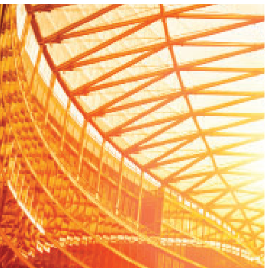
Japanese Equities: Neutral But Looking for an Arrow

We maintain our neutral positioning on Japanese equities

- The "arrows" of Abenomics in Japan appear to be misfiring: growth is slowing, the yen has stabilized, and recent increases in inflation may prove temporary.
- Despite the impressive recovery in Japanese earnings they remain 30% below 2007 levels. Whether the third "arrow" of Abenomics will hit the target—improving corporate efficiency and thus giving profits another leg up—is an open question.
- We remain neutral on Japanese stocks given more compelling opportunities in Europe and emerging markets. We would become more constructive if structural reform accelerated or if macro-driven volatility opened a larger valuation gap relative to peers. Conversely, if strong technicals further increase valuations in the absence of improving fundamentals, we would move to underweight.
- Regardless of portfolio weighting, offshore investors should hedge currency exposure, as a weaker yen is both the government's goal as well as the key for many companies to further grow profits.

Japanese equities significantly outperformed global peers from late 2012 until the middle of 2013 (Figure 1) as hope rose that "Abenomics" would revive economic activity and drive corporate profits higher. Despite strong earnings growth, the rally has since faded, as investors have started to question the sustainability of recent policy initiatives. This research note revisits Japanese equities[1] to evaluate the macro developments and explore whether the recent equity sell-off has created an opportunity. Our conclusion is that while recent earnings growth has been impressive, it was flattered by base effects and is

[1] Please see our June 2013 Market Commentary *Japan: Still Awaiting Confirmation on the Fundamentals*.



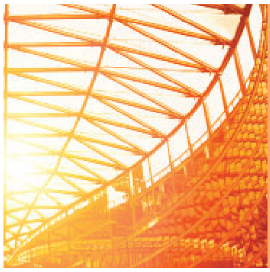
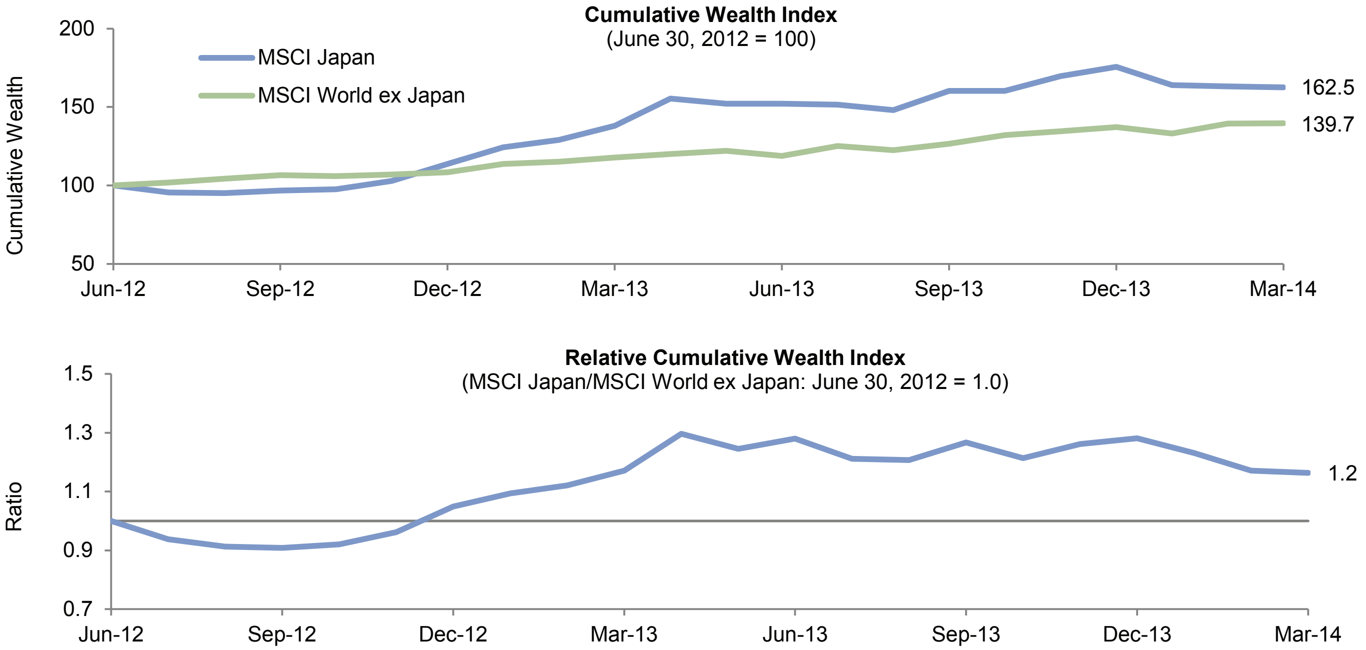


Figure 1. MSCI Japan Performance
June 30, 2012 – March 31, 2014 • Local Currency



unlikely to continue at a similar pace. Moreover, Japanese valuations relative to other regions are not especially compelling, and policy initiatives are facing headwinds. Though there is still room for structural reform to improve corporate profits in Japan, we continue to believe that investors should maintain target weights to Japanese equities.

