June 2013

Asian Market Commentary

Japan: Still Awaiting Confirmation on Fundamentals

Wade O'Brien
Aaron Costello
Alexandra Meyer

C|A CAMBRIDGE ASSOCIATES LLC

C|A CAMBRIDGE ASSOCIATES LLC

Japan: Still Awaiting Confirmation on Fundamentals

Despite the recent sell-off, Japanese equities are up considerably since last October given the promise of Abenomics; however, we remain tactically neutral given valuations and significant structural headwinds.

Since a general election was announced last November, paving the way for Prime Minister Shinzō Abe's Liberal Democratic party to win a landslide election in December, Japanese equities have been on a tear. Through May 31 the MSCI Japan Index had returned almost 34% year-to-date in yen (and almost 60% since last October), led by sectors perceived to benefit most from Abe's plans to revive the domestic economy (Figure 1). Many investors at this point are understandably asking whether it is too late to jump in, or whether this could be just the beginning of a new era for Japanese investing.

Despite inexpensive equity valuations, we have been neutral on Japanese equities for some time[1] given the lack of a catalyst to unlock value amid significant macro issues like high sovereign debt levels and micro problems such as low corporate profitability. Our exuberance has also been tempered by Japanese equities rallying several times over the last two decades, only to eventually disappoint as these structural issues came back to the fore. However, today we must consider that this time could be different, with a change of leadership at the Bank of Japan (BOJ) and renewed political focus on restoring growth. The proposed reforms provide an opportunity for improvement, but a turnaround is by no means certain. Further, such aggressive policies also raise the risk of a significant policy error given extremely high levels of government debt. At the same time, even after the recent pullback, the strong rally has bought the equity market to fair value. To overweight the broad Japanese equity market today, valuation-sensitive investors must believe Japanese companies will be able to increase corporate profitability to levels more consistent with those achieved by other developed markets. As a result, we remain neutral, but could become more positive if we see material market weakness absent signs of deterioration on the fiscal front.[2]

The Promise of "Abenomics"

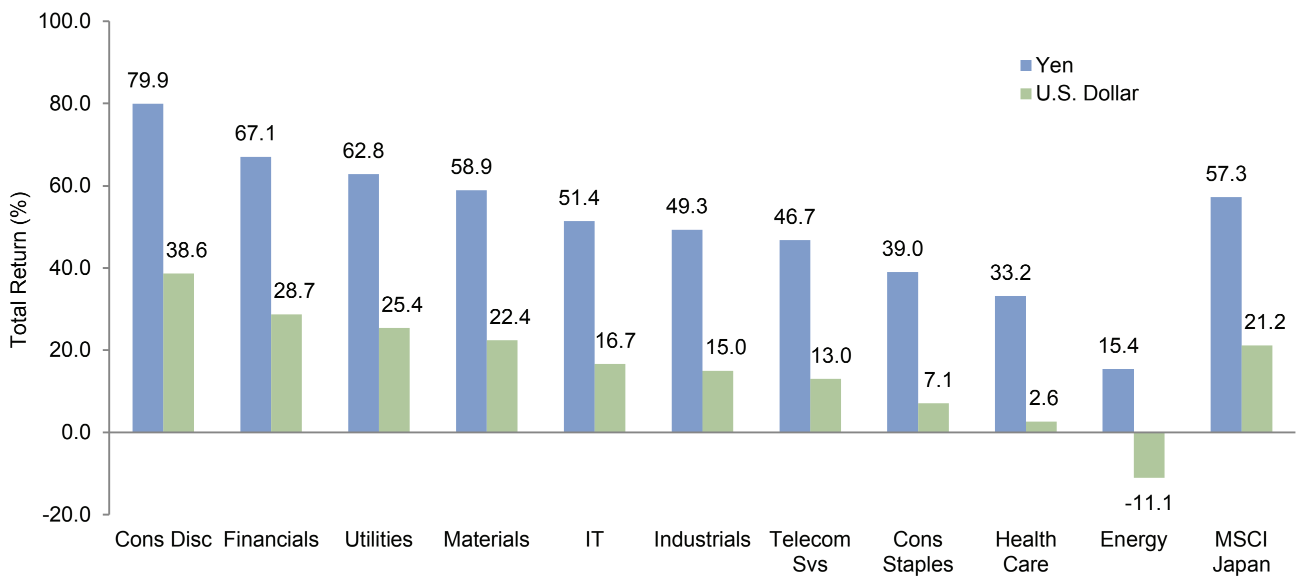
Abenomics intends to use "three arrows" of monetary, fiscal, and structural actions to help spark an economic revival. On the monetary side, BOJ Governor Haruhiko Kuroda has announced an aggressive plan to achieve 2% inflation by weakening the yen and keeping interest rates low. This will entail the BOJ buying around ¥7.5 trillion per month in Japanese government bonds (JGBs) and other risk assets, boosting the ratio of its balance sheet to GDP to roughly 45% by the end of 2013.[3] On the fiscal side, the government's ability to prime the pump is limited by gross debt, which sits at 240% of GDP, but some tax cuts and minor spending increases have been proposed. Finally, on the structural side, a host of potential actions have been cited, including reducing trade barriers and liberalizing some labor laws.

[1] Please see our October 2009 Market Commentary *Japan: Will the Sun Ever Rise?*

[2] Given the market sell-off in late May, the MSCI Japan Index returned -2.2%, but we would not qualify this as a significant pullback. Through June 13, the index had returned another -8.0%.

