

INVESTMENT INSIGHTS

Japan's election result – A catalyst for a long-awaited rally?

DECEMBER 2012

INTRODUCTION

In Japan's general election on 16 December, the Liberal Democratic Party (LDP) achieved a landslide victory. Together with its coalition partner, the New Komeito Party, the LDP secured a two-thirds supermajority that may allow it to end political deadlock in Japan. The result provides the LDP and its leader, Shinzo Abe, with the opportunity to implement aggressive, reflationary monetary and fiscal policy to restore economic growth and to end Japan's persistent deflation.

So far, investors have responded positively to this political swing. The Japanese equity market has extended its winning streak since mid November, and the yen hit a year-to-date low against the US dollar on 17 December. Can the LDP's victory be a catalyst for a long-awaited and enduring rally in the Japanese equity market? Depending on policy developments as we approach summer 2013, it could be.

LDP given mandate for decisive policy action

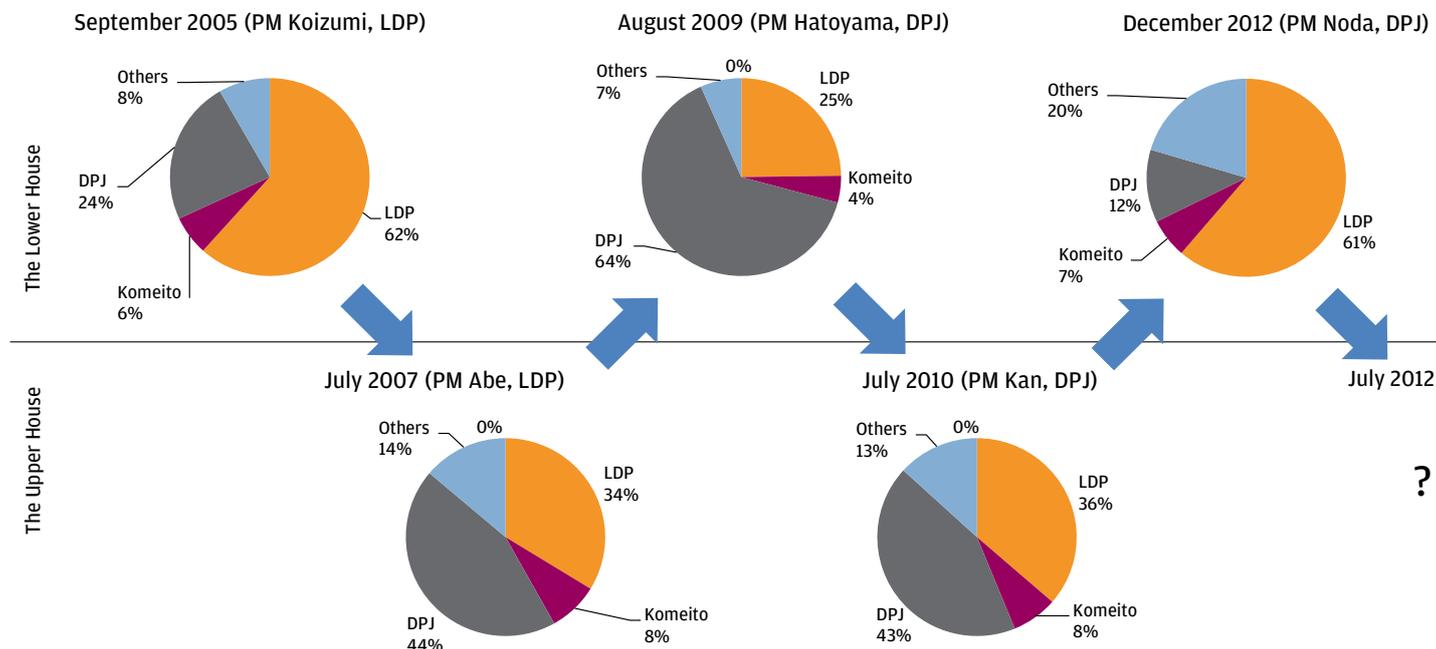
The LDP crushed the ruling Democratic Party of Japan (DPJ) in the election, securing 294 seats in the Lower House. Combined with the 31 seats won by Komeito, the result gives the new coalition a two-thirds supermajority (see **Exhibit 1**). This means that the new government will be able to enact legislation even without the approval of the Diet's Upper House.

However, the result does not necessarily signal strong public support for the LDP, as the party's victory in the 2005 general election did. In 2005, public enthusiasm for the postal reform proposed by the Koizumi-led LDP swept the party to victory, as voters backed efforts to curb the vested interests of the old regime. This year, as Abe admits, voters instead said no to the DPJ, which has failed to revive the economy in last three years, and swung towards a party that is committing to taking more significant steps to boost the economy. In the near term, it is critical for the LDP to establish policies that will convince voters of its ability to support growth, in order to gain a majority in the Upper House in the July election and bring an end to the divided parliament. Even now, though, the LDP has the power to take decisive action to end a decade of deflation. This is because a government with a supermajority of two thirds of the seats in the Lower House is permitted to override legislative decisions by the Upper House.



