

# Market Flash

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## IMPLICATIONS OF THE JAPANESE ELECTION

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On Sunday, August 31, the Japanese people made a dramatic statement, altering the majority hold that Liberal Democratic Party (LDP) has enjoyed for the past fifty years. By winning 308 out of 480 seats in parliament, the Democratic Party of Japan (DPJ) now has full control of the Lower House.

Will this lead to a drastic change in policy? In spite of the initial outlook we believe that the impact on policy will be smaller than what it appears. The main reason for this belief is that many current members of the DPJ leadership, including Prime-Minister-Designate Yukio Hatoyama, are former members of the LDP. Since the 1960s, the LDP has had two competing factions inside its party. One, led by Fukuda, Prime Minister of Japan from 1976 to 1978, and another led by former Prime Minister Kakuei Tanaka (1972-1974).

The Fukuda faction leans to the right, favoring deregulation, a free-market-economy, smaller government, and is more pro-American. This view was shared and implemented by former Prime Minister Junichiro Koizumi and leadership within the Liberal Democrats until the election in August.

The Tanaka faction, part of which spun out from the LDP to lead the DPJ, is more liberal, favoring social welfare and larger government and emphasizing relations with China.

Examining the DPJ leadership's past policy stances, when they were part of LDP, we can expect a relative movement to the left in policy, but no dramatic impact on the investment environment, so long as they adjust their policy implementation to be more realistic, going about it in a dogmatic manner.

However, if campaign rhetoric is to be believed, the Japanese economy could indeed see some changes. The

election was, in large part, an expression of discontent over the results the LDP has achieved since the market crash in 1989. During this "Lost Decade," Prime Ministers changed frequently due to internal politics of the LDP.

The following issues may be addressed by the new government and pose a certain amount of risk:

- *Social Welfare* - The DPJ has promised to increase the social welfare benefits, without increasing the consumption tax for the next four years. For example, the subsidies planned by the DPJ include distributing nearly \$300 per month, per child (up to 15 years old), providing income guarantees for farmers starting in 2012, reducing the tax for gasoline, and eliminating highway tolls. If this policy is implemented, then the increase in personal consumption could benefit industries such as clothing, housing, and education, among others. However, funding these generous social welfare without increasing public debt will be a challenge.
- *Yen Appreciation*. Certain members of the DPJ insist that Japan reduce its investment in U.S.-dollar-denominated Treasuries. In addition, the DPJ has pushed for a significant reduction of U.S. military forces stationed in Japan. Both of these scenarios could lead to the appreciation of the yen.
- *Carbon Emissions*. The DPJ's objectives are potentially burdensome for the Japanese industrial sector. The stated policy objective for CO2 emissions reduction is 30% from the 2005 level by 2020, twice as aggressive as the Liberal Democrats' stated goal. For crucial industries, such as steel, cement, and electric power generation, such a measure would be extremely costly and hinder the Japanese industrial sector's ability to compete on a global scale.

As it currently stands, the DPJ's platform is somewhat radical and it seems they would need to move very quickly to implement some of these changes in advance of next year's election (where they will vote for the Upper House). However, we expect the party to take a more cautious approach than was espoused in their campaign speeches, leading to little or no impact on equity markets, at least over the next six months.

If they do indeed implement some of the measures they have talked about, then we believe there will be a few key equity opportunities and risks including investments in consumer goods companies and those that focus on sustainable initiatives such as carbon emissions trading.

## Bottom Line:

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The Japanese stock market has moved very much in tandem with the United States over the past year and we do not expect this development to have much of an impact on the markets. Theoretically, the change in political party leadership appears to have been politically dramatic because it was a decisive expression of discontent by voters. But in practice, this was merely a shift in leadership from one party to another whose policies are not immensely different.

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