Abenomics meets Trump

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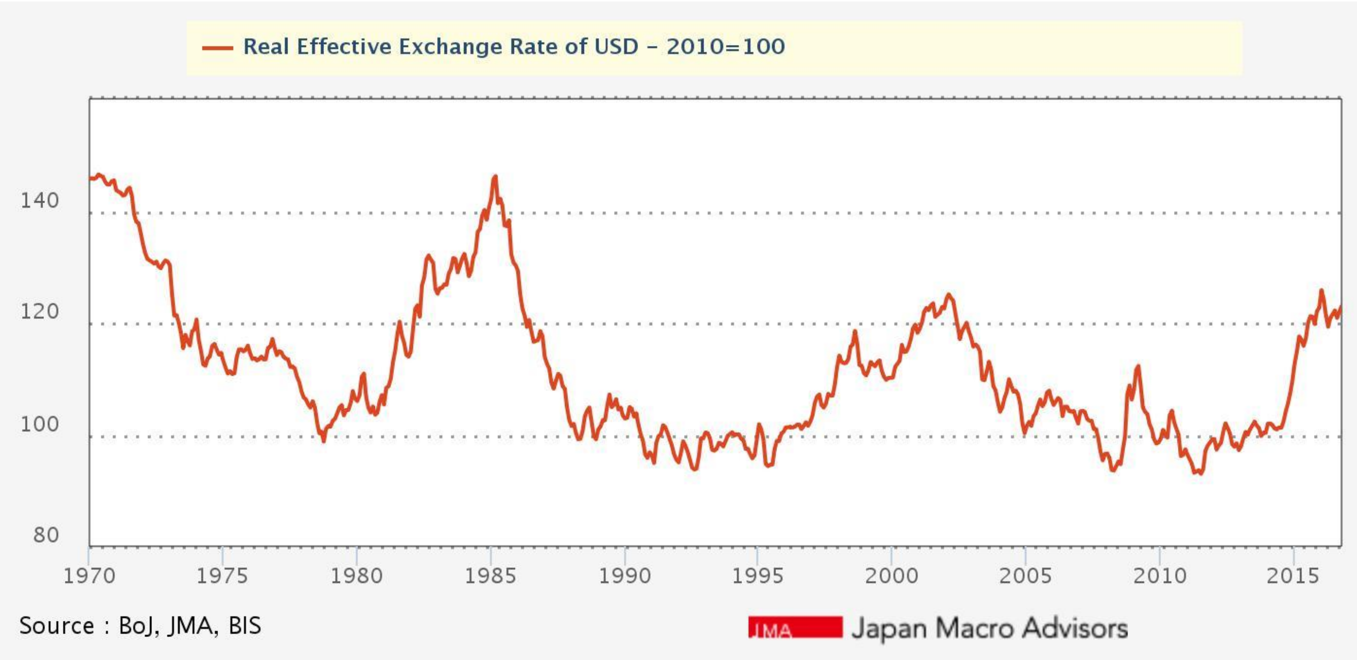
Executive Summary

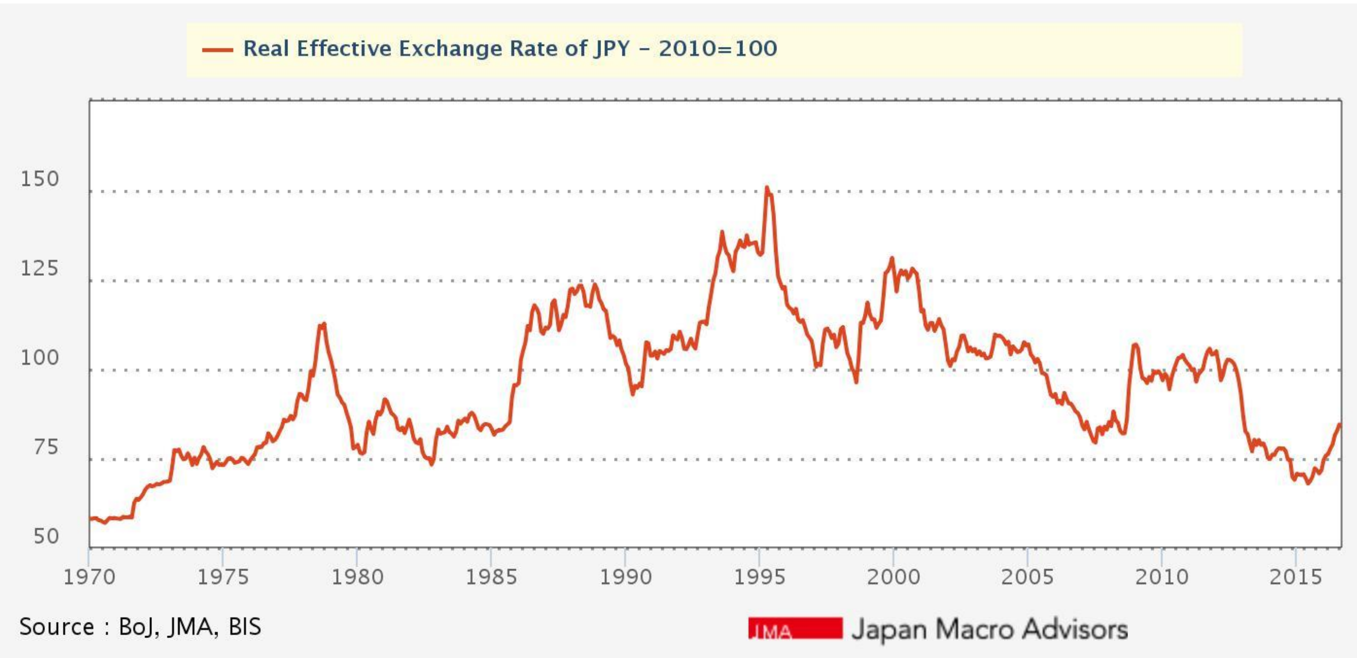
Prime Minister Abe and President-elect Trump shaking hands in NY probably encouraged the market sentiment that all will be well with US-Japan relationship. Indeed, the market developments since the US election result last Tuesday has been favorable for the Japanese policy makers. We do not think such a smooth sailing will not last however. Unlike the time when President Reagan took office, a strong dollar is a wrong policy for US. Inflation is not a visible threat and the dollar has already appreciated by more than 30% in the last 5 years in real terms. The yen depreciation that took place in the last 10 days would quickly reverse once President-elect Trump realizes that a weaker USD would be more beneficial for his electorate. While PM Abe may be able to preserve US-Japan military alliance, Mr Trump is unlikely to be the savior of Abenomics.

