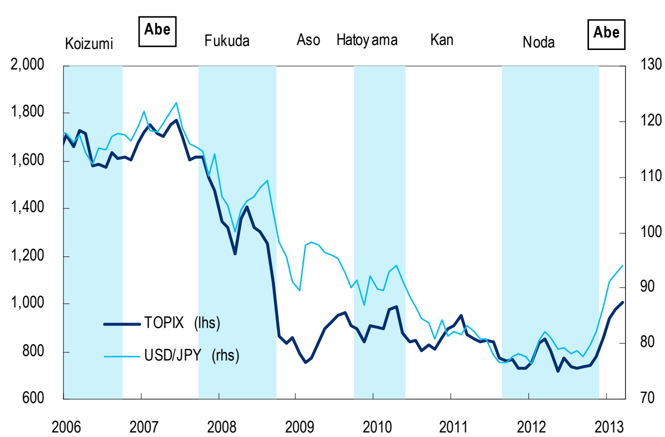
Note: Excluding ad hoc surveys. There was no survey in March 2011 due to the disaster.
Source: NHK polling, Citi Research.

Weak yen/strong stocks trend still in early stages

In 2007 at the time of the previous Abe administration the ¥/$ rate was ¥120/$-¥130/$. The yen strengthened thereafter, hitting ¥76/$ in 2011 (Figure 17). Even with the yen at ¥120/$-¥130/$ Japan was unable to achieve an inflation rate (excluding food and energy) of 2%, and we think the yen has to be above that level for 2% inflation to be achievable. We note that the ¥/$ rate has only made up 38% of the decline through 2011 (Figure 19).

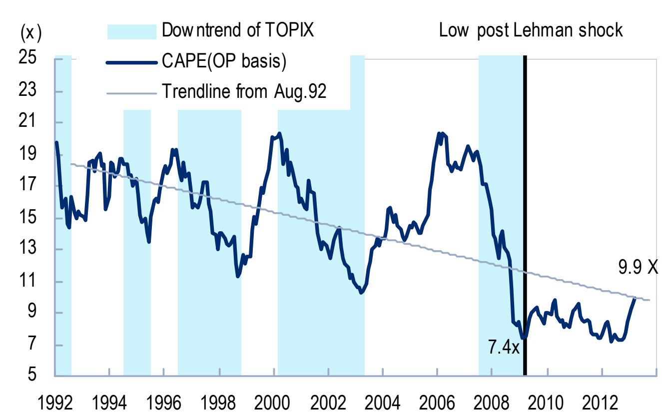
In addition, in 2007 TOPIX was nearly 1,800, but it fell all the way to around 700 in 2012. Recovery from this decline thus far is just 27% (Figure 19). Also, the TOPIX CAPE is at about half of its 1990's peak (Figure 18). We think yen/dollar weakening is still in its early stages.

Figure 16. ¥/$ rate and TOPIX since 2006



Source: Citi Research.

Figure 17. CAPE



Source: Astra Manager, Citi Research.

Figure 18. Rebound for TOPIX and ¥/$ rate

	TOPIX		JPY/USD	
High since 2006	June 2007	1774.88	June 2007	123.26
Low since 2006	May 2012	719.49	December 2011	76.38
Recent value	March 2013	1004.35	March 2013	94.09
Recovery rate		27%		38%

Note: Highs and lows as of month-end. Most recent figures as of March 7, 2013.
Source: Citi Research.

End-March 2014 TOPIX target range: 1,070-1,210

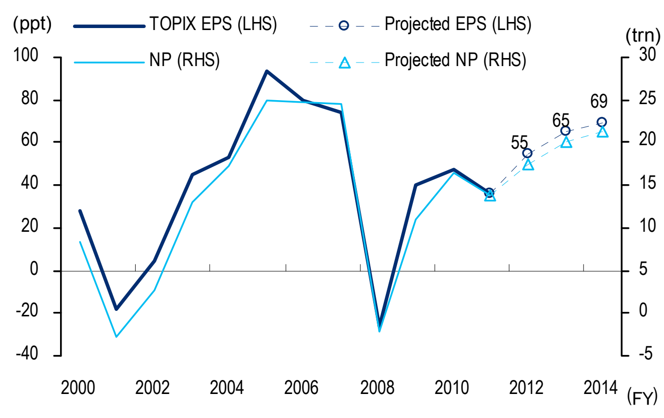
We estimate TOPIX EPS and BPS based on the assumptions in Figure 20 below. For FY3/13 we estimate TOPIX EPS at 55, and for FY3/14 we estimate 65. For BPS (excluding valuation gains/losses due to stock and forex fluctuations) we estimate 855 for FY3/13 and 899 for FY3/14 (Figure 21, 22).

