

From: Ens, Amanda [REDACTED]
Sent: 11/17/2016 8:55:12 PM
To: jeffrey E. [jeevacation@gmail.com]; Richard Kahn [REDACTED]
Subject: USDJPY testing 110. Buy Japan upside
Attachments: image001.png; image002.png; image003.png; image004.jpg; image005.jpg; image006.jpg; image007.jpg; image008.png; image009.jpg; image010.jpg; image011.jpg; image012.gif; Nikkei to 20000.pdf; Japan - Ready for ignition.pdf; Japan Macro Watch.pdf

Importance: High

Buy DXJ Jan 50/52 Call Spread for \$0.35, ref 47.45, 13d. 4.7X net payout

We can also discuss single stock and Topix banks index (TPNBK) ideas

The Republican sweep means higher USD and yields are a foregone conclusion. We see USDJPY reaching 120 next year and Japanese reflation, bullish for Japanese equities, particularly the banks.

- Huge focus on Banks/Financials post Trump election, they're the big winners.
- The Banking sector is the main beneficiary of higher rates/less regulation overhang.
- Investors are still underweight Japan. Especially in financials, so the move can have legs
- Valuation still at depressed levels. Japanese Banks are cheap versus their peers.
- Having said that, uncertainty still there so buying calls and call spreads makes sense. Some investors are still skeptical. Instead of building a large cash position, we believe options are a better play in case the market reverses and initiates a risk off move again.

-BAML expects USDJPY 115-120 by end of 2017. NKY target of 20,000 (12% upside)

-BOJ's intentions to refrain from further flattening of local yield curve positive for Banks and Insurers.

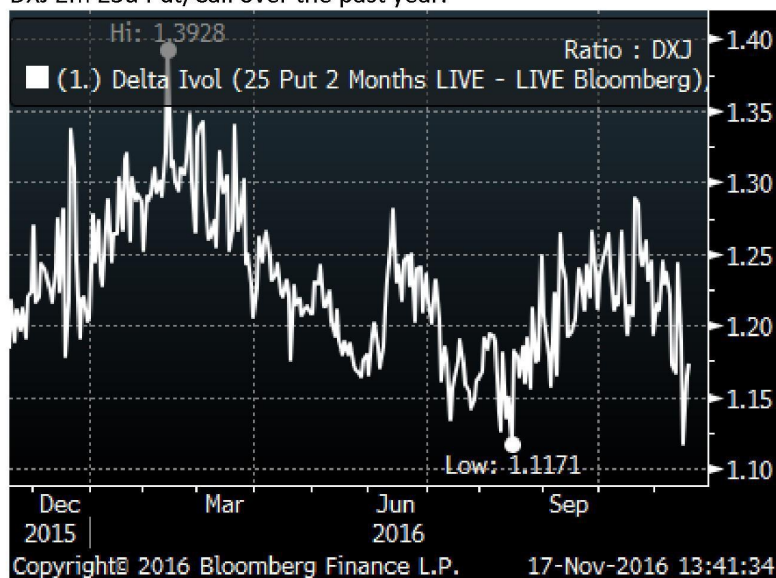
-DXJ carries a **12% weight in banks** whereas NKY is only 1.07% and even TPX is only 8.55%.

-Positioning light. DXJ shares outstanding at 3year lows as foreigners have net sold \$52bln of JP equities ytd.

-DXJ skew remains flat. 2m 25d Put /Call skew at 19%tile over the past year.

