

JAPAN OUTLOOK—SHOW ME THE MONEY

26 Apr 2017

We maintain our view that Japanese risk assets—equities and real estate—are on track for a multiyear structural bull market. We believe 2017 is poised to bring a positive reversal of earnings momentum, with a pickup in top-line sales growth and a weaker currency capable of delivering 25% to 30% earnings growth (after last year’s drop of around 8%, calendar year). Given the relatively attractive valuation backdrop—TOPIX is trading at a modest discount to its 10-year averages on both trailing and forward P/E multiples—the rising visibility of earnings is likely to be the principal driver of Japan’s market performance. In contrast, we expect policy action and initiatives to be relatively less important market drivers for Japan, and the Bank of Japan (BOJ) to stay put and maintain its zero-rate 10-year bond yield target for the foreseeable future.

We expect a steady stream of upward revisions in corporate earnings

Now that the US-Japan bi-lateral economic, trade and investment dialogue is off to a good start—last week’s first round of meetings went well and constructive engagement has been agreed—the next key to propelling Japanese markets out of the disappointing downward adjustment is poised to be the upcoming corporate results season. As this overlaps with the annual “Golden Week” holidays (29 April –6 May), Japan performance is expected to rise in coming weeks, in our view.

Specifically, we expect a steady stream of upward revisions as companies report their full fiscal year earnings end-April/early May. This is because baselines are still very conservative, with companies and analysts still “budgeting” for an average JPY/USD exchange rate of around 105 and top-line sales growth of just below 2%. Note that for every 10 Yen of Yen depreciation, listed companies receive a windfall profits boost of around 8%. Given that the realised exchange rate in the January–March quarter was around JPY113 this would suggest a rise in profits of around 15%, rather than the 8% anticipated by the corporate consensus.²

Of course, forward guidance is going to be key. Here, we anticipate another year of conservative benchmarking with companies likely to budget for around JPY108-110/USD and sales growth of around 2%. Our models suggest this implies earnings growth of around 17.1% for the new fiscal year (starts 1 April 2017, and runs through 31 March 2018). However, if top-line sales growth—which is basically global economic growth—rises by 3%, profits should rise by 30.5%—even if the currency averages the same JPY110/USD. Given the recent acceleration in global growth and inflation³ momentum, Japanese corporate earnings momentum is expected to surprise positively throughout 2017-18, in our view.

The table below outlines the relationship between different foreign exchange assumptions and sales assumptions for FY3/2018 profits growth for TOPIX companies. In addition, it presents “fair-value” levels for TOPIX under different P/E multiples. In our view, 25% to 30% earnings growth should be achievable in FY3/2018.

Figure 1: Japan Equity “Fair Value” Matrix with Different Foreign Exchange Rate and Sales Growth Scenarios

\$ / ¥	Sales Growth Scenario	Implied EPS	%yoy	TOPIX at PE Multiple					
				14	15	16	17	18	19
105	1%	74	-9.8	1036	1110	1184	1258	1332	1406
	2%	85	3.7	1190	1275	1360	1445	1530	1615
	3%	94	14.6	1316	1410	1504	1598	1692	1786
110	1%	85	3.7	1190	1275	1360	1445	1530	1615
	2%	96	17.1	1344	1440	1536	1632	1728	1824
	3%	107	30.5	1498	1605	1712	1819	1926	2033
115	1%	90	9.8	1260	1350	1440	1530	1620	1710
	2%	102	24.4	1428	1530	1632	1734	1836	1938
	3%	115	40.2	1610	1725	1840	1955	2070	2185
120	1%	95	15.9	1330	1425	1520	1615	1710	1805
	2%	107	30.5	1498	1605	1712	1819	1926	2033
	3%	120	46.3	1680	1800	1920	2040	2160	2280

Source: WisdomTree Japan.

Japan is committed to being a ‘bastion of stability’

On top of the expected cyclical upturn in corporate earnings, two added factors should lend structural support to Japanese risk assets: modest but steady increases in domestic demand and nominal GDP⁴, and stable but stimulative fiscal and monetary policy.

The former is driven by the structural tightness of the labour market, which is now delivering not just modest wage increases but, more importantly, a sharp upturn in the quality of jobs created—full-time jobs are now rising smartly, with Japan creating one million full-time jobs over the past 18 months (the first net full-time job creation in almost 20 years). We maintain our view that a “new middle class” is rising in Japan and that the structural labour market outlook has the potential to deliver an endogenous domestic demand growth cycle, uncorrelated to the global business cycle.

On the policy front, Japan is committed to being a “bastion of stability” by comparison to America and Europe. Specifically, fiscal policy⁵ has turned out to be a modest plus to aggregate demand in 2017-18 due to supplementary spending budgets, and monetary policy is committed to maintaining the zero-yield upper bound on Japanese government bonds. In our view, the decoupling of Japanese monetary policy from US Fed policy is one of the key global macro and allocation flow drivers over the coming 6-12 months. Certainly, Japanese institutional asset allocators are expected to respond to the rising interest rate differentials⁶ by increasing non-Yen security allocations, in our view.

What are the risks to this outlook?

We see two principal risk scenarios on the economic policy front. The first one would be the BOJ following the Fed rate hike cycle earlier than anticipated (that is, before the BOJ’s 2% inflation target comes into sight). This seems unlikely, given the BOJ policy commitment to keep current policy until inflation overshoots the 2% target (see policy board decision, September 2016). The second one would be a squeeze on profit margins from rising labour costs. Structurally, this is a serious issue. The good news is that labour market reform is focusing on this and, at the same time, corporations are acting fast with, for example, a domestic merger and consolidation wave now helping to ease

cost-push inflation worries.

Meanwhile, geopolitical risk has become a more acute source of possible volatility⁷, with the unpredictability of the North Korean regime a growing concern for both global and local risk allocators.

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Sources

1. *Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.*
2. *Source: Nikkei.*
3. *Inflation: Characterized by rising price levels.*
4. *Gross domestic product (GDP): The sum total of all goods and services produced across an economy.*
5. *Fiscal policy: Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.*
6. *Interest rate differentials: The difference between the two-year interest rate swaps of two economic regions.*
7. *Volatility: A measure of the dispersion of actual returns around a particular average level.*

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