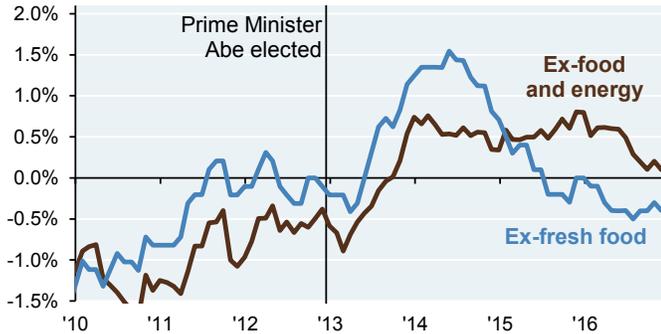


Japan: delusions of inflationary grandeur

Abenomics was designed to reflate Japan. Inflation picked up in 2014, but then rolled over. While the Bank of Japan has been projecting higher inflation (brown dots, right chart), their forecasts have been way too optimistic. I'm not going to spend too much time this year dissecting all the Japanese data, since the core objective of Abenomics isn't working.

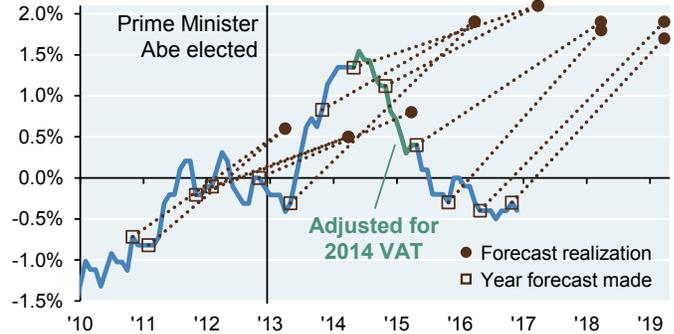
Japanese core inflation

Y/Y % change, both adjusted for 2014 VAT



Source: Japan MIC, Haver Analytics, JPMAM. November 2016.

Bank of Japan overestimated the inflationary benefits of quantitative easing, Y/Y % change, ex-fresh food



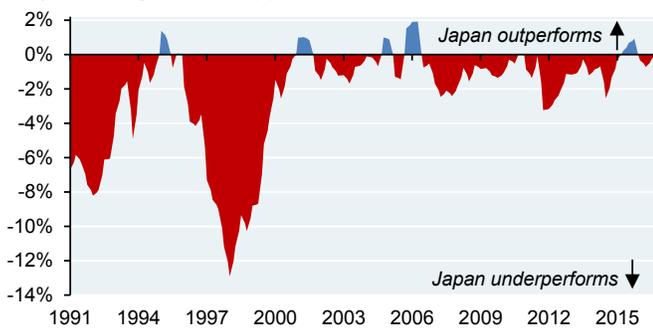
Source: Japan MIC, Bank of Japan, Haver Analytics, JPMAM. Nov. 2016.

JAPAN

For investors, I leave you with this. Where I grew up, every few years, insects called cicadas emerged after spending a decade or more underground, and then flew around for a few weeks before dying. In Japan, the cicada is known as the **higurashi**, and it's a good metaphor for the Japanese equity market. The chart below (left) shows the benefits of overweighting Japanese equities and underweighting a mix of US, Europe and Emerging Markets equities¹⁴ since 1988. For a few short periods over the last 28 years, Japanese equities had their place in the sun, flying around for a while before submerging again. Otherwise, they weren't really worth owning on a **relative** basis.

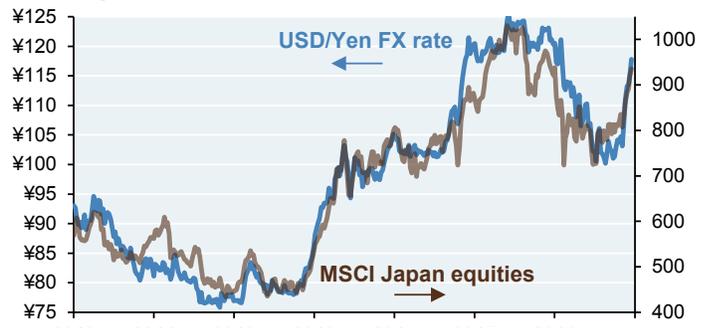
Renewed weakness in the Yen should help Japanese exporters in 2017, fiscal spending is rising, and investors may benefit from Japanese companies increasing buybacks and M&A (cash holdings in Japan are roughly 3x US levels as a % of market capitalization). I'd be comfortable with a neutral position in Japan in 2017 but not an overweight, since I don't think 2017 will be the year of the higurashi, particularly if the Yen starts to rally again.

Higurashi Moments: the benefits of overweighting Japan
3-year rolling out (under) performance



Source: Bloomberg, J.P. Morgan Asset Management. Dec. 15, 2016. Portfolio is quarterly rebalanced and assumes no currency hedging.

Japan equities and the Yen: a one-trick pony



Source: Bloomberg. December 16, 2016.

¹⁴ Computations are based on an all-equity portfolio that is overweight Japan by 7.5%, underweight the US by 3.5%, underweight Europe by 2.5% and underweight emerging markets by 1.5%. All overweights and underweights are expressed relative to prevailing MSCI index weights.

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