[3] For comparison, the Fed had $3.2 trillion in assets as of first quarter 2013, roughly 24% of GDP.

Figure 1. MSCI Japan: Sector Performance
September 30, 2012 – May 31, 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

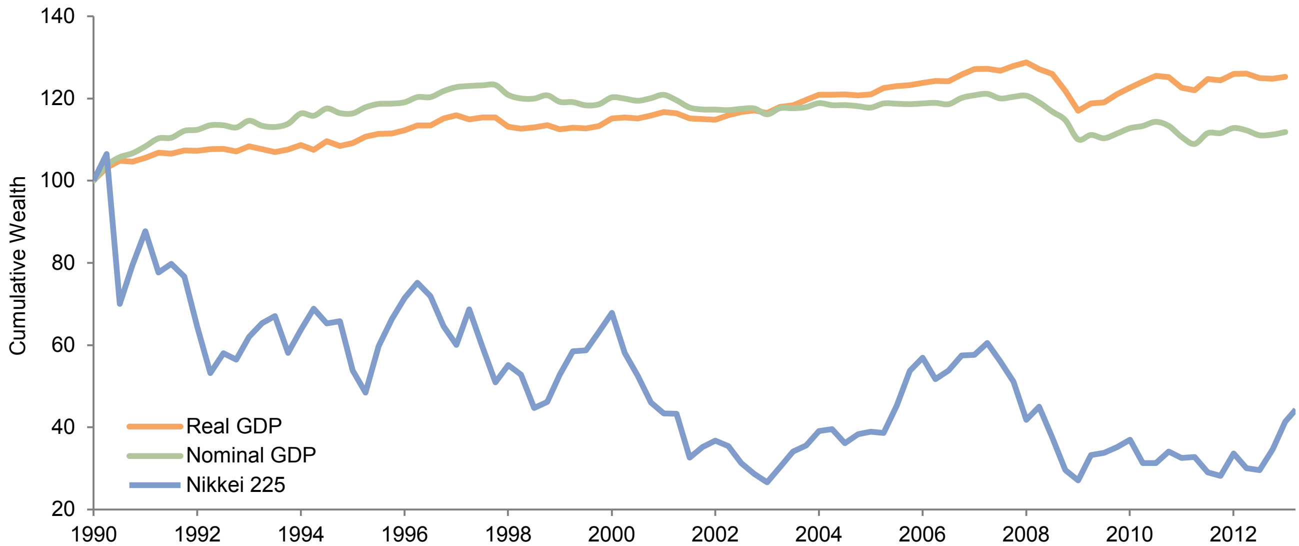
Will It Work?

Given Japan's recent track record, a certain amount of skepticism is justified about whether the three arrows will deliver a sustained recovery. Indeed, Shinzō Abe was prime minister back in 2006 when the last Japanese equity rally and economic recovery stalled out, as he backed away from some of the reforms pursued by his dynamic predecessor, Junichiro Koizumi. Nominal GDP growth has been stagnant for more than a decade, and stock markets remain well below historical peaks (Figure 2). However, the government appears to have a political mandate to shake things up, and this will be further solidified if the Liberal Democratic Party takes control of the Upper House in the July election. Were this to occur, the Liberal Democratic Party would have control over both houses of the Diet for at least three years, allowing substantial time to implement and tweak structural reforms

This political mandate is motivated by several factors, including a growing China that tests not just Japan's economic but also political power in the region.[4] Another factor is frustration with the ongoing economic stagnation and the recognition that things must change structurally given the manner in which the manufacturing base has lost ground to lower-cost regional competitors. Finally, desperation may play a role—unless the country can generate nominal GDP growth greater than its debt costs, its debt burden (Figure 3) and entitlement promises will quickly become unsustainable. In 1990, there were nearly six active employees per retiree; by 2025, there will

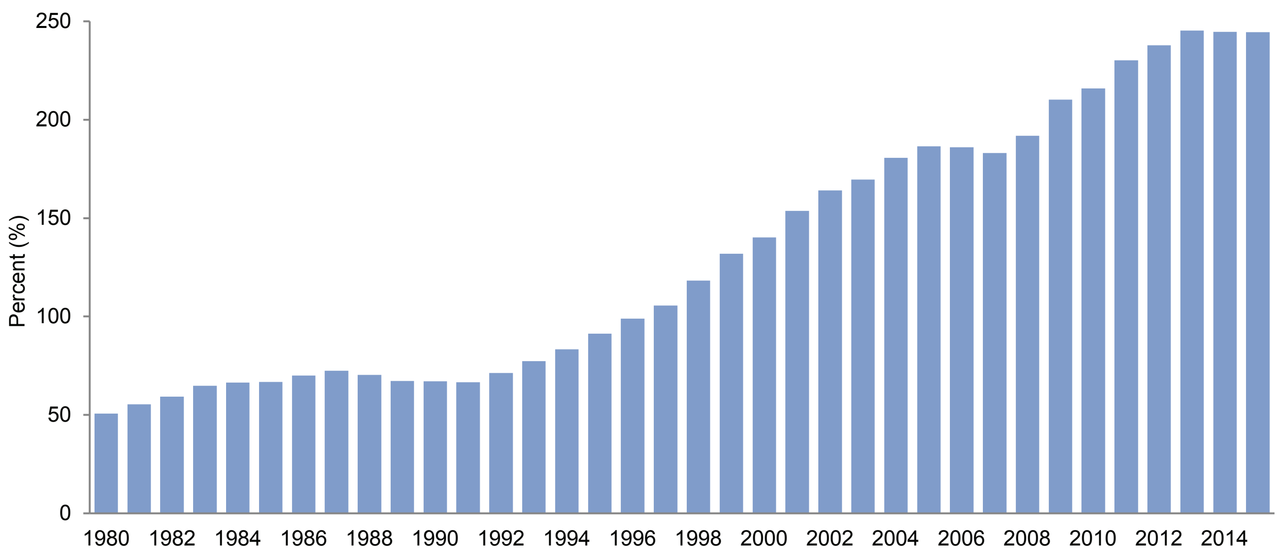
[4] For example, see "Abe's Master Plan," *The Economist*, May 18, 2013.