Update on Abenomics

Prime Minister Shinzō Abe swept into office in late 2012 with a program to revive the Japanese economy using the "three arrows" of aggressive monetary policy, flexible fiscal policy, and structural reform. Abe viewed a weaker yen as an important tool to help generate inflation and boost corporate profits, in turn allowing companies to boost wages and increase consumption. Support for Abe's platform was widespread, as persistent deflation and lackluster growth in recent years increased Japan's real debt burden and eroded the country's political and economic influence.

In the 15 months since Abe's election, the Bank of Japan (BOJ) has gone "all in" in an attempt to generate inflation by dramatically boosting its purchases of Japanese government bonds and using other tools such as providing cheap loans to local banks. Its balance sheet has exploded to over 40% of GDP (Figure 2), well above levels seen in other developed countries. This quantitative easing initially triggered a steep sell-off in the yen, but since last summer the currency has stabilized against the US dollar (and other peers) (Figure 3). A variety of forces have stabilized

Figure 2. Central Bank Balance Sheet Expansion as a % of GDP
December 31, 2006 – March 31, 2014

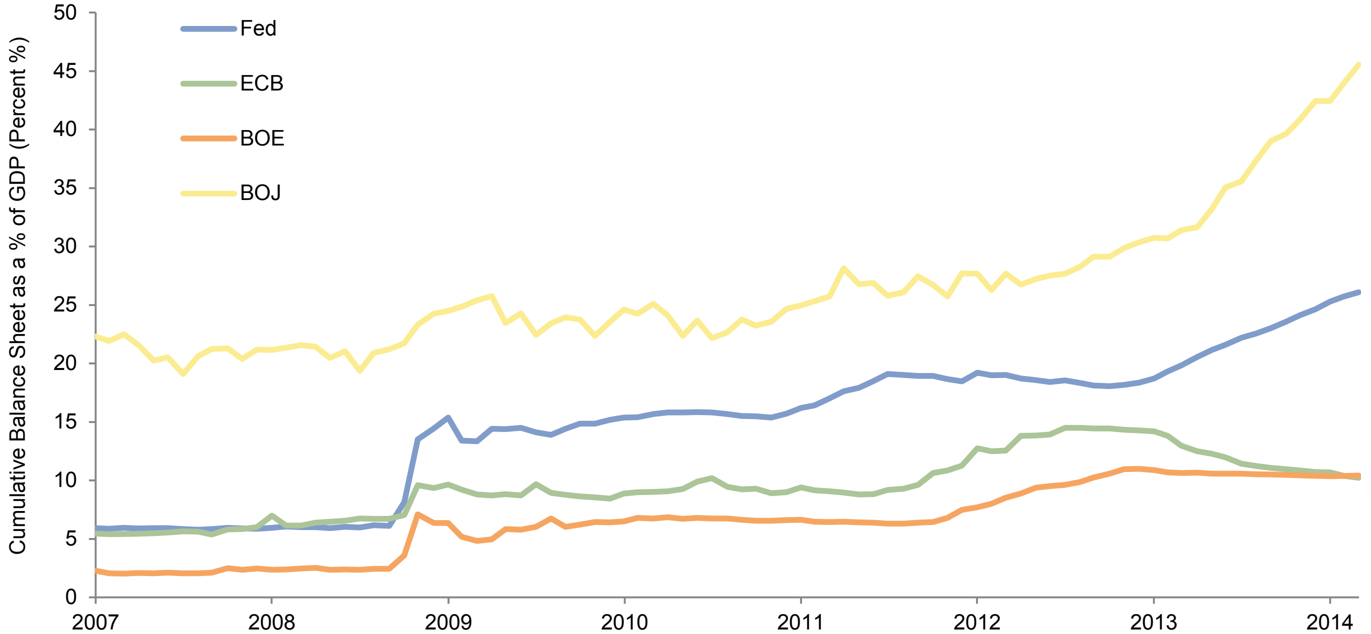
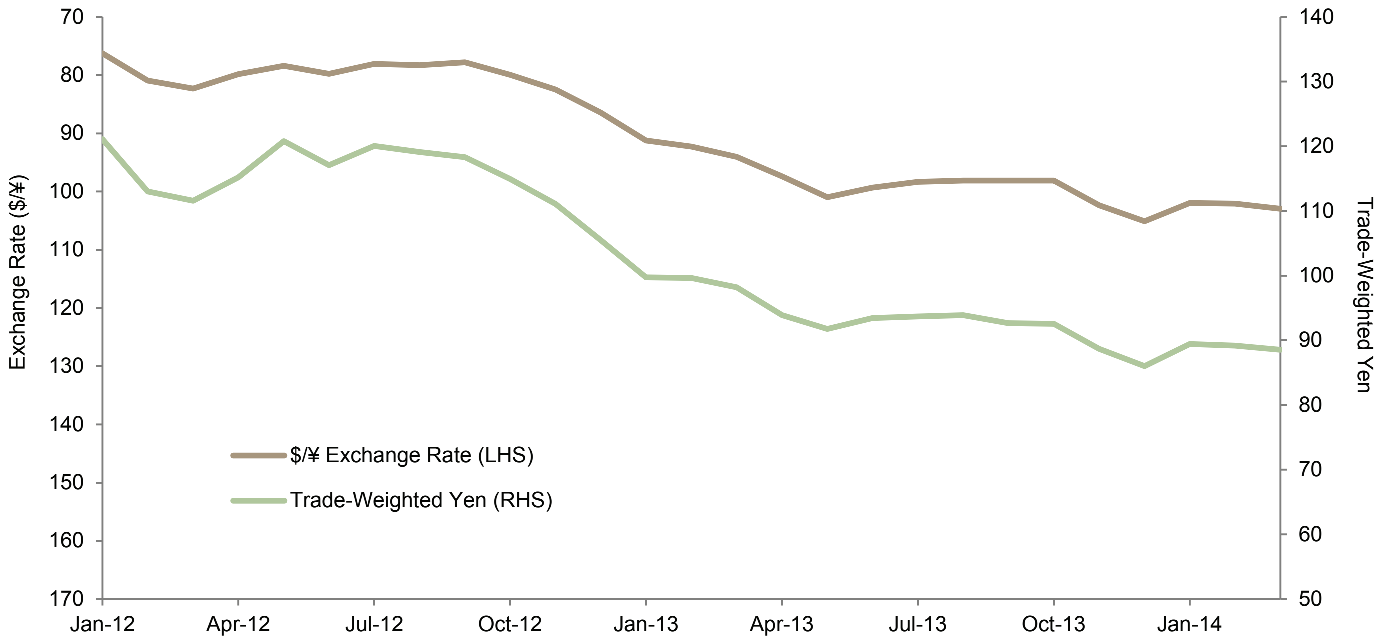