Prime Minister Abe and President-elect Trump shaking hands in NY made a nice picture and probably encouraged the market sentiment that all will be well with US-Japan relationship. Indeed, the market developments since the US election results last Tuesday has been favorable for the Japanese policy makers. In the last 10 days since the election result was known, Nikkei rose by 4.6%, yen depreciated from 104.4 to 110.6. The prospect of the Trump presidency seems to be helping Japan to reflate. Could the Trump presidency help Abenomics achieve its reflation goal?

While we respect the wisdom of the market in efficiently forecasting the future, we think the market movement in the last 10 days is unlikely to be sustained. In our view, the market seems to assume that the Trump presidency will pursue policies similar to what President Reagan pursued in his first terms, namely, the combination of looser fiscal policy and tighter monetary policy that leads to a stronger dollar. While we feel that a looser fiscal policy may actually help the US economy, we do not think a tighter monetary policy would be beneficial for the US economy, and especially to those who voted for President-elect. The biggest difference between the Reagan era and Trump era is the inflation in US. When President Reagan came in, US was suffering from a high inflation and USD was near its historical low.



In comparison, inflation is not a threat to the US economy and USD has already appreciated by more than 30% in the last 5 years, marking the USD at a level 10% above its 45 years' average. If President-elect Trump would want to increase jobs in US, a weaker USD, rather than a stronger USD would be a better choice. While the phrase "strong dollar" may have some nice sound to the ears of US nationals, it will not help create more jobs in US. We think President-elect will soon realize this point. Japan had over 60 billion USD trade surpluses with US in 2015 and a protectionist side of the President-elect Trump may even become critical of Japanese government officials trying to talk down yen from time to time. Japanese yen is still near its historical low when measured in the real effective terms.