Figure 2. Japanese GDP and Nikkei 225 Price Levels
First Quarter 1990 – First Quarter 2013 • Rebased to 100 at First Quarter 1990



Sources: Nomura Securities, OECD, and Thomson Reuters Datastream.
Note: Data are quarterly through March 31, except for the Nikkei 225, which is as of June 12.

Figure 3. Japan's Gross Government Debt as a Percentage of GDP
1980–2015



Sources: International Monetary Fund - World Economic Outlook Database and Thomson Reuters Datastream.
Notes: Data are as of June 12, 2013. IMF staff estimates begin after 2011.

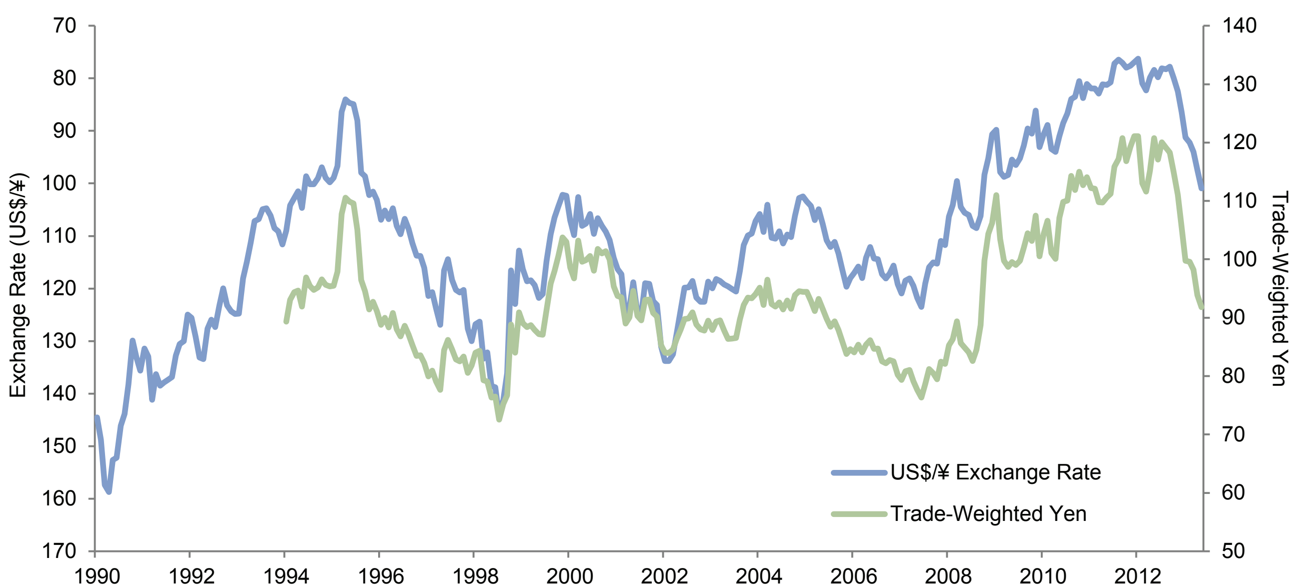
be around two. The working age population is shrinking and bringing GDP down with it.

There is some early evidence that Abe is following through on promises of structural reform. The government is pursuing membership in the Trans Pacific Partnership regional trading pact over the objections of constituents like small farmers. Corporate tax cuts and labor market reforms have also been proposed. The yen has depreciated by around 30% since late September (Figure 4), and exporters are revising profit forecasts upward. In response to revised profit expectations, stock prices have risen, creating wealth effects and providing a boost to consumption. While early days, the 4.1% annualized pace of first quarter real GDP growth is an encouraging sign.

The question that remains is whether the promise for growth from Abenomics becomes self-fulfilling, changing the national deflationary mindset. For this to happen, Japanese companies will need to share higher profits with workers, invest more particularly at home, and pursue structural reforms. A heavily unionized workforce and inefficient agricultural sector will have to make concessions. Consumers will need to spend these wage hikes (if they occur), as well as some of the wealth effects generated by rising asset prices.