Figure 3. The Yen
January 1, 2012 – March 31, 2014



the yen, including disappointing growth in other developed markets that has lowered relative interest rates as well as emerging markets volatility, which boosts demand for safe-haven assets.

The central bank's moves have been successful in generating inflation. Consumer prices in Japan rose 1.6% last year, the fastest clip since 2008 (Figure 4), but most of the rise was driven by the higher cost of imported goods like energy given the cheaper currency. Many analysts are concerned that these one-off effects are unlikely to be repeated; some also wonder if the impact from expensive energy imports will fade in any event as shuttered nuclear reactors are reactivated. Acknowledging these possibilities, the BOJ in January said inflation was likely to be closer to 1.25% than its previously stated goal of 2% for some time. The increase in imports has widened Japan's trade deficit (Figure 5) and the current account slipped into deficit earlier this year. Should Japan's current account position continue to deteriorate, the foreign investors financing the country's substantial debt burden may require higher interest rates.

Outside of monetary policy, the government has also attempted to generate inflation by urging companies to boost wages, but thus far has seen little success as wages (excluding bonuses) have fallen for 21 straight months. Resistance to wage hikes is high given that corporate margins and labor productivity are already low in comparison to other countries. The government hopes that companies will pass higher corporate profits onto labor, but ignores the fact that small- and

