Confluence INVESTMENT MANAGEMENT

Weekly
Geopolitical Report

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Japan: Will the Tax Hike Bite? Part II

Some of Japan's biggest economic hiccups have started with a major tax hike, so investors are wondering what will happen following a boost in the country's value-added tax (a type of sales tax) that went into effect early last month. To lay the groundwork for understanding the VAT hike and its implications, Part I of this report last week provided an overview of the Japanese economy and financial markets, including a discussion of how they've performed over the past several decades. The analysis showed just how sharply Japan's economic growth has slowed since the boom years of the 1970s and 1980s and the implosion of its asset bubble in 1989. Part of the long slowdown simply reflects Japan's decision to gradually eliminate its post-bubble excess capacity and bad debts. However, we also examined how Japan's extended revaluation process has been exacerbated by a unique set of headwinds: an aging population, high debt levels and disinflation.

This week, in Part II, we'll home in on the Japanese government's geopolitical and domestic priorities and the reasons for its new VAT hike. We'll also examine why the tax hike doesn't seem to be hurting the economy as much as past hikes have. As always, we'll conclude with ramifications for investors as they face Japan's current economic and financial trends.

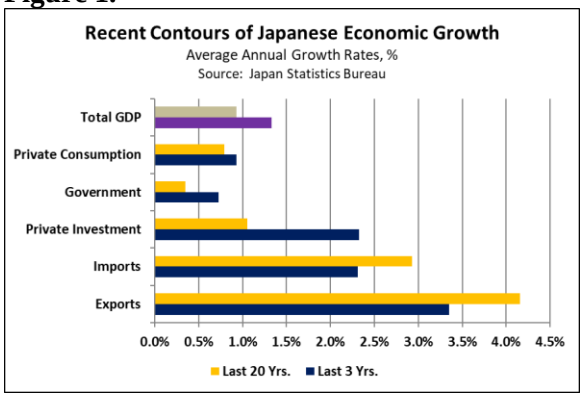
Japan's Policy Priorities

Although we're focusing on a specific tax measure in this report, we think it's important to understand it in the broader context of Japan's national security, economic and social priorities. The link to national security may seem tenuous, especially given Japan's pacifist constitution and reluctance to assert itself diplomatically or militarily since World War II. However, Prime Minister Abe and his nationalist allies have long sought to remove the limits on Japan's military and once again project power independently. Abe continues to push for the required constitutional change even after this summer's parliamentary elections, when his party won but fell short of the two-thirds majority in the upper house that is needed for a constitutional amendment. Putting a positive spin on things, Abe said the results reflected "the judgment by voters that constitutional revision at least be debated." As the United States grows weary of its traditional role as global hegemon and pulls back from its foreign defense commitments, and as China becomes an increasingly powerful and aggressive regional competitor, we think Japanese leaders will feel compelled to rebuild the country's defense capabilities. By necessity, doing so will require a strong and stable economic resource base.

The Japanese people have been slow to support Abe's dream of an unfettered military. Ever since Abe began his current tenure as prime minister in 2012, he has therefore put more emphasis on voters' pocketbook issues, like the security of their pensions and the high level of government debt described in Part I. His "Abenomics"

program aims to spur growth, boost the number of jobs, increase wages and encourage faster population growth, mostly as a way to increase government tax receipts and ease the burden of rising pensions and other costs associated with Japan's aging population. To achieve those goals, the three components of Abenomics are: 1) increased fiscal stimulus; 2) easier monetary policy; and 3) structural deregulation to boost employment (especially for women) and encourage private investment.

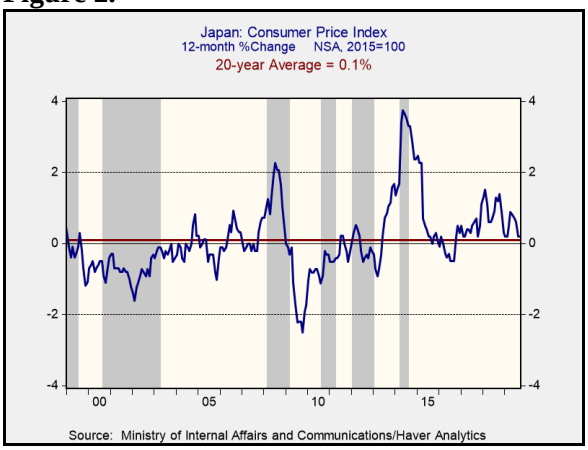
Figure 1.