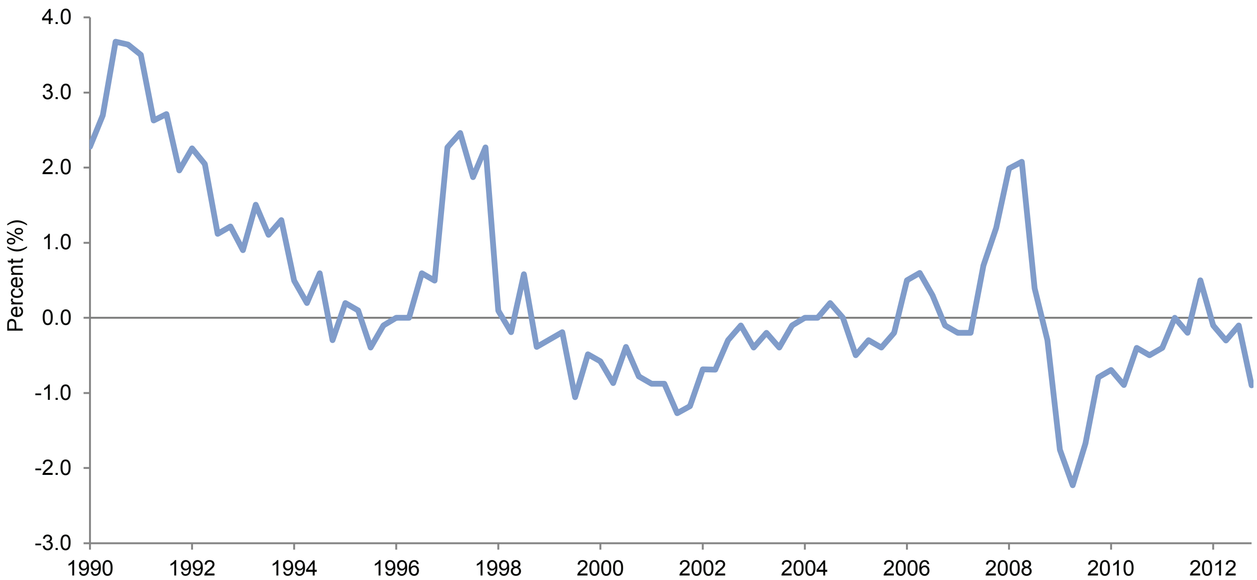
Abe's plan could fall short for any number of reasons. Japan has tried to generate higher inflation throughout most of the past two decades and has usually come up short. The country basically invented quantitative easing, and has kept short-term rates near zero since 1998. However, consumer price inflation has very rarely been above 2% since the early 1990s (Figure 5). Higher wages would help, but this means corporate profits have to rise and management has to believe these gains

Figure 4. The Yen
January 31, 1990 – May 31, 2013



Sources: J.P. Morgan Securities, Inc. and Thomson Reuters Datastream.

Figure 5. Japan Year-Over-Year Inflation
Second Quarter 1990 – First Quarter 2013