Figure 4. Japanese Inflation
Second Quarter 1990 – Fourth Quarter 2013

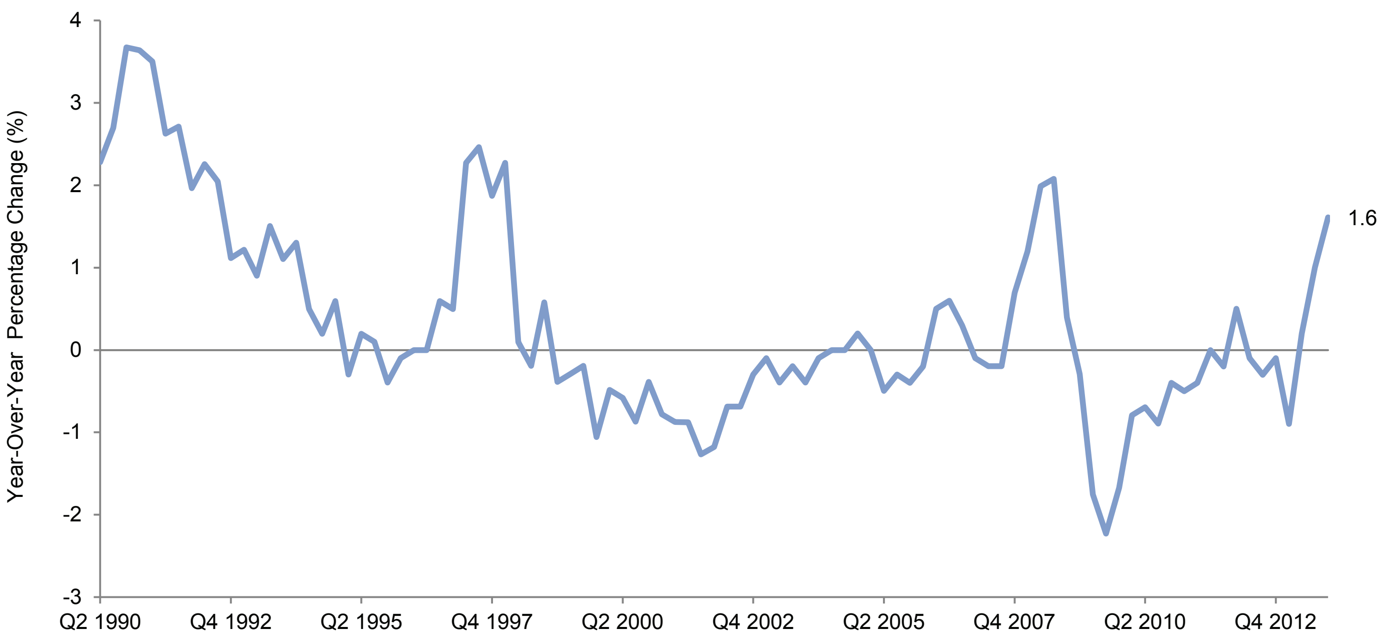
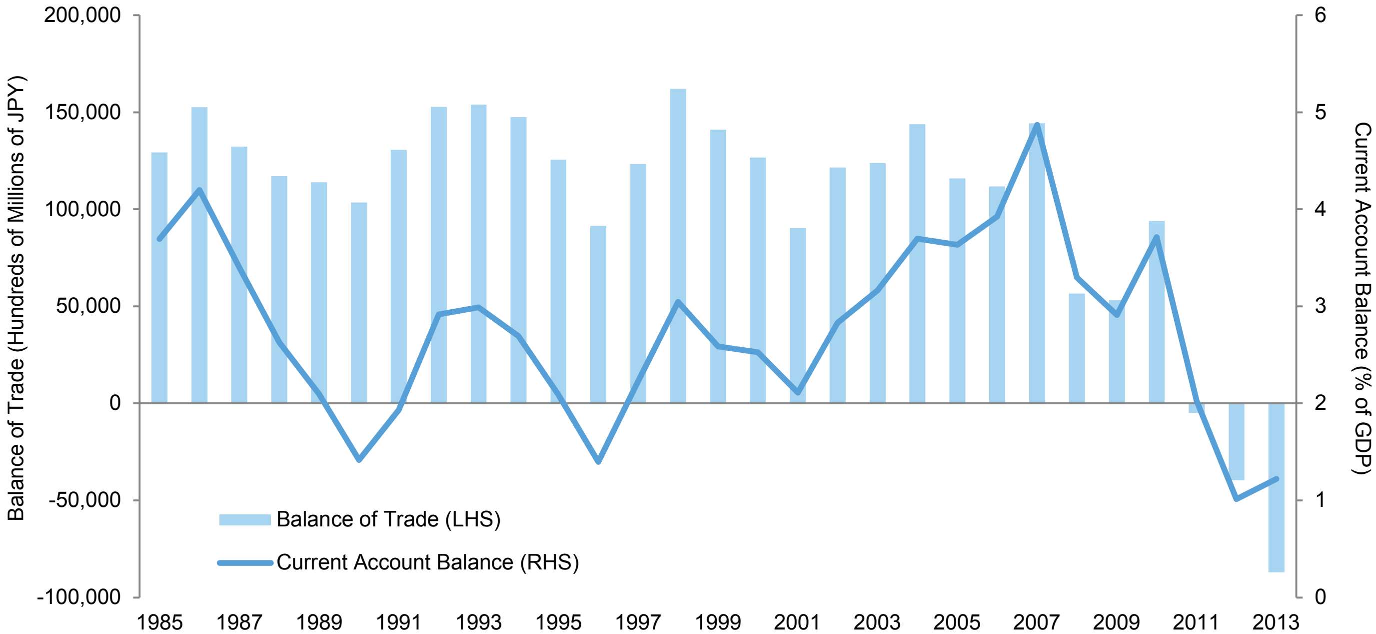


Figure 5. Japan's Current Account Balance as a Percentage of GDP vs Balance of Trade
1985–2013



medium-sized companies, which employ 70% of the Japanese labor force, have seen little benefit from the weaker yen.

The government's attempt to generate faster economic growth has also met with mixed success. After a strong start to 2013, GDP growth during the second half fell short of expectations. Fourth quarter GDP growth was recently revised downward to 0.7%, a fraction of the 2.8% initially expected, partly due to the disproportionate rise in imports relative to exports. The government's ability to boost activity via spending increases was always going to be limited given Japan's high debt load. Abe nonetheless championed targeted efforts where possible, including stimulus to help offset an upcoming hike in the consumption tax. Still, given the government's goal of cutting the budget deficit in half by 2015, a fiscal drag will be unavoidable as spending is reduced and taxes are increased. The recent increase in consumer spending offers slightly better news, though some of this may have been households accelerating purchases ahead of the consumption tax hike from 5% to 8% on April 1.

While more could possibly be done with "arrows" one and two (some analysts believe, for example, that the BOJ may resort to buying riskier assets like equities[2]), their fading potency may shift the onus for increasing growth to Abe's third arrow: structural reforms. Abe

[2] The BOJ may have no other choice, given it already buys 80% of new Japanese government bond issuance.

has proposed deregulating certain industries, changing the tax code to spur investment and encourage rationalization, and liberalizing labor laws, among other initiatives. The third arrow is likely the most promising avenue for Japanese companies to increase activity and profitability, but also the most difficult. Data from the OECD showing that Japanese workers are less productive than global peers[3] suggest staffing levels may be bloated, but cultural biases exist against firing workers. Japanese companies also have too much vertical integration, which means that some miss out on economies of scale when sourcing inputs. Finally, there may be too much competition in industries like consumer electronics.