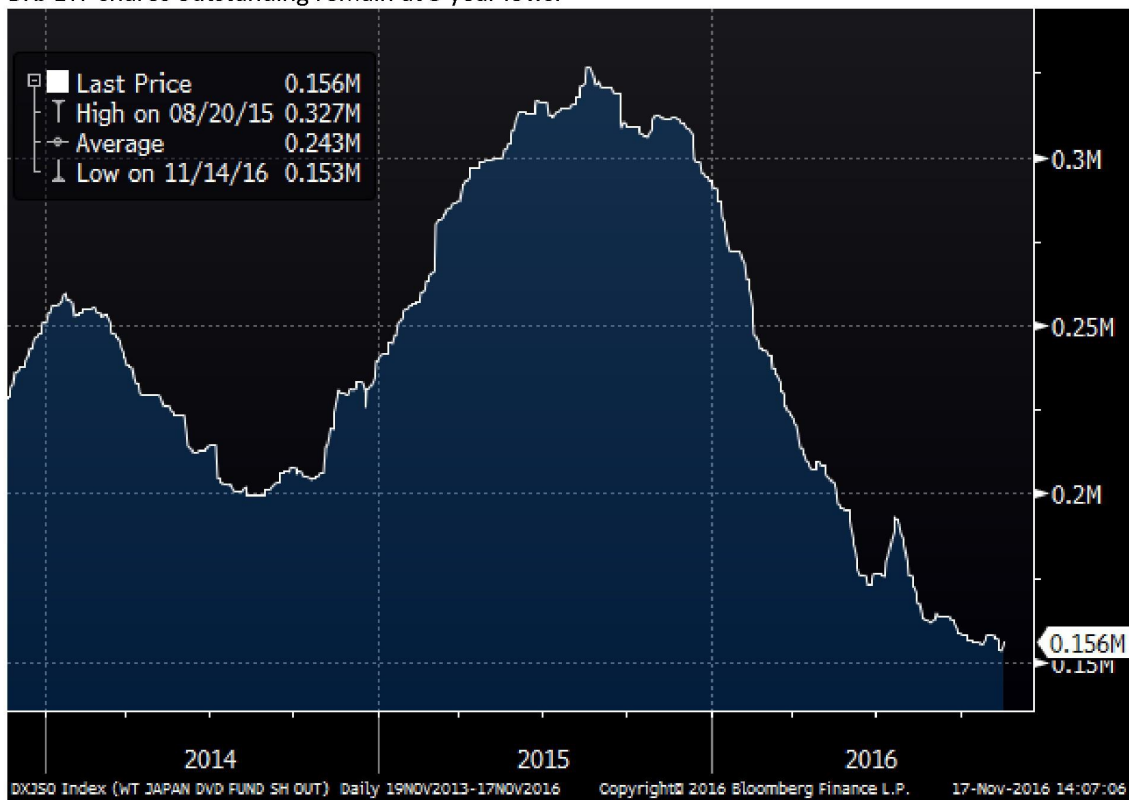
Japan Investment Strategy, Japan Econ Outlook and Japan Macro Watch attached

DXJ 2m 25d Put/Call over the past year.



