JAPAN REFORMS AIM TO LIFT LONG-TERM GROWTH RATE

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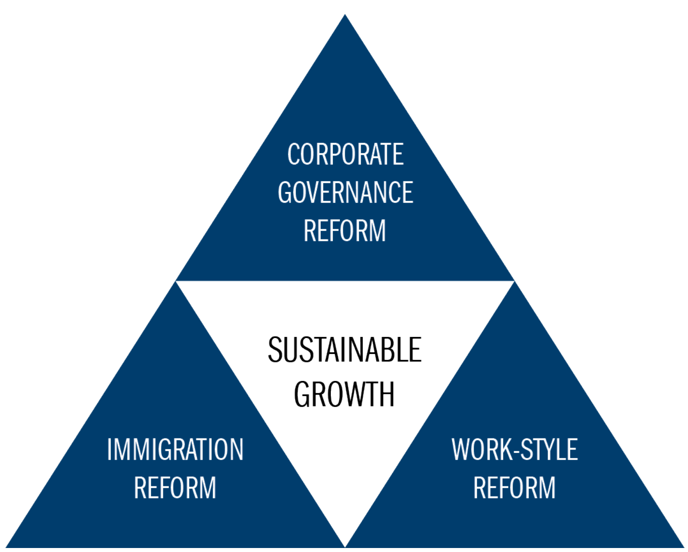
While the global growth outlook is less clear due to U.S.- China trade frictions and the gravitational pull of higher interest rates, we believe Japan's ongoing reform program is likely to lift its long-term growth rate. In time, we believe this should provide impetus for higher equity prices.

Japan is introducing three sets of reforms, all designed to address its structural and governance weaknesses. These are:

- *Immigration Reform*
- *Work-style Reform*
- *Corporate Governance Reform.*



GDP MOVES TOWARD ¥600 TRILLION

In order to put the current reforms into context, it is useful to examine Japan's recent economic history and success. You can divide the past 40 years into three periods: the extraordinary growth of the 1980s; oppressive deflation in the 1990s; and the period from late 2012 to the present characterized by the structural reforms of Prime Minister Shinzo Abe's economic policies ("Abenomics"). After the long period of deflation that followed the 1980s' rapid growth, most Japanese companies became more inward-looking. Rather than investing for future growth to earn superior returns, they focused on protecting their vested interests—paying little attention to capital allocation efficiency. After 15 years of zero growth, from 1998 to 2013, Abe's reforms are finally starting to pay off, and GDP has been rising toward ¥600 trillion over the last few years, in line with the government's target.

Inflation pressure hasn't been strong enough to exceed the Bank of Japan's (BoJ) 2% target, but economic indicators clearly suggest that deflation has been overcome. Although we wouldn't be surprised if the BoJ tweaked its monetary policy and allowed the 10-year Japanese government bond yield to rise a little, we believe the bank will remain accommodative for a while longer and will maintain the key short-term rate at -0.1%, a stark contrast to the Federal Reserve's tightening policy.

REFORM ONE: IMMIGRATION

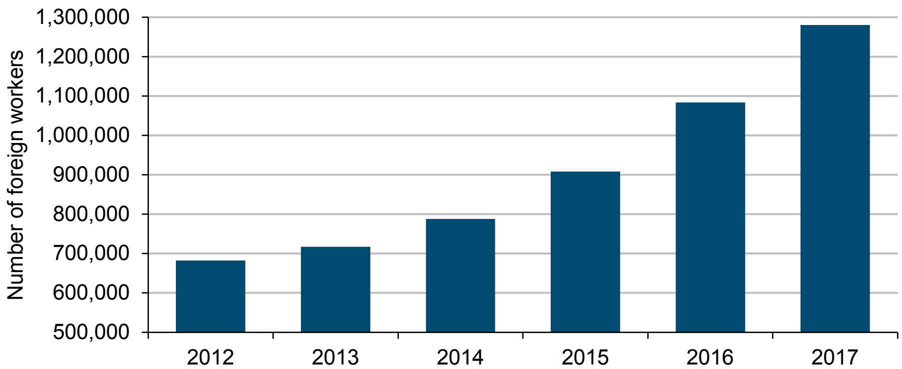
GDP is a function of both the size of the labor force and productivity. Japan has historically been wary of immigration, but given its aging population, increasing the labor force through immigration is now urgent. Initially, government policy focused only on introducing more women and seniors into the workforce. This alone will not fill the wide demand/supply gap, so Japan has been gradually opening the door for foreign workers.

While immigration can be a controversial topic, for a country that immediately needs more labor to sustain economic growth, deregulation is a positive development in Japan. The number of foreign workers has risen by 87% in the last five years to 1.3 million, but this is still a mere 2% of the total labor force, relative to approximately 17% in the U.S.[1] and 11% the U.K.[2], suggesting significant room for expansion.

[1] Bureau of Labor Statistics as of December 31, 2017
[2] Office for National Statistics as of March 31, 2018

In June 2018, the Japanese government announced a designated-skill visa intended to attract 500,000 new workers by 2025. According to the United Nations' "Replacement Migration" report, from 2000 to 2050, Japan needed 343,000 migrants each year to maintain its total population of 126 million, and 647,000 migrants a year to maintain its total working-age population of 77 million.