Valuations

Assessing equity valuations relative to history is trickier in Japan than it is in most other developed markets. Normalized earnings metrics, used in our composite price-earnings calculations, are not meaningful in Japan given that a long period of extreme overvaluation in the late 1980s/early 1990s artificially inflates historical averages (and led to a 20+ year period of underperformance versus global peers). We focus instead on the price-to-book (P/B) ratio, though this too is not unimpeachable given questions over Japanese accounting practices and historically low returns on equity. Currently Japanese companies trade around 1.2 times book value, a 16% discount to their recent average (Figure 6).

Looking at shorter-term metrics, the MSCI Japan Index trades at 13.3 times forward earnings, an 18% discount to its recent average. As with the P/B ratio, the question is whether a cheaper currency (which may limit earnings growth) now justifies a lower valuation. Perhaps for this reason, expectations for earnings growth are much more muted than they were 12 months ago, with Japanese companies only expected to increase earnings around 8% for their fiscal year ending March 2015, according to J.P. Morgan.

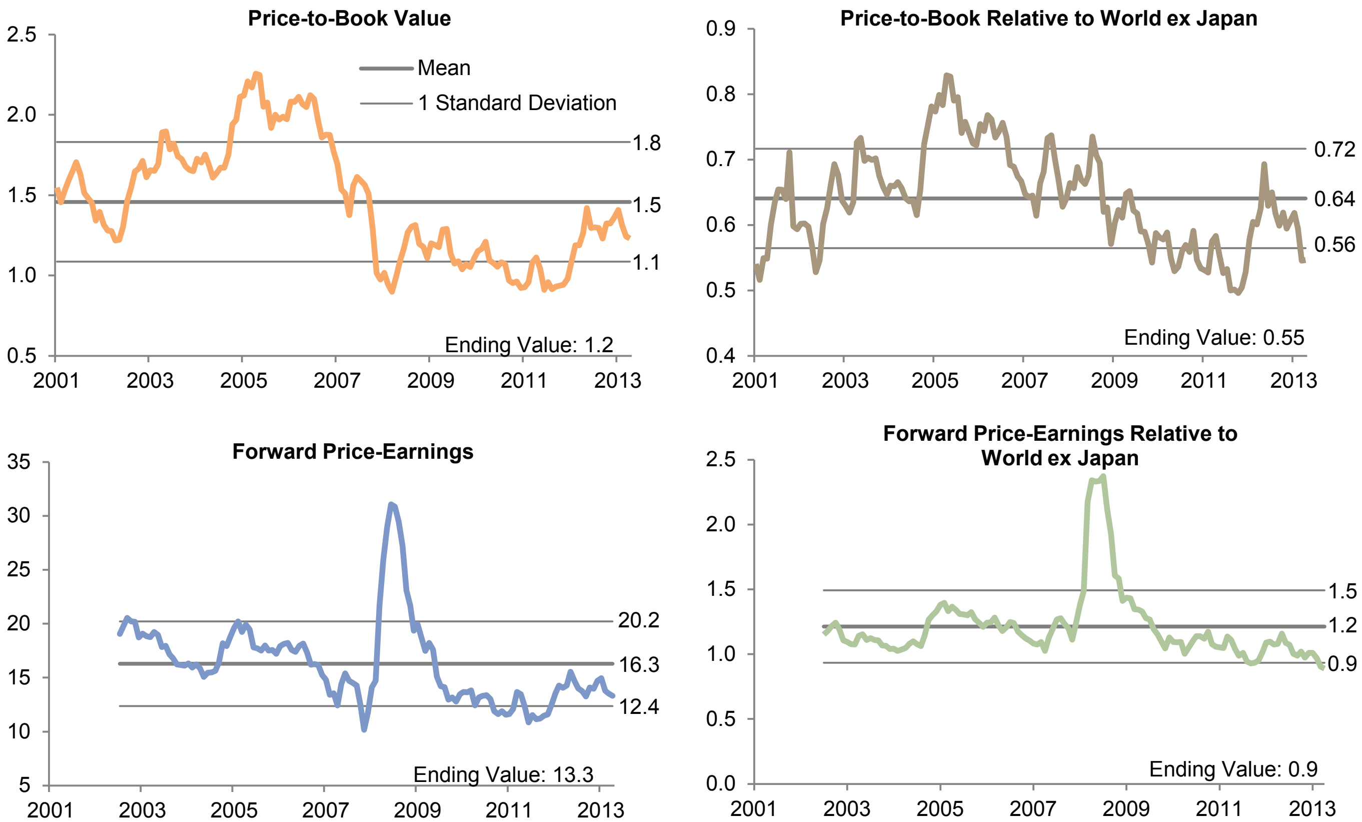
Earnings

Expectations for future earnings growth and recent performance should be placed in context. Despite the 81% increase in Japanese earnings during calendar year 2013, they still remain roughly 30% below pre-crisis levels given the severity of their previous collapse (Figure 7). Profit margins in turn also roughly doubled in 2013, and now stand near their highest level in decades (Figure 8). For the most part, sectors such as consumer discretionary and materials, which have a high reliance on offshore sales, have seen the stronger growth, while earnings increases for domestically oriented sectors like telecoms and retailing have been more muted, with some exceptions.