Figure 19. Earnings forecast assumptions

FY	Industrial production YoY (%)	¥/$	¥/€	Corporate goods price index YoY (%)	Price of crude imports (¥/kl)
FY2012	-2.8	83.4	106.5	-0.5	57,728.6
FY2013	3.1	95.0	120.0	-0.3	58,382.9
FY2014	0.8	100.0	115.0	0.7	59,614.7

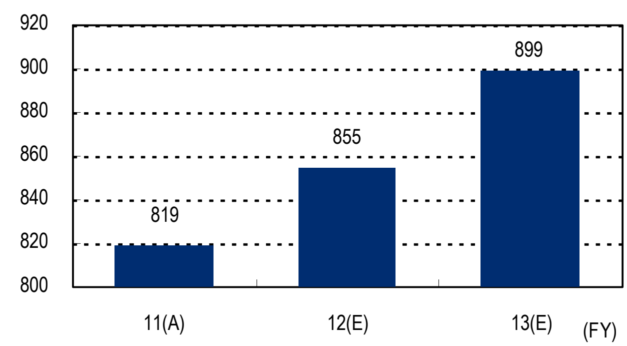
Source: Citi Research.

Figure 20. TOPIX EPS



Source: Bloomberg, Astra Manager, Citi Research.

Figure 21. TOPIX BPS



Source: Bloomberg, Citi Research.

In Figure 23 below we plot the TOPIX PBR and the ¥/$ rate since 2010. There appears to be a strong relationship between the two. Regressing TOPIX PBR on 12-month actual RoEs and the ¥/$ rate yields the following equation:

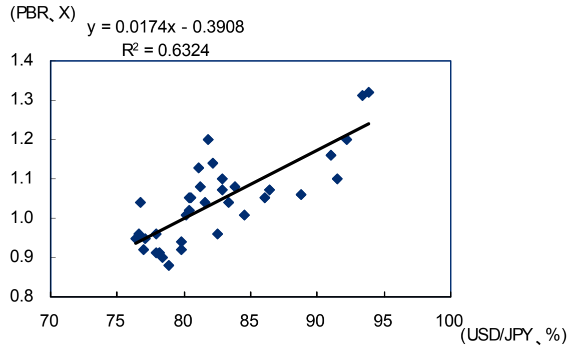
PBR = -0.53 + 0.026 RoE (12-month actual) + 0.017¥/$ rate

Using 7.4% for the 12-month actual RoE for FY3/14 and a ¥/$ rate of ¥95/$ results in a TOPIX PBR of 1.31x. We estimate the TOPIX BPS for FY3/13 (including the impact of share price and forex volatility) at 867, and based on this TOPIX works out to 1,139. Using a Nikkei-TOPIX ratio of 11.9x, the Nikkei average would thus work out to 13,571 (Figure 24).

If we instead use a ¥/$ rate of ¥90/$, the TOPIX PBR comes to 1.23x, TOPIX comes to 1,066, and the Nikkei average comes to 12,708. At ¥100/$ the TOPIX PBR comes to 1.40x, TOPIX comes to 1,214, and the Nikkei comes to 14,472.

Based on these calculations, we set our end-March 2014 TOPIX target at 1,140, assuming ¥95/$ (Figure 25).

Figure 22. ¥/$ rate and PBR



Source: Bloomberg, Citi Research.

Figure 23. Theoretical March 2014 TOPIX matrix

BPS FY12E	867		
JPY/USD assumption	90	95	100
PBR	1.23	1.31	1.40
TOPIX	1,066	1,139	1,214
Nikkei 225	12,708	13,571	14,472

Source: Citi Research.

Figure 24. TOPIX and Nikkei 225 targets

	TOPIX	日経平均
End-December 2013	1,110	13,200
End-March 2014	1,140	13,600

Source: Citi Research.

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.

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