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Japan's entry into the Trans-Pacific Partnership (TPP), a free trade agreement that has the potential to eclipse NAFTA in economic importance, should boost Japanese exports to other trade partners and could raise growth prospects considerably.

We think it likely that commodities in aggregate have peaked. This is because big price increases tend to reduce demand while increasing supplies lead to a period of stable prices.

Explaining Abenomics and Weak Commodity Prices

Prime Minister Shinzo Abe's approach to reviving the Japanese economy employs 'three arrows' – (1) **quantitative easing** (to reverse deflation and weaken the yen), (2) **fiscal stimulus** (to promote investment and growth), and (3) **structural reforms** (to increase competitiveness and sustain corporate profit expansion). Thus far, investor attention has been primarily on the Bank of Japan's quantitative easing. Increasingly, however, with the BOJ having 'done its part,' we think the focus will shift to whether Abenomics is working. We think the successful implementation of all three strategies is necessary to remain long-term bulls on Japan and maintain our overweight exposure.

Japan's government debt is approaching 250% of GDP, by far the largest among developed nations, and its total debt is more than 500% of GDP. Despite this, the yen has been perceived as a safe haven currency, and Japan's interest rates remain extremely low. This is in part because of deflation (which lowers prices and thus raises yen purchasing power), Japan's stable society, and its ample national wealth (liabilities should also be evaluated against net national assets, or net worth, of around $35 trillion, compared with about $14 trillion in public debt). Yet with a rapidly aging population, declining savings rates, and a deteriorating trade balance, there is a pressing need for structural reforms to deliver growth and assure long-term fiscal solvency.

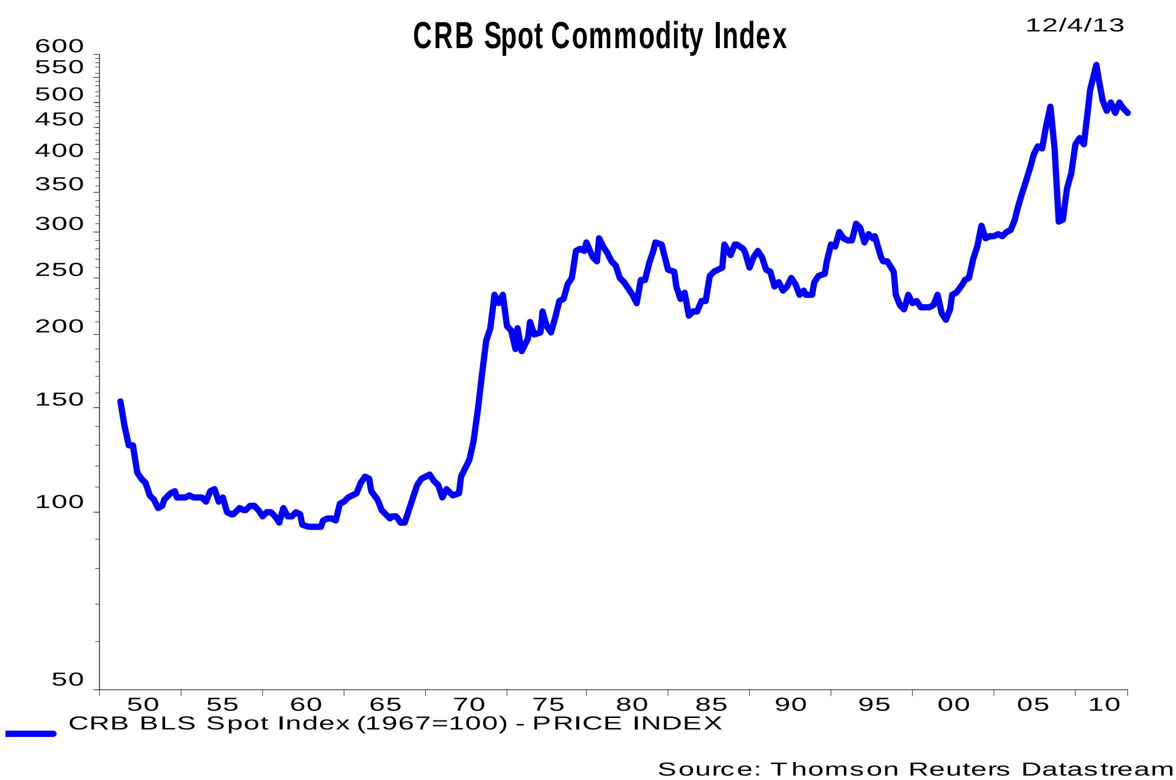
One key structural reform initiative that was announced by the US Treasury last Friday was Japan's entry into the Trans-Pacific Partnership (TPP), a free trade agreement that has the potential to eclipse NAFTA in economic importance. Besides the TPP's geopolitical significance (China has been conspicuously left out of talks), the boost in Japanese exports to other trade partners such as Australia, Chile, Canada, and Mexico could raise growth prospects considerably. It might also provide a catalyst for long-needed reforms to boost competitiveness, such as better utilization of Japan's labor force, encouraging female job participation, making it easier to hire and fire workers, improving shareholder governance, and lowering corporate taxes. Additional steps, such as safely restarting Japan's nuclear power program and increasing the efficiency and resilience of its power grid would also be helpful in revitalizing its growth outlook. While these are not required for a short-term boost to growth and stock prices, we think they are important to its sustainability.

Fiscally, perhaps the most important issue facing Japanese policymakers is whether to impose a consumption tax hike next year. As in most of the rest of Asia, we view Japan's problem more as deficient consumer demand and thus see benefits from delaying the consumption tax, despite the likelihood of increased consumption this year as demand is pulled forward. Already announced fiscal stimulus measures — mostly disaster prevention, infrastructure improvements, promoting private investment to save energy, and strengthening medical and child care services — should lift GDP over 3% this year, among the highest in the developed world.

Abenomics has proven to be a potent cocktail for investors thus far, but it also has relevance beyond Japan by indirectly lowering bond yields in Europe and emerging markets as Japanese investors 'reach for yield'. Lower funding costs are being welcomed by Spain and Italy, although (like Japan) structural reforms are still necessary for growth to reach its full potential. More broadly, similar to the way Japan provided a development model for emerging economies, Abenomics is a blueprint for moribund developed economies that, if successful, is likely to be replicated around the world.

The S&P 500 reached all-time highs on March 28, breaking above its previous October 2007 record high. Two more new highs were made last Wednesday and Thursday, peaking at 1593, before stocks fell on Friday. Although, we are not looking for a significant correction in US stocks, we have set levels at which we expect the S&P 500 to find support during pullbacks – initial support is around 1530 and the next support level is around 1500.

THE WEEKLY CHART: COMMODITY INDEX ENTERS CONSOLIDATION PHASE



Twenty years of stagnant commodity prices from 1982 led to underinvestment in production. This, combined with a decade of strong global growth driven by China and four years of easy money in the US has resulted in a major bull in commodities. As our weekly chart shows, following a collapse in prices in 2008, commodity prices surged again as China primed its economy; but for the last year commodity prices have fallen even as stock prices have risen.

We think it likely that commodities in aggregate have peaked and will at best move sideways for the next few years. The spot commodities index that RiverFront uses for its Price Matters® analysis (which is adjusted for inflation) is down about 19% from its April 2011 peak but remains in the upper zone of its 40-year range. ISI Group points out that commodity prices have historically tended to surge for ten years or so and then stabilize for many years. Big price increases tend to reduce demand while increasing supplies led to a period of stable prices. Furthermore, slowing growth in China and other emerging economies will also lower the demand for commodities, in our view.