

JAPAN EQUITIES: PERFORMANCE POWER THAT CAN LAST

05 Dec 2016

Japanese equities have been made great again by the Trump victory – they have outperformed most global markets since 8 November, with TOPIX up 7.2% against the 3% rise in the S&P 500[1]. We believe that, Japan's recent performance is not just a one-off adjustment but does have the potential to develop into a broad-based rally throughout the next 12-18 months. In coming weeks, any consolidation after the recent strong rally offers a great opportunity to reconsider a sizeable Japan allocation to capture positive momentum for Dollar investors.

The post-election rally has demonstrated that, clearly, Japan equities are one of the most geared assets into rising US rates, a strong US Dollar / weak Yen scenario and rotation out of low-volatility stocks into cyclicals and growth exposures. But it is not just this global macro inflection that is pushing up Japanese equities. Japan does have, unlike Europe, endogenous forces supporting a bullish stance on risk assets, equities and real estate.

Specifically:

+ Corporate earnings momentum is poised to turn positive over the coming three months. This is because both domestic and global sales growth targets are now too conservative. In addition, exporters are budgeting for ¥103, and every five Yen of depreciation adds back about four percentage points to earnings. In other words: Against a projected drop in profits of 2% in the fiscal year that ends in March 2017, profits should rise by around 5% this current fiscal year; and an added rise of 15% is likely for 2017 (assuming 2.5% global growth and ¥110).

+ The Bank of Japan (BoJ) is actively promoting a weaker Yen. Specifically, they adopted a "zero upper bound" policy and will cap the 10 year JGB yield at zero. This means that Japan could have the flattest yield curve amongst developed countries, which in turn points to a weaker Yen. The BoJ will likely keep the zero-yield policy in place until CPI inflation overshoots the 2% target. In other words: The zero yield is poised to be in place until at least summer 2018. The de-synchronisation between US rising rates and fixed-at-zero Japan rates suggest the Yen could weaken well beyond the ¥125 level seen last year, in my view.

+ Domestic portfolio rebalancing is poised to accelerate. As the BoJ zero-yield fix gains credibility, domestic insurance and pension funds may have no choice but to raise equity allocations. In 2016, the primary allocation shift was from bonds to non-Yen securities. In 2017, domestic equities are set to become the Japanese asset of choice. Why? Rising earnings visibility and attractive valuations. Against zero-bond yield, the equity market earnings yield gap stands at historic highs. Moreover, corporate governance changes are not just retro-rockets but quantifiable reality; despite the earnings recession over the past 15 months, the dividend and buyback stream has actually risen. This is the first time in the history of corporate Japan that shareholder yield went up during a profits down-cycle.

There are added reasons to be bullish about Japan, again independent of the US reflation trade: rising evidence that wage and income growth is accelerating, pro-active fiscal spending, an accelerating housing and real estate appreciation cycle, etc.

Moreover, technically, the market is also attractive, with global investor positioning at the lowest level in over five years. This creates upside potential while the downside is de-facto protected by the BOJ—it recently doubled its market ETF buying budget from ¥3 trillion to ¥6 trillion. Add to this corporate buybacks running at around ¥9 trillion, and you get committed buying power equivalent

to about 4.3% of TOPIX market cap. To our knowledge, there is no other equity market in the world that offers this sort of fundamental downside protection from central bank and corporate buying commitment.

In our view, 2017 could well become the year when Japan benefits from both domestic investor and global investor buying.

[1] Source: Bloomberg 7 November 2016 - 29 November 2016

The views expressed in this blog are those of Jesper Koll, any reference to "we" should be considered the view of Jesper and not necessarily those of WisdomTree Europe.

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