The earnings outlook for Japanese companies has both sector-specific and macroeconomic drivers. A key question for consumer discretionary companies, for example, which make up a sizeable 21% of the MSCI Japan Index

[3] OECD data suggests Japanese GDP generated per hour worked is far lower than in countries such as the United States and Germany.

Figure 6. MSCI Japan Index Valuations
December 31, 2001 – March 31, 2014



(Figure 9), is whether the weaker yen can continue to boost profits for automakers, which altogether constitute more than half of the sector weighting. A significant part of the increase in automakers' 2013 earnings came from the translation effect of recording foreign profits in a weak domestic currency, as opposed to significantly higher volumes. For example, Toyota sold just 2.3% more vehicles during the last nine months of 2013 than during the same period in 2012, but saw profits rise a whopping 135%! These translation effects will soon fade unless the yen can resume its downward march, and competition is mounting from a resurgent US auto industry. A separate issue for consumer electronics firms (also part of consumer discretionary sector) is whether they will accelerate efforts to rationalize production and product lines. Some analysts believe this sector may have little choice, as profits have been heavily impacted by its failure to adapt to changing consumer preferences and international competition in products like personal computers and mobile phones.

Figure 7. MSCI Japan Earnings

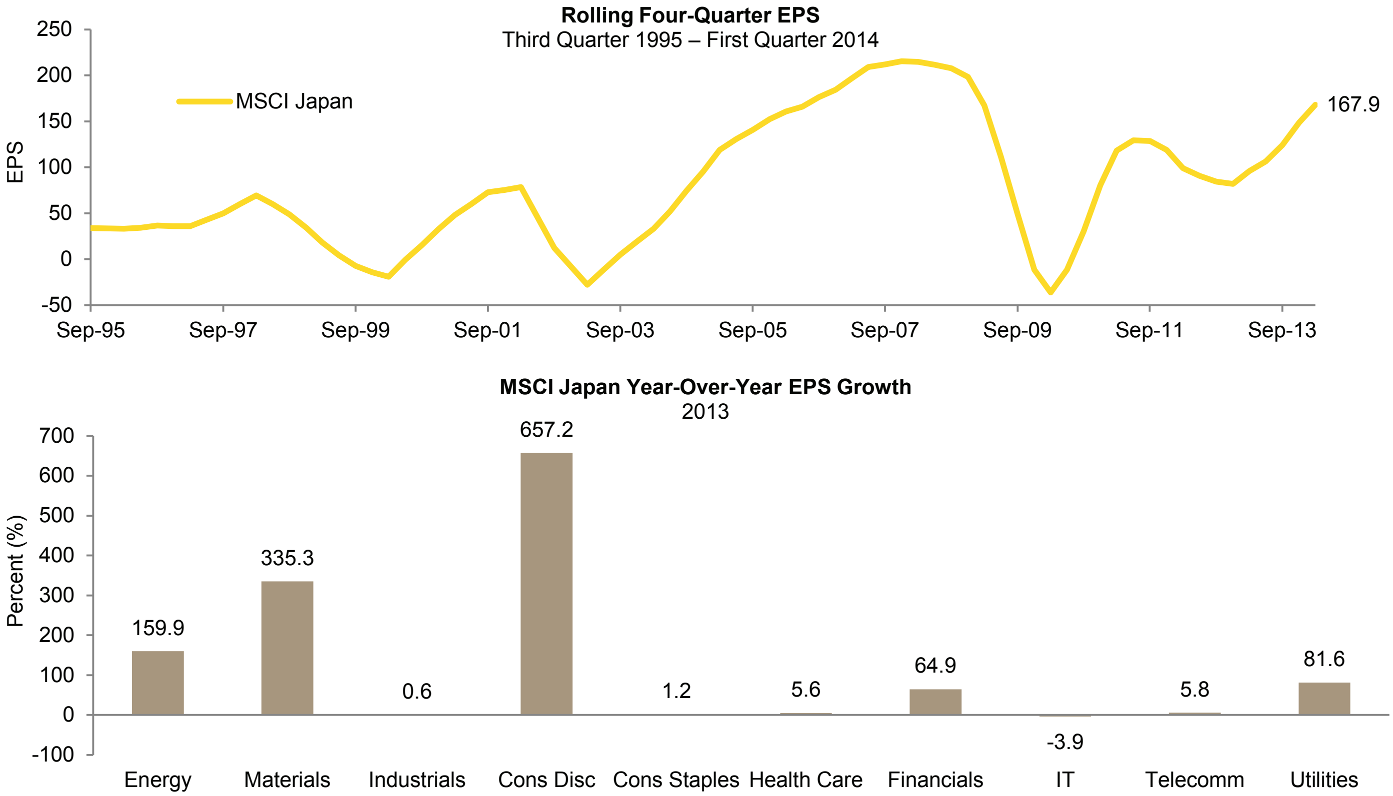


Figure 8. Profit Margin

January 31, 1995 – March 31, 2014

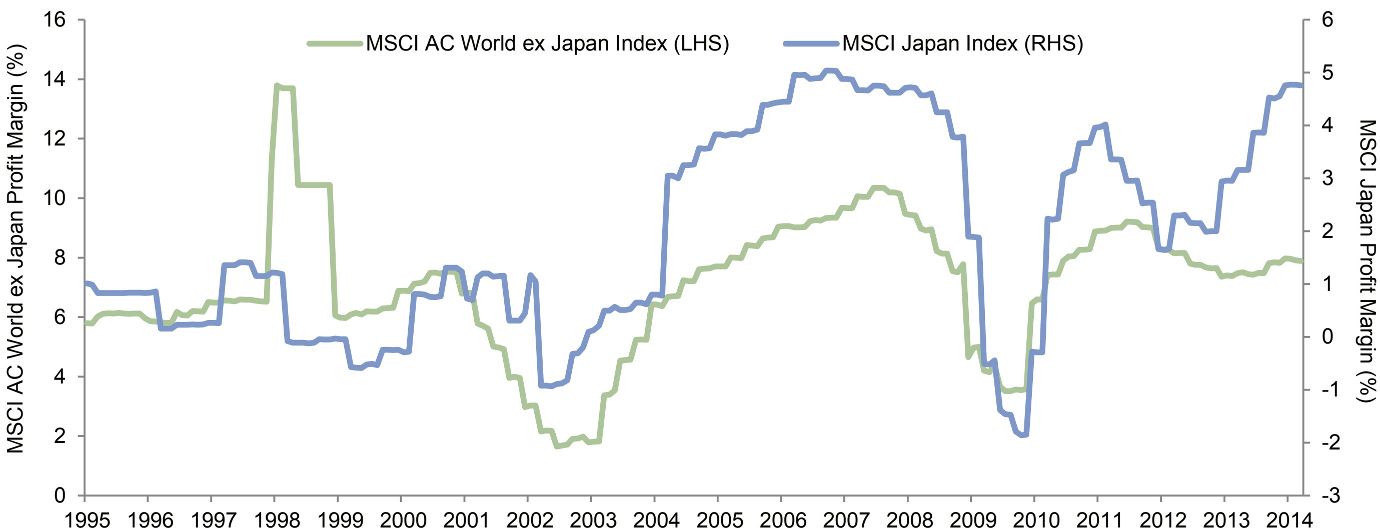
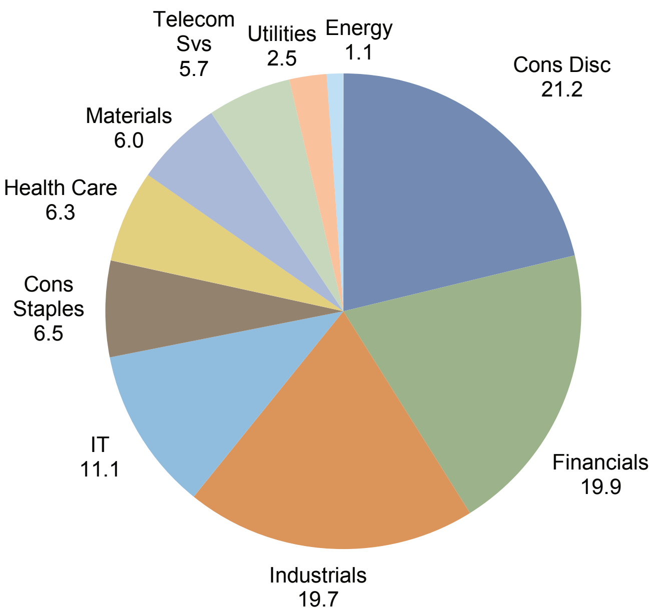


Figure 9. MSCI Japan Sector Exposure
As of March 31, 2014



It is much more difficult to generalize about the outlook for industrial companies, which represent a further 20% of index market cap, as the sector is diverse and thus affected by numerous factors including global and domestic growth, exchange rates, and technological advancement. For example, while robotics powerhouse Fanuc is a large exporter, its profits recently *declined* due to slowing growth in China, a key market. Conversely, East Japan Rail has seen a modest increase in operating earnings, but efforts to boost domestic tourism and thus ridership have borne little fruit.