Comparing the three years ended June 30 with the average growth rates over the last two decades, Figure 1 offers a "passing" but not "excellent" report card for Abenomics. Overall gross domestic product (GDP), in constant prices, has accelerated modestly, driven by higher labor force participation and a small improvement in consumption spending. The fiscal stimulus from Abenomics is evident in the near-doubling of government spending growth, but that increase came mostly from higher government consumption outlays. Government fixed investment has merely stabilized after a long period of declines. The most successful aspect of Abenomics has been a boost in private investment, which probably reflects both ultra-low interest rates and a more friendly regulatory environment. Finally, easier monetary policy helped to weaken the yen in the first years of Abenomics. The exchange rate moved from just 80 per dollar in 2012 to more than 120 per dollar in 2015, before retreating a bit in recent years. The lower yen contributed to a growth-friendly decline in import growth in recent years, but it failed to prevent a slowdown in export growth.

Against this backdrop of modestly improved growth, Japanese consumer prices have started rising again, but they are still lethargic. The consumer price index has increased at an average annual rate of 0.7% over the last three years compared with an average rate of just 0.1% over the last two decades and frequent annual declines until 2016 (Figure 2).

Figure 2.



The VAT Hike

With fiscal stimulus being one of the key "arrows" in Abe's quiver, it may seem incongruous for Japan to be hiking its VAT rate. The key to the riddle is the government's widening budget deficit and burgeoning debt. Faced with galloping social security costs and stagnating revenues, multiple Japanese governments have decided that tax increases are a necessary evil to stave off an eventual fiscal crisis. Rather than hike taxes on corporate or household incomes (which could discourage the investment needed to lift economic growth over the long term), the

government has preferred to increase taxes on consumption, even though the impact on growth was typically severe. In 1997, for example, the government hiked the VAT to 5% from 3% previously, throwing the economy into one of many recent recessions. Shortly before Abe returned to power, the government of former Prime Minister Yoshihiko Noda passed a law to increase the VAT to 8% in 2014 and 10% in 2015. The law also gave the prime minister discretion to temporarily postpone the hikes if economic conditions warranted, but Abe implemented the 2014 hike on schedule based on the assumption that the negative impact would be offset by an accompanying cut in corporate income taxes. Unfortunately, the gamble didn't pay off. The massive three-percentage-point VAT hike once again threw the economy into a deep recession, and the budget deficit showed no sign of closing.

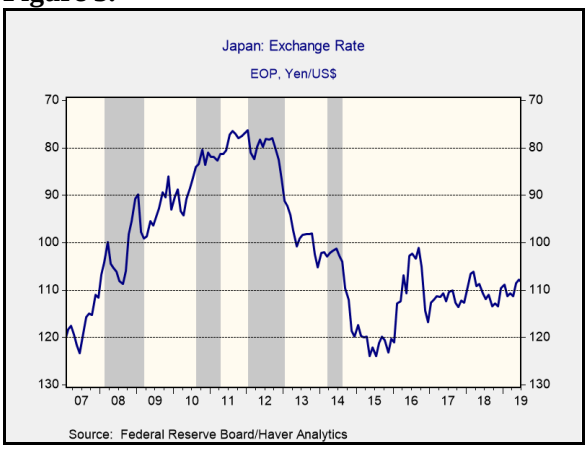
Because of Japan's sour experience with the last two VAT hikes, Prime Minister Abe was naturally wary about implementing the final hike to 10% in 2015. Taking advantage of the discretion provided by law, he postponed the hike first to 2017, and then to 2019. This year, however, improved international and domestic economic conditions made it untenable for Abe to call for another postponement. His government's annual economic plan, issued in June, confirmed the hike in order to cover Japan's rapidly rising social security costs. Indeed, the government has promised that all 14 trillion yen expected to be raised by the VAT hike will be used to shore up the social security system.

