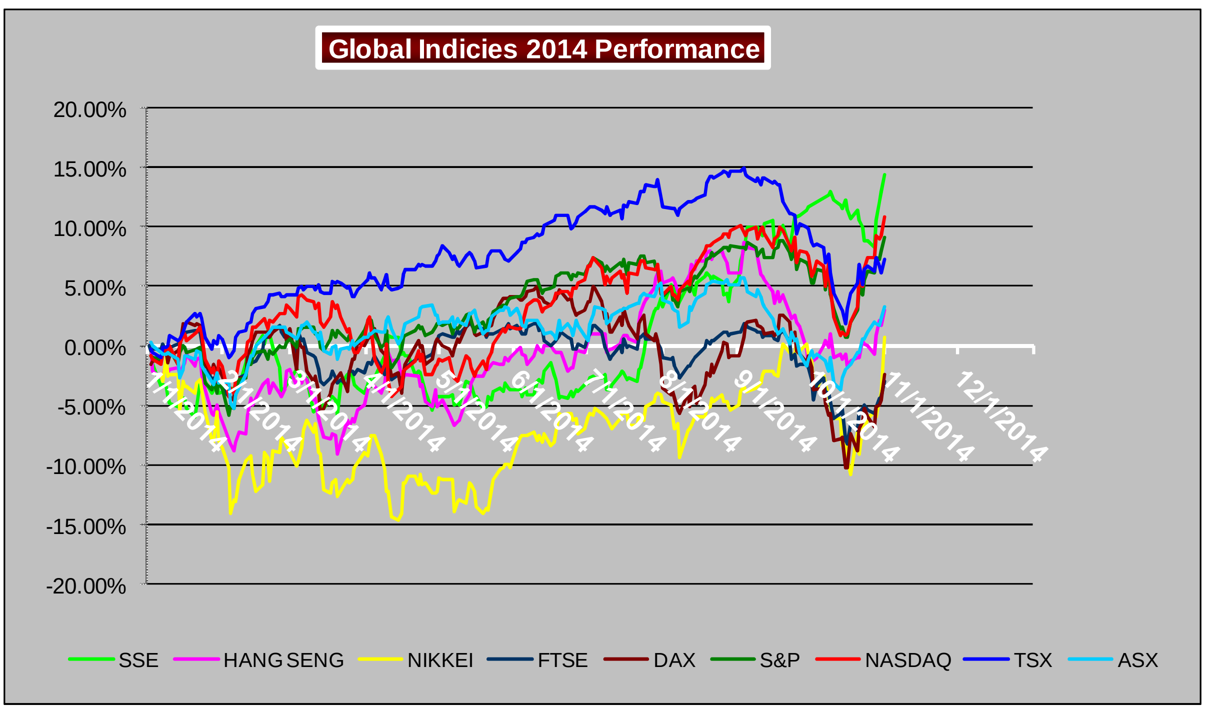
GDB November 2014 Newsletter

Monthly Market Summary:

2014 October Market Activity		
SSE COMPOSITE	***2,420.18***	+56.31 (+2.38%)
HANG SENG	***23,998.06***	+1,065.08 (+4.64%)
NIKKEI 225	***16,413.76***	+240.24 (+1.49%)
FTSE 100	***6,546.50***	-76.20 (-1.15%)
DAX	***9,326.87***	-147.43 (-1.56%)
DOW	***17,390.52***	+347.62 (+2.04%)
S&P 500	***2,018.05***	+45.76 (+2.32%)
NASDAQ COMPOSITE	***4,630.74***	+137.35 (+3.06%)
ASX 200	***5,526.60***	+233.80 (+4.42%)
TSX COMPOSITE	***14,613.30***	-347.20 (-2.32%)



Investment Themes:

During the month of November, there were a flurry of policies and economic news coming out from Japan:

October 31 – BoJ shocked the market by expanding its massive quantitative easing program by 30 trillion yen to 80 trillion yen ($ 723.4 billion). It would also triple its purchases of Japanese ETFs and REITs and longer-dated bonds.

October 31 – While the central bank was stepping up its buying of Japanese bonds, the Government Pension Investment Fund announced it would double its holdings in equities to 50%, equally split between domestic and foreign markets, and reduce its domestic bond holding by 25% to 35%.

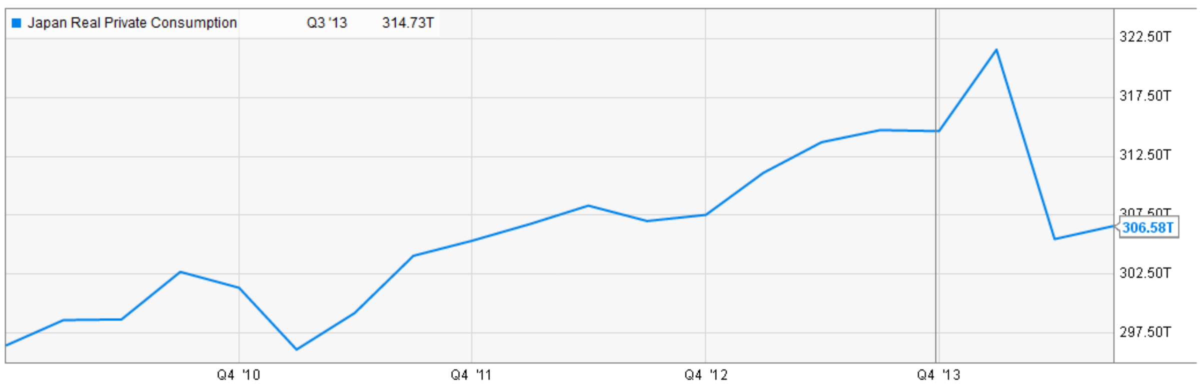
November 16 – Japan's third-quarter GDP shrunk unexpectedly by an annualized 1.6%, putting the country into a technical recession after previous quarter's contraction of 7.3%.