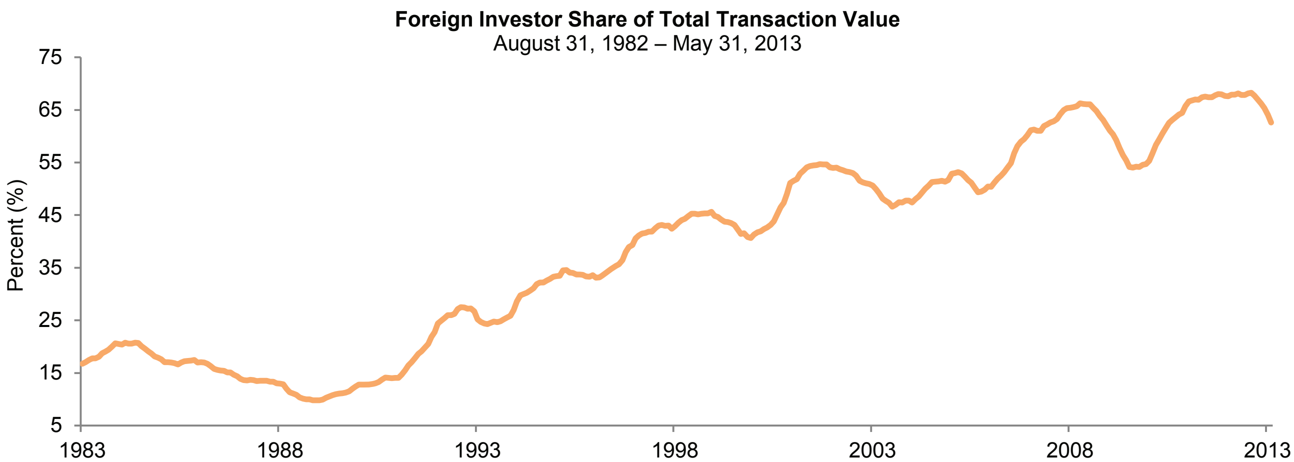


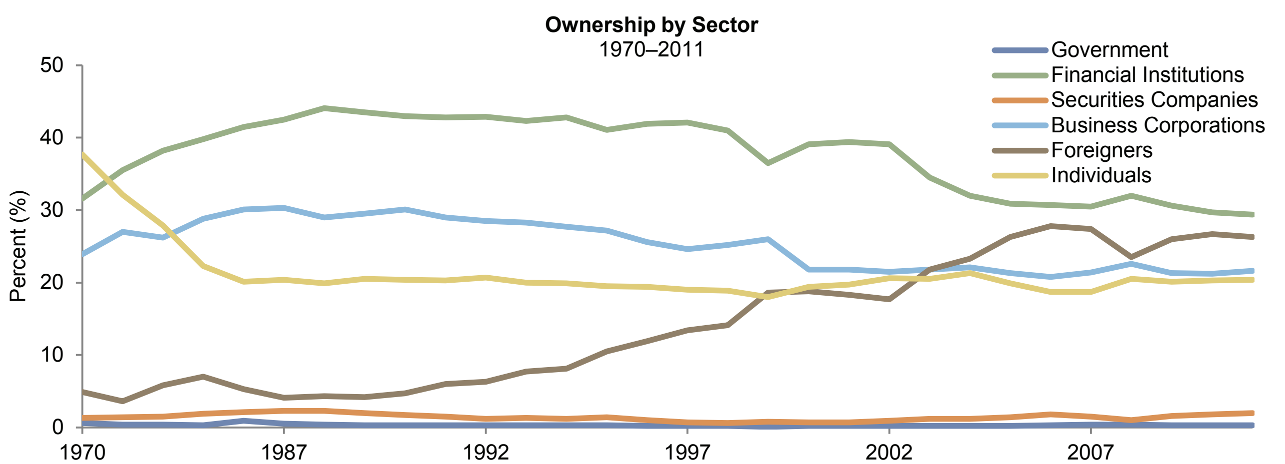
Source: Thomson Reuters Datastream.

are sustainable. A shrinking/aging population makes achieving economic growth more difficult, and aging savers who hold most of their wealth in cash may resist seeing inflation erode the value of bank deposits and bond holdings. Wealth effects also do not always pan out as intended; rather than spending some of their newfound increases in net worth, some retirees may fear this is a one-off event and batten down the hatches. Furthermore, much of the recent equity market appreciation has benefitted foreign investors as domestic household ownership of Japanese equities is fairly low (Figure 6). Still, households attempting to preempt inflation and higher mortgage rates are beginning to drive property prices higher, and domestic investors are seeing the value of their offshore investments grow given the cheaper yen.

Trying to generate higher inflation while also maintaining debt affordability is an extremely delicate process. Typically, as inflation expectations rise so too do interest rates. The BOJ will attempt to suppress this via QE. Currently, the BOJ owns around 12% of issuance, and has said it will take this share up to 25% by buying around 70% of new issuance. The problem is that if inflation does rise, rational investors at some point may simply refuse to own JGBs with negative real yields, and the BOJ may end up having to monetize an ever-increasing percentage of outstanding issuance. This remains a high-risk strategy. For example, domestic capital may flee the country given negative real rates, while at the same time Japan's trade surplus has turned into a trade deficit given increased reliance on energy imports. This puts pressure on Japan's current account, and at some point could trigger an unruly depreciation in the yen and sharply rising bond yields, threatening debt sustainability.

Figure 6. Japanese Equity Trading & Ownership



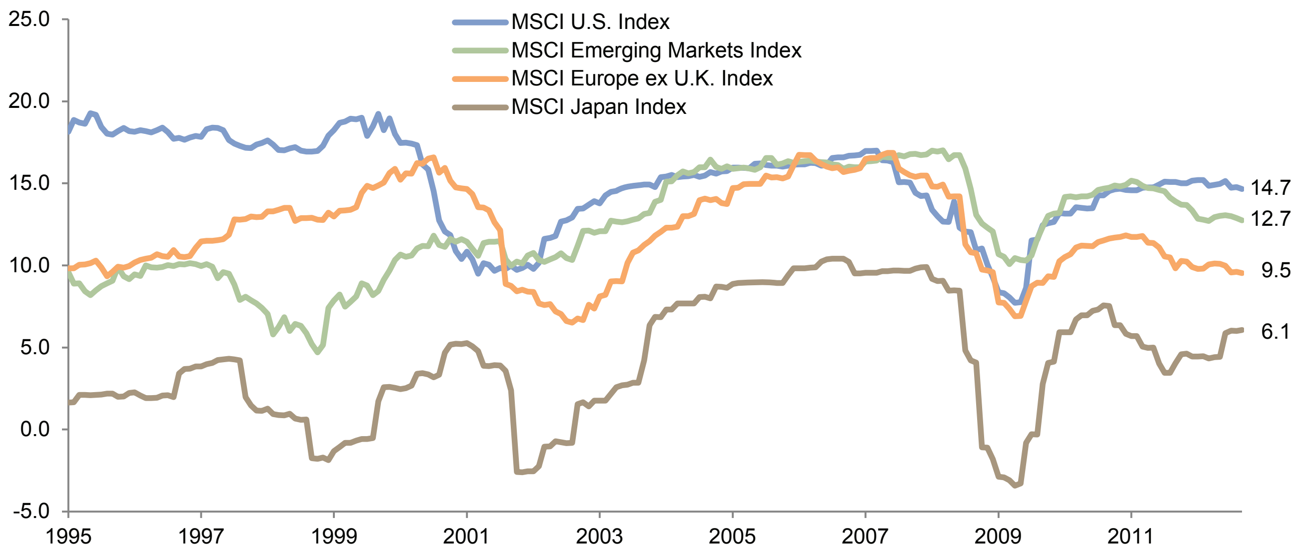


Sources: Thomson Reuters Datastream and Tokyo Stock Exchange.
Notes: Transaction values are for the first section of the Tokyo Stock Exchange and exclude proprietary trading. Net purchases are calculated on a rolling 12-month basis. Ownership data from 1970 to 1985 are in five-year increments and annual thereafter.

On the fiscal side, the government is expected to tighten extremely high debt levels in 2014 either via higher taxes or reduced expenditure, which could take some of the shine off any recovery in economic activity. However, should the recovery fail to become self-sustaining, the government may change tack and consider scaling back planned tax increases or even additional spending on projects such as infrastructure.