The financial industry, another key sector at 20% of index market cap, should theoretically be a prime beneficiary of Abenomics thanks to rising asset prices and economic expansion fueling credit demand. In reality, earnings growth has varied across institutions and many analysts believe sector earnings will actually decline in 2014. Government policies to encourage savers to invest in the stock market have boosted fee income, and some banks have benefited from the increased value of offshore profits. However, low interest rates mean Japanese banks continue to have among the lowest net interest margins in the world, and rising yields are not a panacea given the threat of mark-to-market losses on their significant holdings of Japanese government bonds.[4] Stronger domestic growth and rising capital expenditure could encourage more corporate borrowing, but companies are cash rich and household appetite for credit may remain anemic given aging demographics.

From a top-down perspective, some features of Abenomics may boost margins and thus profits. High effective corporate tax rates in Japan reduce profitability compared to other developed markets. In April, the government will eliminate the special tsunami-related surcharge and lower the corporate tax rate to 35.6%, but many both inside and outside the government have called for an even more drastic reduction. Whether the government can afford to grant such a reduction, and whether the cost of higher wages would in effect offset the benefit from lower taxes, is an open question. The government has also put in place tax incentives for companies to rationalize production, which, when

[4] According to Bloomberg, Japanese banks sit on ¥140 trillion of Japanese government bonds.

combined with shareholder pressure, is already having an impact in sectors like electronics.