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EXHIBIT 1: COMPOSITION OF THE DIET



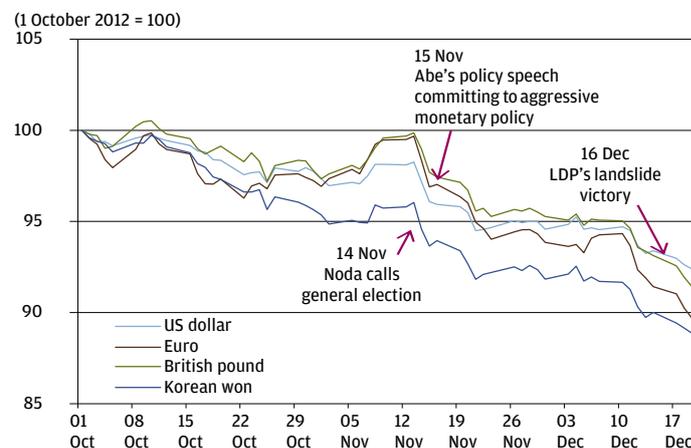
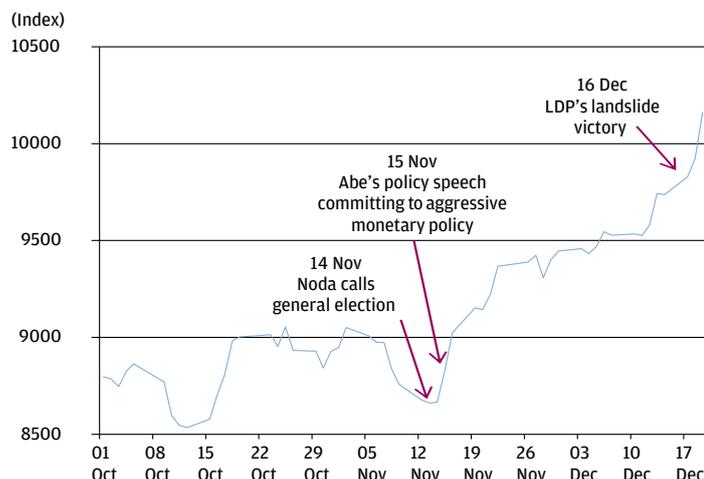
As at 17 December 2012
 Source: Ministry of Internal Affairs and Communications, NHK, J.P. Morgan Asset Management.

Hopes for policy change mean markets welcome the political shift

Investors have reacted positively to the election result so far. Since the middle of November, when Yoshihiko Noda, the DPJ prime minister, called a general election and Abe made a bold policy speech committing to monetary and fiscal stimulus, the Japanese equity market has rallied and the Japanese yen has weakened across currencies. The election result has supplied

increased momentum. As at 19 December, the Nikkei has broken JPY 10,000 level for the first time in eight months and the Japanese yen has hit a year-to-date low against currencies including the US dollar, the euro, the British pound and the Korean won (see **Exhibit 2**).

EXHIBIT 2: ELECTION RESULT FUELS MARKET RALLY AND WEAKENS YEN



As at 19 December 2012 Source: Bloomberg, J.P. Morgan Asset Management

Will the election result serve as a much-needed catalyst?

In the first half of 2013, there are several policy events that might become catalysts for investors to change their strategic views on Japan. On 26 December, Abe will be appointed as Japan's seventh prime minister in six years. Soon after his appointment, he will select ministers for his cabinet and plan a fiscal year 2013 budget and a supplementary budget for fiscal year 2012 to kickstart the stagnating economy. Then, on 8 April and 19 March respectively, the new Bank of Japan (BoJ) governor and two deputy governors will be appointed, with approval needed from both the Upper House and the Lower House.

In the very near term, it will be important to monitor whether Abe maintains his campaign commitment to put pressure on the BoJ to introduce radical monetary policy, including a new 2-3% inflation target. A 2% inflation target has become the LDP's official policy pledge and we are fairly comfortable that the new government will maintain its pledged focus on fiscal and monetary policy.

July will bring the general election for the Diet's Upper House. This will indeed be a critical moment for Japanese policy development, providing politicians with the opportunity to restore economic growth, to end the vicious circle of deflation, and to finally turn around the Japanese equity market after the bursting of the asset bubble in the early 1990s.

Yoshito Sakakibara, executive director, is an economist in Investment Research based in Tokyo. He is also the chairperson of the Japan asset allocation committee and works closely with the Global Strategy Team of the Global Multi-Assets Group. An employee since 2002, he worked as a sell-side economist for ten years starting from Salomon Brothers Asia Limited, then in Goldman Sachs (Japan) Ltd and Merrill Lynch Japan Securities Co. Ltd. Yoshito obtained a BA from International Christian University in Tokyo. He also holds a Master of Pacific International Relations in economic policy analysis from the Graduate School of International Relations and Pacific Studies at the University of California, San Diego.

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