Looking at the proposed structural reforms, some may be easier than others. Japanese companies have exhibited lower levels of profitability over the past two decades than developed markets peers (Figure 7). There are a variety of theories as to why this is the case, and some are more promising than others with respect to corporate Japan's ability to revive itself. One argument is that Japanese companies habitually understate profitability by overstating deprecia-

Figure 7. Return on Equity for Various Markets
September 30, 1995 – May 31, 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Return on equity is calculated by dividing the index's price-to-book ratio by its price-earnings ratio.

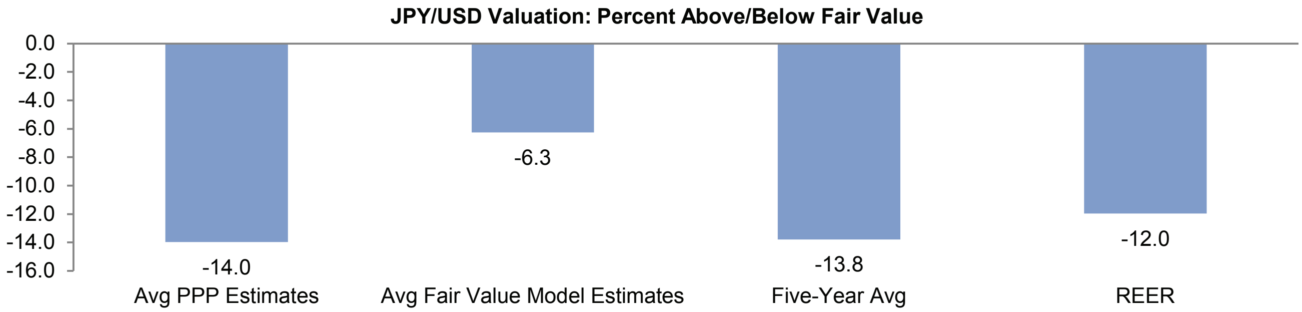
tion to limit tax liabilities; this could mean book values are understated and competitiveness is higher. However, others point to inefficient investment given the country's surplus savings, as well as rigid labor laws and local customs that make it hard for companies to trim labor forces and cut wages. Cross-shareholdings also may discourage proper corporate governance, though we note these may be on the wane as traditional institutional investors control a growing share of the equity market; their ownership may rise further given Abe's proposals.

The Yen Wildcard

Given the recent depreciation, the currency looks slightly undervalued by several metrics (Figure 8). However, currency valuation is not an exact science and the exchange rate could either continue to sell off or bounce back for various reasons. For example, the yen could continue to depreciate given momentum and current account trends, or it could bounce back if real interest rates increase or foreign capital continues to flow into Japan chasing the equity rally.

A cheap yen helps some export-oriented sectors like auto and consumer electronics, and improved profit forecasts from companies like Toyota show depreciation is having an immediate impact. This may flow through into higher wages and dividends. However, for companies that shifted production abroad, costs will increase as well as revenues, reducing some of the benefit. One unambiguous positive is that companies that made investments overseas in recent years can now write up the FX adjustment to their book value, generating a one-off boost to their net asset calculation.

Figure 8. Japanese Yen Valuation
As of May 31, 2013



Sources: Bank of International Settlements, *The Economist,* Goldman, Sachs & Co., International Monetary Fund, J.P. Morgan Securities, Inc., and Thomson Reuters Datastream.
Notes: REER is the real effective exchange rate based on trade-weighted indices produced by BIS and is as of April 30. PPP-implied exchange rates are based on relative price levels between countries, with the assumption that a basket of identical goods should cost the same across countries. Average PPP estimates reflect a simple average using International Monetary Fund and *The Economist* data, which are based on consumer prices. Fair value model estimates are derived from econometric models that take into account several variables such as PPP, interest rate differentials, fund flows, etc., to produce an equilibrium exchange rate. These fair value estimates differ from currency forecasts, as it is not always assumed that currencies revert to fair value over the forecast horizon. Average fair value model estimates reflect a simple average using Goldman Sachs and J.P. Morgan data.

Whether the cheaper yen will provide a sustainable boost to growth is debatable. Japanese executives may be reluctant to reverse policies of investing more in offshore production in case the yen reverses course, eroding the advantage from producing more domestically. A weak yen may also bring too much inflation, as costs for imported items like energy may soar,[5] offsetting some of the benefits mentioned above. The yen movement also may not be one-way. Countries that compete with Japan for exports like South Korea may retaliate by devaluing their own currencies; in recent weeks, we have seen some emerging markets central banks announce a series of rate cuts.