Likely Impact on the Economy

Contrary to Japan's experience with its previous VAT hikes, all indications are that the economy is having little problem weathering this one. We ascribe that to three main differences compared with the VAT hike in 2014:

Conducive Economic Conditions. A key reason for optimism is simply that Japan is now facing a more propitious economic environment than in 2014. Global economic growth has been slowing in 2019, but the slowdown has been measured and there is probably still some chance that a global or domestic recession can be avoided if international trade tensions dissipate. Indeed, good relations between Prime Minister Abe and President Trump have ensured that U.S.-Japanese trade relations remain calm and predictable. Moreover, the yen remains almost 10% weaker than it was in 2014, which should help buoy exports and discourage imports (Figure 3). Global oil prices are also well behaved, and monetary policy is stable and stimulative.

Figure 3.

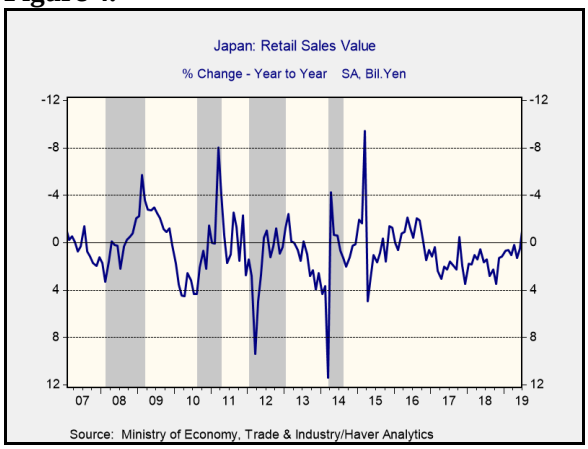


Exceptions and Exclusions. To ease the pain of this VAT hike, the Japanese government has also passed several exceptions, exclusions and rebates. For example, the VAT will not be raised for most food and for newspapers published at least twice a week. The VAT hike will also be refunded for cashless purchases from small and medium-sized businesses. Even though these exceptions and refunds may appear relatively limited, we think they will

help ease concern about the hike by creating an impression that it can be avoided.

Proportionally Smaller Rise. Finally, the hike in the VAT during 2019 will be proportionately much smaller than either of the previous hikes. The VAT rate after the hike will be 25% greater than the previous rate, but that's still much less onerous than in 2014, when the new rate was 60% greater than the previous one. As evidence that the impending rate hike doesn't seem to be scaring consumers into pre-hike hoarding, Japanese retail sales have only shown a modest acceleration in the months leading up to the change (Figure 4).

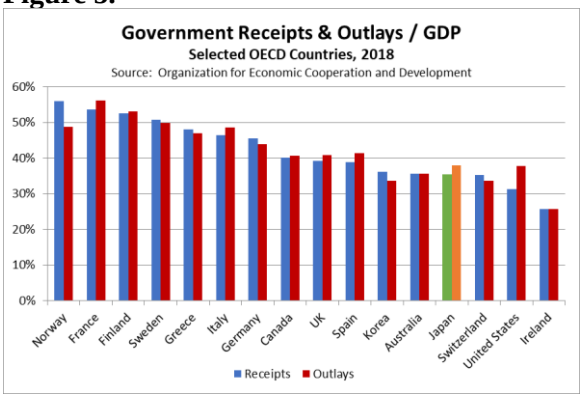
Figure 4.



Ramifications

Even with the VAT hikes, Japan remains a relatively low-tax country. As shown in Figure 5, total government receipts equaled 35.4% of Japanese GDP in 2018, comparable to the healthy economies of Australia and Switzerland, and only modestly higher than the 31.3% of GDP in the United States. Total government spending stood at approximately 37.9% of GDP in both Japan and the U.S., but because Japan's tax take is higher, its public deficit as a share of the economy is now healthier than in the U.S. Along with the deregulation and structural reforms under Abenomics, as well as the country's overall high competitiveness as laid out in Part I of this report, the Japanese economy certainly has attractive aspects in spite of the October VAT hike.