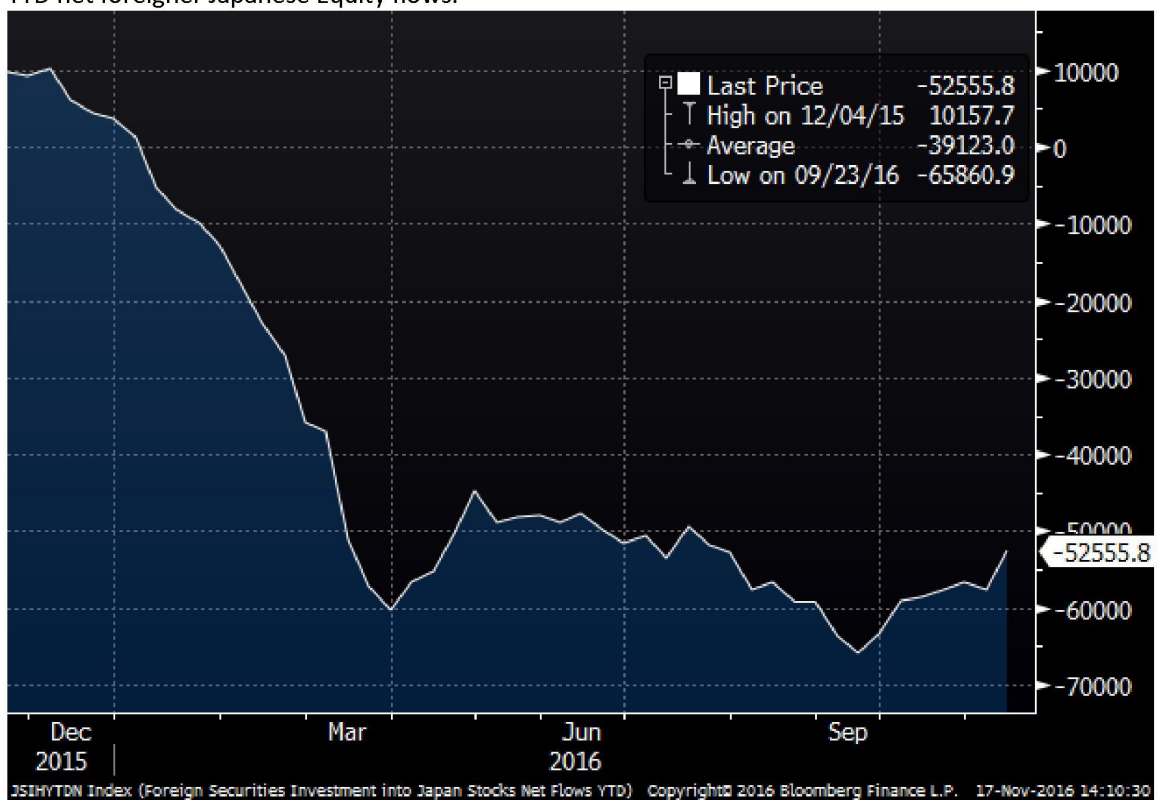
Source: Bloomberg

DXJ ETF shares outstanding remain at 3 year lows.



Source: Bloomberg

YTD net foreigner Japanese Equity flows:



Source: Bloomberg

Amanda Ens
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Japan Investment Strategy

Nikkei to 20,000: Inventory cycle upturn → cyclicals; inflation → banks, insurance

Investment Strategy

18 November 2016

Key takeaways

- Solid macro and weaker JPY positive for Japan equities, which also tend to outperform when US rate rises (esp. steepening)
- The inventory cycle continues to recover on fiscal easing and capex, implying cyclical stocks will outperform
- Inflation and higher yields positive for banks, insurance. Risk is diplomacy, protectionism, and US economic cycle

FULL REPORT



Bullish equities 2017; rotation into cyclicals, banks, insurance

We are bullish Japan equities for 2017 and we estimate the Nikkei 225 index will recover to 20,000 by end-2017 (see [\\$/¥'s eventual surge: Buy Nikkei 06 September 2016](#)). Our new Chief Japan Economist Izumi Devalier forecasts above-consensus Japan GDP growth and inflation in 2017, which is also supportive of our bullish equities scenario (see [Ready for ignition 18 November 2016](#)). We expect rotation into cyclicals, banks and insurance as explained below.

1) Upturn in inventory cycle: Defensives→Cyclicals

We expect cyclicals to outperform defensives, premised on [our end-2017 \\$/¥ estimate of ¥120](#), and this is supported by our above-consensus economic growth outlook. Our Japan economist sees a shift to fiscal easing, firms countering the tight labor market by increasing capex, and estimates industrial production to grow 3.5% and 3.6% in 2017 and 2018, respectively. With the inventory cycle exiting a "contraction" phase and entering a "recovery" phase, conditions are likely to remain conducive to cyclicals outperforming defensives ([Chart 1](#), [Exhibit 3](#)).

2) Higher inflation, rates: Deflation stocks→Inflation stocks

Up to 1H16, the Japan equity market saw continued preference for deflationary stocks as domestic inflation remained subdued and the JGB curve underwent excessive bull flattening. Defensives outperformed cyclicals ([Chart 1](#)), growth outperformed value ([Chart 2](#)), and stocks that benefit from a low-yield environment (REITs) outperformed the converse (banks, insurance; [Chart 3](#)). However, we expect conditions to reverse into 2017. We see US Treasury yields rising and Japanese core CPI inflation recovering to +1.4% yoy by 2018 and core-core to +1.1% yoy. Stronger inflation and higher foreign yields should steepen the JGB yield curve above 10yr, while below 10yr should escape from downward pressure as BoJ rate cut expectations recede. Against this backdrop, we expect to see a rotation from deflation to inflation stocks, which in addition to cyclicals means banks and insurance should outperform REITs within the financial sector ([Chart 3](#)). This is also in line with the global rotation expected by Michael Hartnett ([The Flow Show: The Inflation Era Begins 10 November 2016](#)).