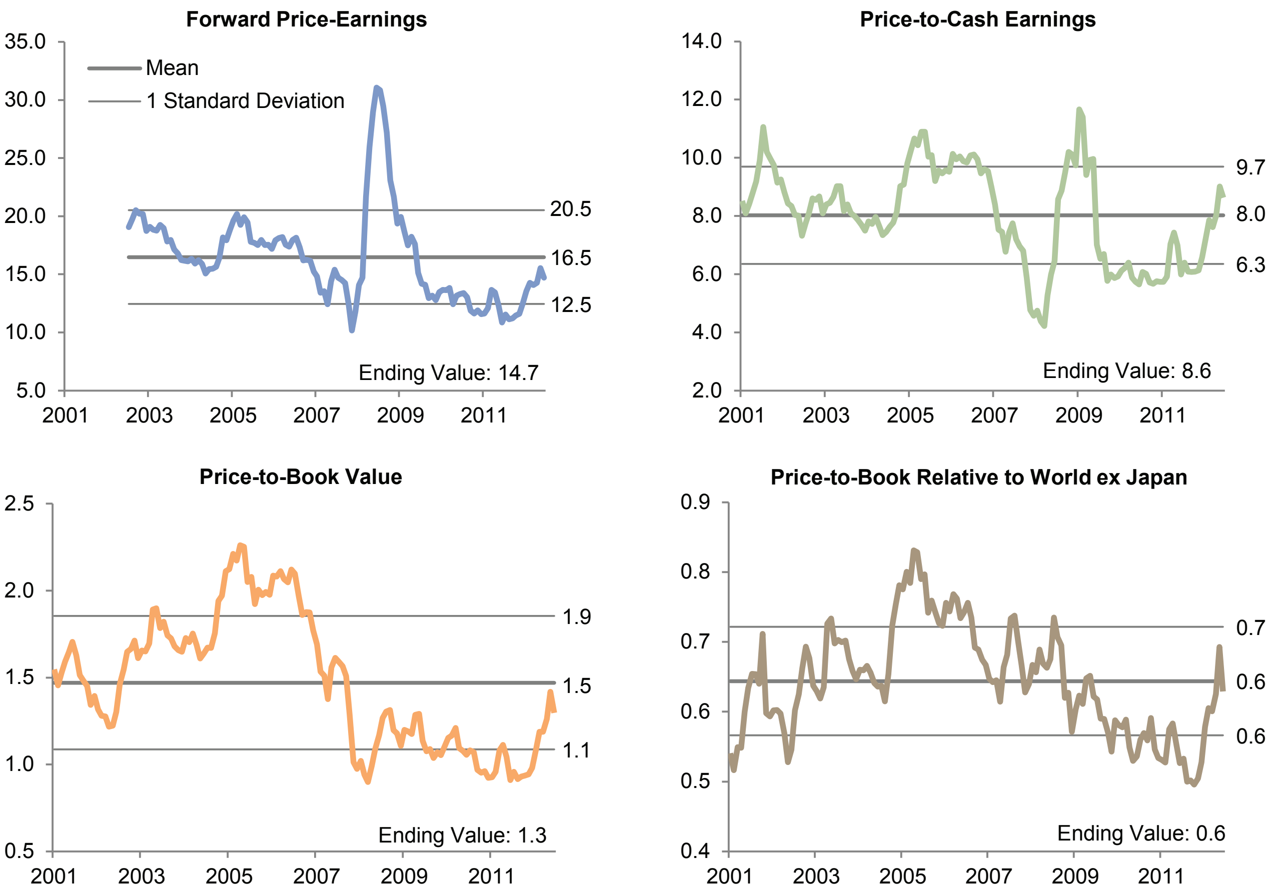
[5] This may change if Abe sticks to his promise to restart many of the nuclear reactors that were mothballed during the Fukushima meltdown.

Equity Valuations

We think about valuing Japanese companies in several ways. Our preferred metric is the price-to-book (P/B) ratio, as normalized price-earnings (P/E) multiples are less insightful given the historical volatility of earnings. At the end of May, Japanese equities traded at a P/B of around 1.3, roughly a 25% discount relative to the post-1991 average but only 12% cheap to the post-2002 average (Figure 9). Japanese stocks also trade on a P/B basis about 37% cheap to World ex Japan equities, in line with their average historical discount. Given that Japan has consistently generated a lower return on equity than other markets, such a discount is warranted. The story is similar looking at price-to–cash flow and forward P/E—Japan is now in line with recent historical averages. As a result, we now consider Japanese equities fairly valued.

Figure 9. MSCI Japan Index Valuations

December 31, 2001 – May 31, 2013



Sources: MSCI Inc and Thomson Reuters Datastream. MSCI data provided "as is" without any express of implied warranties.
Notes: Forward price-earnings data start in June 2003. Relative price-to-book (P/B) graph shows Japan's P/B as a percentage of the World ex Japan's P/B.

Why Japanese companies demonstrate lower levels of profitability may be relevant to choosing the best valuation metric. If the explanation is that firms try to keep reported profits low to minimize their tax burden, and as a result over-depreciate their capital stock, then investors should take greater comfort in the book value calculation. However, if the reason is because managers have simply refused to trim workforces and chosen the wrong types of capital expenditure given limited pressure from capital markets to boost margins, then book value may be less insightful.