November 18 – Prime Minister Shinzo Abe called a snap election in December and delayed a second consumption tax hike from 8% to 10% by 18 months from next October.

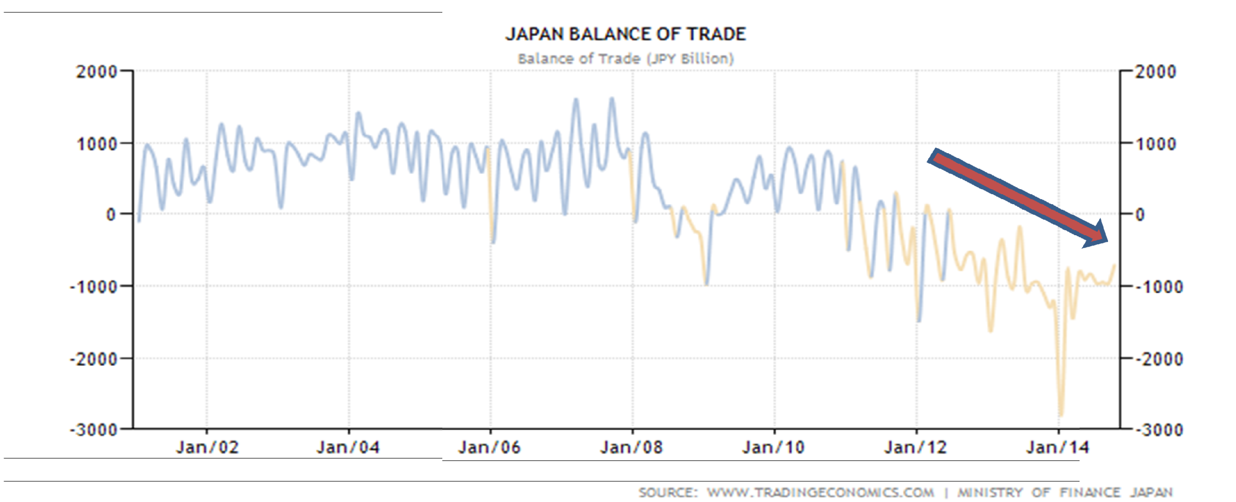
These series of events have undoubtedly raised questions about the effectiveness and the future of "Abenomics". Since the program was introduced in December 2012, one of its key components is to stimulate growth through aggressively inflating the economy through monetary stimulus, aka the first arrow of Abenomics. In turn, this will drive consumption and growth which will put Japan in a good position to launch the second arrow - fiscal reforms to shed its mammoth public debt which is over 200% of GDP. A third arrow of structural reform such as increasing labor participation of women, lower corporate taxes, deregulation and free trade will also be used to spur the economy into growth.

While the easiest and most painless part of Abenomics was easy for the government to set in motion, the second arrow seems to be tangled in the bow, failing to take flight. The aggressive monetary easing introduced by the BoJ has effectively depreciated the yen 23% against the dollar. Core inflation, which was slightly negative in 2012, has also been pushed up to 3.1% according to the Statistics Bureau of Japan.

However, did price inflation and the depreciating yen really translated into real economic growth for Japan as Abenomics would have hoped? As we can see below, Japanese real private consumption took a real hit after the tax hike in April and is now back below 2012 levels when Abenomics was first launched. Consumer spending constitutes about 60% of Japan's GDP.



And what about the lower yen, did it translate into higher exports? Trade statistics indicate to the contrary. Japan has actually carried a trade deficit for the last couple of years.



So without the economy on a sound footing, the launching of the second arrow to bring in fiscal reform undoubtedly met with resistance from the Japanese consumers. This is also the reason for calling the snap election as Shinzo Abe seeks to regroup and re-solidify his support for Abenomics.

Many analysts believe Shinzo Abe and his LDP party is likely to win the election coming up as opposition parties remain divided. After the vote of confidence from winning the snap election, we believe Abe and the BoJ will continue push forward in Abenomics as they have both committed too deep politically and policy wise to turn back at this point. However, instead of shooting all three arrows of Abenomics, the second and third arrow will not be as easy to implement as the first arrow. It will take a great deal of political will to bring about the proposed fiscal and structural reforms. As a result, we believe much of Abemonics will continue to be focused on the first arrow – monetary stimulus. And the likely outcome is for the yen to depreciate even further in the coming year.