3) Nikkei winner of steeper UST and strong macro

In a scenario of strong external demand and US rate hikes (particularly with curve steepening), Japan equities tend to be the winner on a local currency basis, led by cyclicals, banks and insurance stocks ([Exhibit 4](#)). Resurgence in the "Japan macro trade" of short yen / buy equities is also a possibility.

Our Buy-rated stocks in bank, insurance and cyclical sectors are listed in [Table 1](#).

Shusuke Yamada, CFA 

FX/Equity Strategist
Merrill Lynch (Japan)

Japan Economics Viewpoint

Ready for ignition

18 November 2016

Key takeaways

- We are upbeat on Japan's outlook and think consensus is underestimating the strength of medium-term GDP and inflation.
- While the consensus looks for just 0.8% growth next year, we expect growth of 1.4% in CY17 and 1.2% in CY18.
- With inflation moving in the right direction, we expect BoJ to keep its rates targets unchanged for the foreseeable future.

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[FULL REPORT](#)



Consensus underestimating GDP and inflation

We are upbeat on Japan's outlook and think consensus is underestimating the strength of medium-term GDP and inflation. We expect growth of 1.4% in CY2017 and 1.2% in CY2018, well above consensus of just 0.8% growth next year. For the first time in four years both monetary and fiscal policy are supporting growth. The combination of modestly higher commodity prices, a weaker yen, and a tightening output gap should drive Japan-style core inflation to 1.0% in CY2017, and 1.4% in CY2018. We expect the BoJ to keep its rate targets unchanged for the foreseeable future as inflation moves in the right direction.

Fiscal and monetary policy realigning

For years Japan has oscillated between loose and tight fiscal policy. Japanese policymakers now seem to be on the same page and we see little risk of another policy error. If anything, we see upside risks from greater fiscal stimulus via a third supplementary budget or a relatively aggressive FY17 ordinary budget. Meanwhile,

the BoJ's new interest-pegging regime ensures that financial conditions will become increasingly stimulatory as inflation rises.

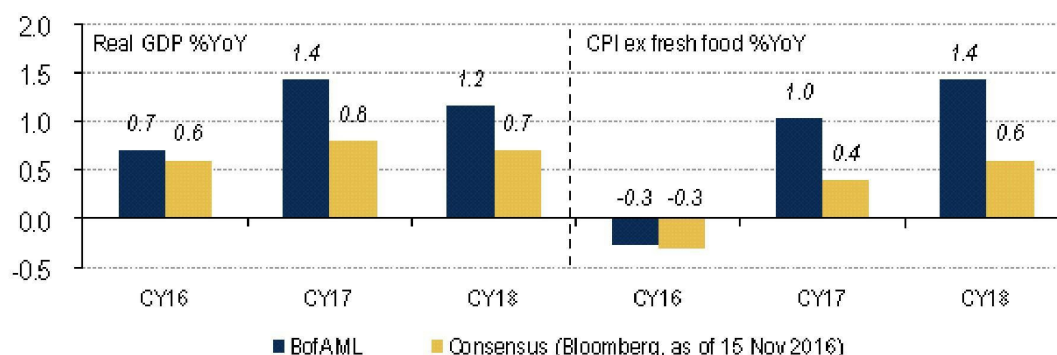
2017 - a year of recovering domestic demand

We think the economy is heading towards a cyclical sweet spot and see a broad-based recovery in domestic demand. Specifically, 1) consumption is poised to rebound as the saving rate peaks; 2) capex should accelerate in response to the improving demand outlook, deepening supply-side constraints, and "low-for-longer" real rates; and 3) increased efforts by policymakers to accelerate income redistribution could push up the velocity of money at the margin, helping to reflate the economy.

Biggest risk factor: US policy uncertainty

External developments pose the greatest risk to our forecasts, chief among them US policy uncertainty. The downside scenario for Japan is a combination of rising US protectionism, sliding global trade, and a stronger yen, which could reduce 2017 growth to zero. The Trump presidency may increase pressure on Japan to achieve greater military self-reliance, boosting defense spending. There will also be greater incentives to deepen economic and trade linkages with key regional players, such as China and Russia.

Chart 1: We think consensus is underestimating the strength of medium-term GDP and inflation



Source: BofA Merrill Lynch forecasts, Bloomberg

Izumi Devalier 
Japan Economist
Merrill Lynch (Japan)



2017 Institutional Investor (All-Japan) Survey
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