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Consumption tax hike postponement and late 2014 election will push up stock prices

Musha Research Co., Ltd.
President
Ryoji Musha
Direct ＋81-3-5408-6821
musha@musha.co.jp
http://www.musha.co.jp

901 Renai Partire Shiodome
2-18-3 Hiagshishinbashi,
Minato-ku, 105-0021 Tokyo

Although we have heard nothing from Prime Minister Abe, the dissolution of Japan's lower house for an election later this year may be virtually certain. Furthermore, the possibility of a delay of one year to 18 months in Japan's 2% consumption tax hike has become greater. How will the market react to these two big events? Most likely, investors will pay close attention over the next week or two to the possibility of a consumption tax hike postponement and an election.

There are two views concerning the tax hike and election. The first is the standpoint of people who are critical of Abenomics. They believe that pushing back the consumption tax hike would cause a loss of faith in Japan and its financial soundness. In addition, if the Abe administration calls for an election based on partisan politics and with no central issue for the voters to settle, the resulting political vacuum would undermine the administration's strength. Taking this action would therefore lead to the failure of Abenomics and make the outlook for the economy and stocks worse. In fact, there were editorials on November 12 by two newspapers that criticize the Abe administration based on liberal viewpoints. The Asahi Shimbun editorial titled "Is there a good reason for an election?" and Mainichi Shimbun editorial titled "The idea of an election is deceitful" stated that a lower house election would serve no purpose. The newspapers have significant doubts about using an election to postpone the next consumption tax increase.

The other view is the stance of supporters of the Abe administration and Abenomics. They believe that an election and delay in the consumption tax hike would be good for Japan. The reason is that the delay would eliminate a source of downward pressure on the economy, thereby bringing Japan even closer to eradicating deflation. Furthermore, although many people think an election would do no good, the Abe administration would probably focus the election on the growth strategy and deregulation. Prime Minister Abe is having much difficulty with both initiatives because of opposition to these measures. Abe's supporters believe that an election would reinforce expectations for the Abe administration to overcome opposition and enact reforms. For example, the government could probably take growth-oriented actions like cutting the corporate income tax, reforming the healthcare system, and reforming Japan's agriculture sector and agricultural cooperatives.

Late in October, the Bank of Japan announced new quantitative easing measures. Obviously, the bank and the Abe administration have assumed full responsibility for working together to terminate deflation. Holding an election at this time would therefore be very significant as a referendum concerning Abenomics and the Abe administration. Prime Minister Abe would very likely be victorious in this election. Having received a vote of confidence for Abenomics, the prime minister would be in an even better position to implement this policy forcefully. Opponents would lose much of their influence. The Yomiuri Shimbun adopted a neutral stance with an editorial titled "Ask for support after designating the issues." The gist of the editorial was that the Abe administration should aim for a vote of confidence and erosion of its opponents' influence. Overall, a lower house election and delay in the next consumption tax hike would both be very good news for financial markets.

Once the government's intention of calling an election becomes clear, the Nikkei Average may start climbing rapidly and top ¥20,000 by the end of the year. If Prime Minister Abe wins and he implements Abenomics even more vigorously, we could even see the Nikkei Average climb to the ¥24,000 to ¥25,000 range in 2015. Moreover, a stock market rally of this magnitude would most likely be a great source of power for the Abe administration. Stock market capitalization in Japan is now almost ¥500 trillion. A rally of only about 20% would therefore produce an economic benefit of ¥100 trillion from higher stock prices. If only a few percent of this benefit is converted into additional demand, it would obviously make an enormous contribution the growth of the Japanese economy.

In 2015, there is good reason to expect that the long-delayed benefits of the weaker yen will finally begin to appear. I have already written a report about this subject. As I explained, in the past, a weaker yen led to growth in export volume and thus manufacturing in Japan. The result was a chain reaction of positive effects. This is why a weaker yen in the past quickly fueled economic growth in Japan. But today Japanese companies are no longer using prices to compete. Consequently, companies do not lower prices even when the yen weakens, and export volume therefore does not grow. What is the significance of this difference? When the yen declines, earnings at Japanese companies become even higher because of the resulting increase in yen-denominated export prices. Higher earnings would allow companies to raise wages and dividends or increase their investments and M&A. All of these actions would have a positive effect on the economy. This situation is like a reservoir that is full of corporate earnings that are finally released into the real economy. We can expect to see this release take place in the first half of 2015.

The emergence of these benefits of a weaker yen will probably further reinforce Abenomics programs and push stock prices even higher. The result may be a period of remarkable economic vigor in Japan in 2015 and 2016. As this growth takes place, Japan's economy would have no difficulty absorbing the burden of about ¥5 trillion yen from another 2% consumption tax increase. The conclusion is that a consumption tax hike postponement and lower house election late in 2014 would very likely bring the absolute end of deflation in Japan within sight.