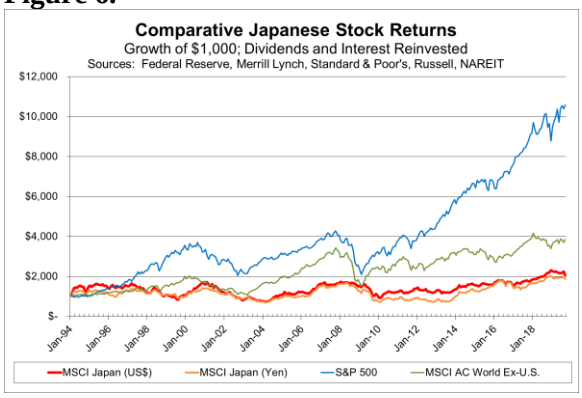
Figure 5.



All the same, the positive attributes of the Japanese economy and financial markets continue to be outweighed by the demographic, debt and disinflation headwinds we described in Part I. From the peak of the economic bubble in 1989 to 2018, the profits of Japanese nonfinancial companies have grown at an average nominal rate of just 2.7%, roughly triple the rate of nominal GDP growth over the period but still much slower than the 7.4% pace in the 1980s and the 6.9% rate for total U.S. corporate profits since 1989.

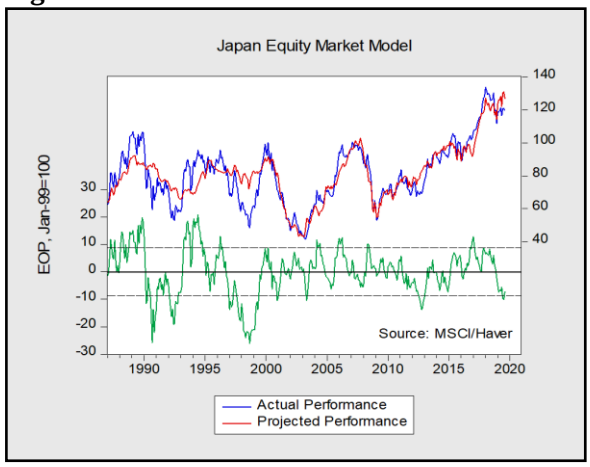
For stock investors, the underperformance has been even more noticeable. Since 1989, the MSCI Japan Index has posted an average annual total return of just 1.7% in U.S. dollars and 1.6% in yen. Over the same period, the MSCI All-Cap World Index Ex-U.S. posted an average total return of 5.0% in dollars, while the S&P 500 Index of U.S. stocks yielded 9.1% per year (Figure 6). Of course, past performance is no guarantee of future results, but the figures do suggest investors have generally been hurt by Japanese headwinds.

Figure 6.



Given its large share of globally competitive, export-oriented industrial companies, the Japanese stock market certainly can have periods of outperformance, especially when the yen weakens enough to boost those companies' profits. In recent years, the Japanese stock market has actually performed well compared with other non-U.S. markets. In the immediate future, we think the improved performance could even continue. That's because Japanese stocks are currently trading significantly below the fair value level estimated by our Confluence Six-Factor International Equity Model for Japan (Figure 7). Our modeling also shows the yen is currently undervalued.

Figure 7.



All the same, the bigger message here is that investors need to be wary of slowing population growth and aging populations that are now evident throughout the world – not just in Japan, but in countries like the United States, Germany, Russia and China. The Japanese experience teaches that the demographic headwind is even worse when it's coupled with high debt levels and flat or falling prices. The whole world struggles with those problems to some extent, so we would expect to see globally weaker demand and reduced corporate pricing power over time. That factor alone would likely impede profit growth, but margins could be compressed even more if regulation simultaneously increases as the world swings from its recent "efficiency cycle" to a new "equality cycle," as we've been discussing in past reports for some time now. That will likely limit global stock returns going forward, while supporting bonds, especially in countries with relatively lower debt levels. Finally, commodity prices are likely to be challenged, except for the boost to precious metals as U.S. hegemony wanes and global geopolitics becomes more chaotic.

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Confluence Investment Management LLC

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