Exhibit 1: Trend in foreign workers



Source: Japanese Ministry of Health, Labor and Welfare as of December 2017.

This forecast suggests that the government's target of 500,000 is too low to maintain the working population, but we believe admitting foreigners is the first step in transforming Japan's demographic structure. Perhaps the number of immigrants will be raised in due course, but Japan is about to become a less homogeneous society, repeating a similar experience from about 150 years ago, when the Kanagawa Treaty of 1854 (with the U.S.) forced Japan to end its policy of national isolationism. Rapid Westernization of Japan's culture and significant industrialization followed. If history repeats itself, higher immigration could trigger a multi-decade investment opportunity.

REFORM 2: WORK-STYLE REFORM TO RAISE PRODUCTIVITY

Recognizing that its productivity is well below the OECD average, the Japanese government has introduced work-style reform in 2018, as part of a broader package of labor reforms.

While Japan's manufacturing sector is a global leader in adopting factory automation, labor productivity in non-manufacturing sectors remains quite low. Work-style reforms have important implications for productivity growth and the quality of the workplace environment. The reforms go beyond traditional working hours, wages and labor flexibility targets. To lift productivity, the country has focused on the adoption of new technologies.

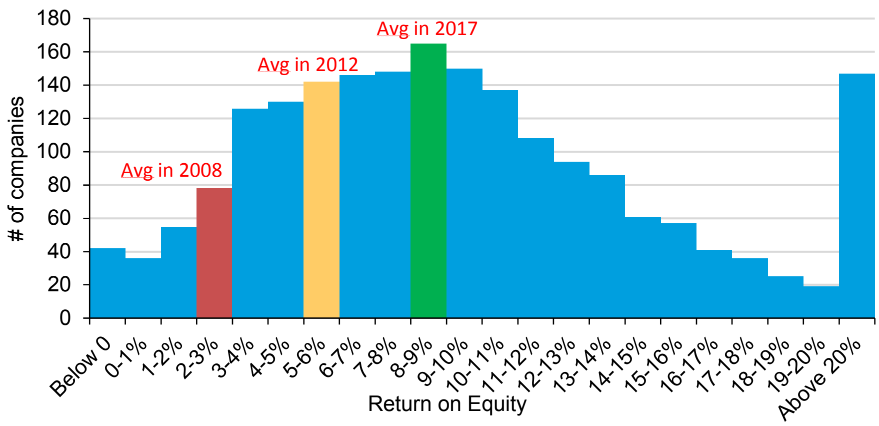
The government is looking to spur innovation in areas such as artificial intelligence, factory automation and the "Internet of Things", all of which should improve productivity. In addition, accelerating the build-out of 5G communications infrastructure may increase the pace of change.

The U.S. may serve as a guide when assessing the likely effectiveness of work-style reforms in Japan. U.S. productivity accelerated with the broad-based adoption of computers—from IBM's mainframe computers in the 1960 and 70s, to personal computers in the 1980s, networked PCs and client server computing in the 90s and 00s, and current cloud-based applications have allowed the U.S. to become more competitive and accelerate productivity.

It seems to us that Japan today shares some similarities with the U.S. In Japan, radical deregulation, which may spark technological change, has started in the agricultural, financial and medical sectors as well as in the labor market. It's still not clear how dramatically Japan's productivity will improve, but we believe there is a good chance it will at least catch up with OECD figures over the next few years.

REFORM 3: CORPORATE GOVERNANCE

Exhibit 2: TOPIX ROE distribution (2017)



Source: Nomura Research Institute, Toyo-kezai, December 2017

Overhauling corporate governance to harness the power of private enterprise is another key aspect of Japan's growth strategy. Letting corporate management focus on return on equity (ROE), increasing external board membership and encouraging constructive communication with investors have been extremely beneficial.

Japanese companies have become more focused on profitability and capital efficiency. As a result, their ROE has increased from 3% in 2011 to approximately 9% in 2017, roughly on a par with European companies. Along with corporate governance reform, the agenda in research meetings with many Japanese senior management teams has changed noticeably—focusing on long-term strategy, returns, capital management policy and how to create unique business models. We believe corporate governance reform is a multi-year, irreversible trend.

REASONS FOR OPTIMISM

Even if the macro picture were to become less upbeat, Japanese companies have low-hanging fruit to pick to sustain higher ROE.

There is significant room for improvement in business portfolio management, including better implementation of mergers and acquisitions, capex spending, restructurings, divestitures of non-core assets and product innovation. With a cash hoard of approximately $1.7 trillion[3], it is highly likely that companies will continue to raise dividends and purchase their own shares. In other words, we believe the high corporate cash position can serve to protect the downside in share prices.

Over the longer term, the combination of these three reforms—increasing the labor force, raising productivity and enhancing governance—should prove a powerful driver for Japan's economy and equity market.

[3] Policy Research Institute, Ministry of Finance Japan as of June 2018

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