For investors that prefer to focus on short-term earnings, Japanese stocks trade at roughly 14.7 times 2014 earnings, a significant premium to the 12.8 multiple for the MSCI World Index. Given that the 57% return for the MSCI Japan Index since September almost exactly matches the 56% increase in consensus estimates for

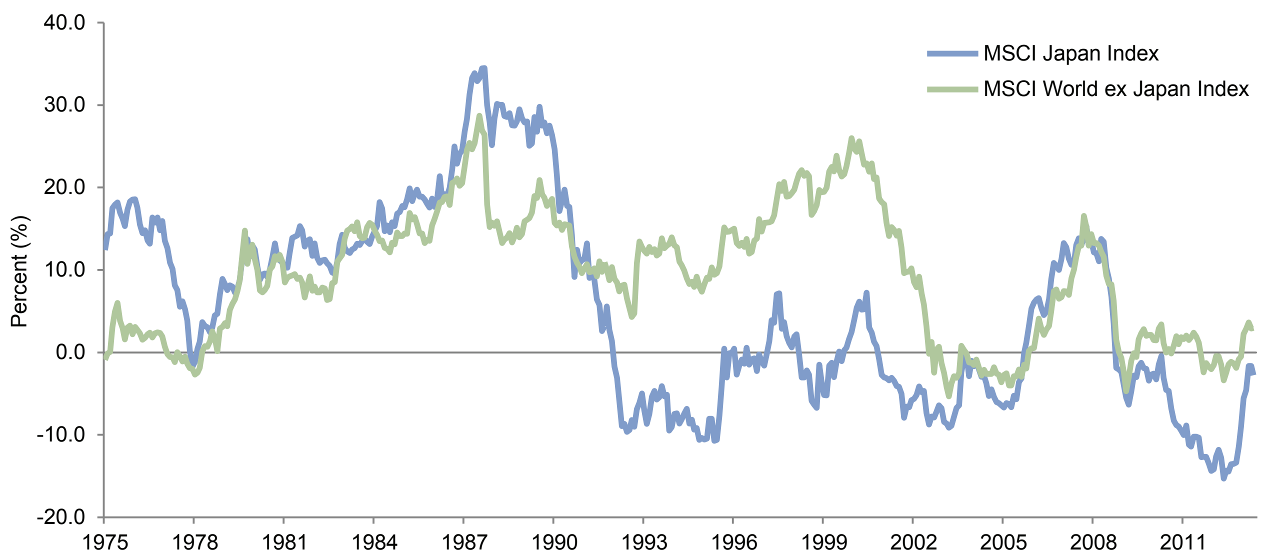
2013 earnings growth, it would seem the rally in the stock market has priced in this improvement. This is not to say, of course, that further earnings per share improvements cannot drive returns going forward. For instance, Japanese equities peaked in early 2006 at a P/B ratio of 2.3, roughly 75% higher than today's levels, and only a 17% discount to global equities, driven by a strong rebound in profits. But looking farther out, it remains to be seen whether Japanese corporations can capitalize on a weaker yen to gain market share and competitiveness and maintain a higher level of profitability, especially if nominal GDP growth does not pick up. This is the key risk to Japanese equities today.

Advice

For most of the past two decades, Japanese equities have failed to generate subsequent returns in line with global peers as earnings have stagnated and valuation multiples have contracted. Even after the meteoric run over the past six months, the trailing five-year return on Japanese equities still trails that of the MSCI World ex Japan Index by over 500 basis points (Figure 10). The question is whether the recent run-up is a triumph of hope over experience, as we simply do not know if some of the nascent recovery in growth or earnings has staying power. Those who argue it is different this time around point to the new administration's political mandate to effect change, the fact that the BOJ strategy may be difficult to reverse (it must continue to hold bond yields down, else the government borrowing will be untenable),

Figure 10. Rolling Five-Year Average Annual Compound Total Returns

January 1, 1969 – May 31, 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Performance in local currency terms.

and that the involvement of domestic investors might add another leg to the rally.

However, there are good reasons to be cautious, including the historical lackluster profitability of Japanese companies and macro concerns such as the sovereign debt overhang. The wildcard is the global growth outlook, and what this will mean for everything from Japanese export demand to the strength of the currency. The bullish case is a benign muddle-through environment that sees Japanese inflation tick up, while JGB rates remain low, the yen stays weak, and rising exports help the economy to generate positive nominal growth.

However, there are far less favorable potential outcomes. If global growth remains subdued, other exporters may tit for tat attempt to devalue their own currencies, reducing the ability of Japanese exports to drive growth. In addition, further global volatility could see the yen resume its status as a safe-haven currency and reverse some of its recent losses. Japan probably has a limited number of years to get its fiscal house in order before its debts become unsustainable, and in the absence of growth, tax cuts or increased government spending will only worsen the situation.

Many investors have chosen to ignore these "big picture" arguments, and prefer to focus instead on strong recent momentum and the fact that earnings growth *may* mean valuations look attractive. While tempted to chase the rally, we would prefer to bide our time and wait for confirmation of underlying improvement in earnings capacity and structural reforms. For now, we continue to recommend neutral weights to Japanese equities given neutral absolute and relative valuations, absent conviction that lasting secular change is afoot. We concede that markets may run even higher in the interim, but do not believe current prices provide enough downside cushion at current valuations. Markets are priced such that they are only cheap if you believe that corporations will be able to deliver structurally higher levels of profitability. This is certainly possible, but we are not willing to give corporate Japan the benefit of the doubt without more evidence or more of a valuation discount.

We are, however, supportive of global managers with Japan overweights based on stock-specific views. Furthermore, given the sharp broad-based rally, going forward the gains in Japanese equities may be less beta-driven and more stock/sector specific. If the decline in the yen moderates, other sectors may begin to lead the next leg of the market rally, while any emergence of a domestic mergers & acquisitions market (long the dream of foreign investors) is likely to benefit small- to mid-cap stocks.

Finally, those considering a dedicated Japan overweight are encouraged to hedge the yen. While it is not entirely certain that the yen will continue to depreciate in the near term, given this is the stated goal of policymakers, investors should consider at least reducing their currency risk for any overweight position. ■