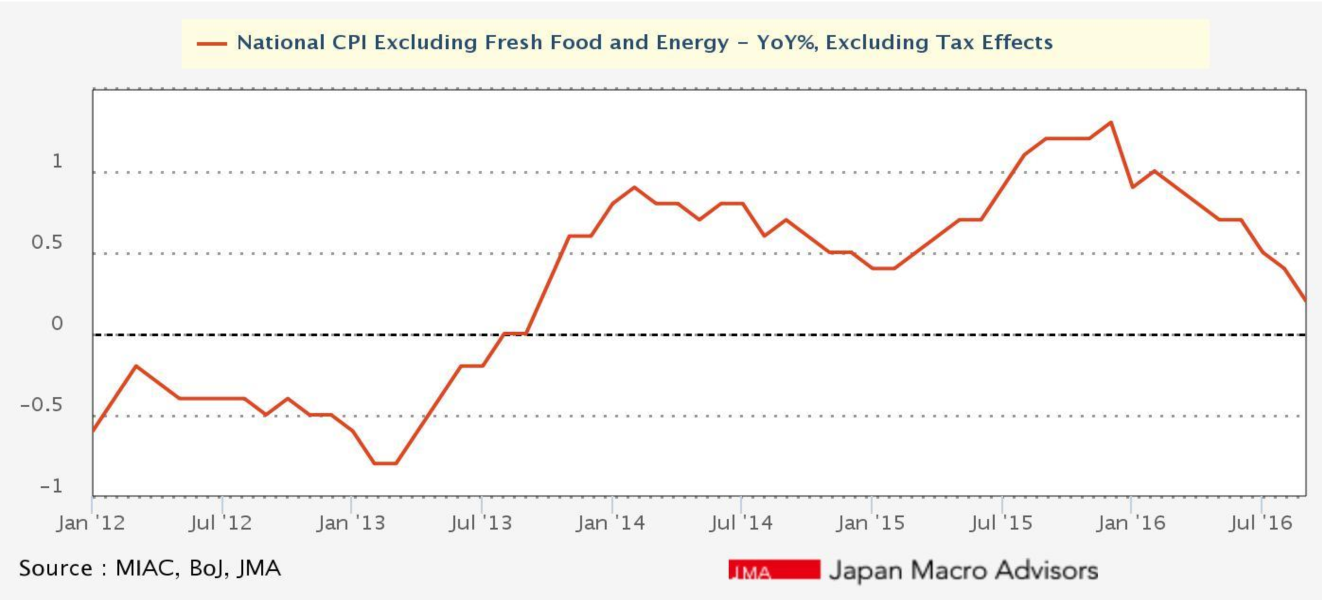


In our view, the "strong dollar" policy is unlikely to be pursued for much longer and we expect yen to resume its appreciation trend in the new year.

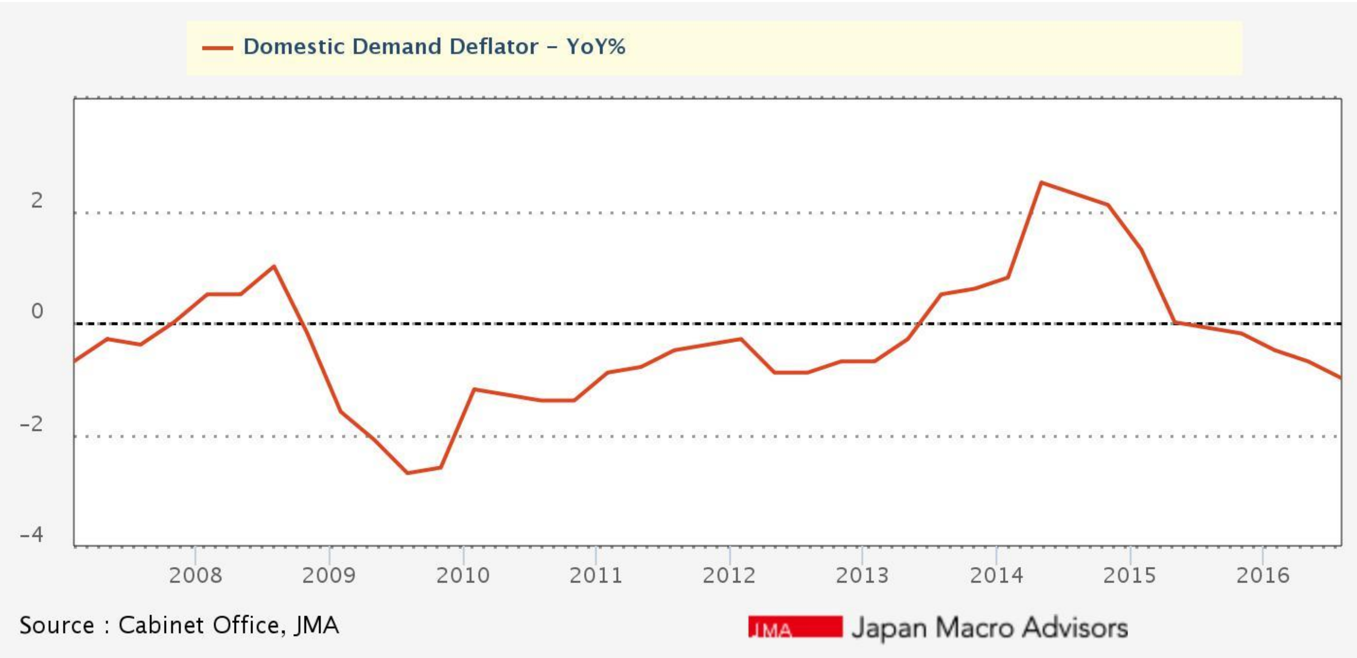
Japan's economic outlook with the Trump presidency

In our view, the Trump presidency is unlikely dramatically change the course of the Japanese economy. If the fiscal expansion in the US succeeds in lifting the US economic growth, it will definitely be a plus for Japan. However, a stronger US economy on its own will not be enough to resuscitate Abenomics. As we have commented earlier, Abenomics has already failed. The well-known three arrows in fact consisted of a single arrow, an aggressive monetary easing. Unfortunately, the aggressive monetary easing alone was not enough to reflate the Japanese economy. The BoJ already admitted its limitation in its September meeting when it dropped the 2% inflation in 2 years' target. While the Japanese policy makers are nominally keeping its long term 2% growth and 2% inflation goals, they have no credible roadmap.

What would follow Abenomics? We think "back to deflation" is the answer. The consumer price is already falling, even when we exclude energy.



In economists' jargon, deflation is a state of the economy where prices and outputs are falling in a sustained fashion. In this sense, Japan is not yet in deflation. However, we expect the other component, the fall in output, to come about soon enough. Just wait and see.



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