Faster domestic economic growth could also boost operating leverage (and thus margins), but as noted earlier, growth seems to be slowing down. Given that 30% of Japanese revenue comes from overseas, faster growth for trading partners like China and South Korea would also help. However, trying to separate the impact of increased operating leverage from currency translation effects is very difficult when looking at many companies given supply chains that can snake through multiple countries. Further weakening of the yen against the US dollar will clearly benefit some sectors, but is not the only exchange rate that can materially impact others.

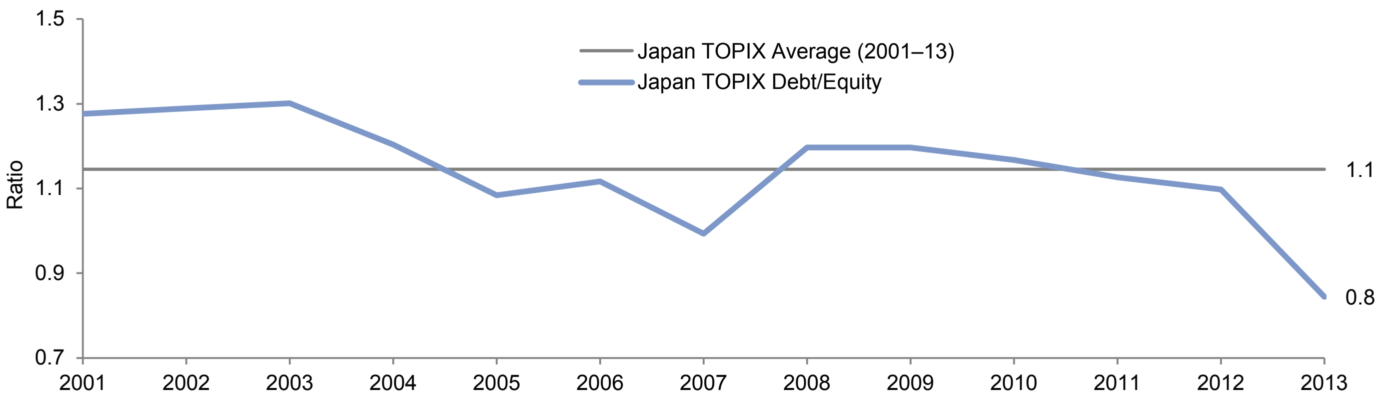
Wildcards

Our neutral take on Japanese stocks could prove overly bearish if domestic investors demonstrate increased appetite for Japanese equities in the months ahead. Many expect that the BOJ will increase its purchases of Japanese stock exchange-traded funds from the current ¥1 trillion target for 2014, though even doubling this program would still target a relatively small percentage of the ¥262 trillion index market capitalization. The main government pension fund (GPIF), the largest public pension fund in the world, has around 58% of its assets in local bonds and just 16% in local shares, according to Bloomberg. Political pressure is mounting for GPIF to change its allocation targets and buy more equities; any such move within its US$1.2 trillion of assets under management could provide support to the equity market.

Domestic households, which on average have less than 10% of their savings in stocks, also could increase their holdings. While it is entirely rational for households to trim cash holdings as inflation rises, it is worth noting that ongoing FX depreciation may mean foreign equities (or other assets) become even more attractive in the eyes of Japanese investors. Though the MSCI Japan Index enjoyed a massive increase in 2013, domestic investors would have done equally well buying the S&P 500 (unhedged) last year.

Finally, corporations themselves might also increase share purchases. In recent years Japanese companies have delevered and amassed significant cash balances, which in effect boosted shareholder equity and lowered returns on that equity (Figure 10). Japanese companies currently sit on a record ¥224 trillion of cash ($2.2 trillion), motivated in part by deflation that boosted its value in inflation-adjusted terms. Many believe companies will increase share buybacks to boost returns on equity; Goldman Sachs, for example, thinks purchases could more than double to ¥3.5 trillion in fiscal year 2014 and rise further in fiscal year 2015. Whether companies would actually boost leverage to conduct these buybacks is an open question; to the extent that rising interest rates followed inflation, this would become less likely.

Figure 10. Japan Corporate Debt-to-Equity
2001–13



Concluding Thoughts

On balance, the combination of high macro-economic uncertainty and more compelling opportunities in other markets lead us to recommend that investors keep a market weight to Japanese equities. Japanese companies suffer from lower returns on equity and lower shareholder returns than global peers, and we don't see enough substance or action regarding the third arrow of Abenomics to address this. This said, we concede that the prospect of further monetary easing or increased asset purchases by domestic investors could push share prices higher, at least in the short term. We would reconsider our neutral stance should structural reform accelerate or if macro-driven selling meant a larger valuations gap opened relative to global peers.

Notwithstanding our reservations about the beta of Japanese equities, we wouldn't shy away from international equity managers that maintain an overweight based on stock-specific factors.

Large macro-driven shifts in sentiment such as last year's initial rally and subsequent dip may unearth interesting opportunities for skilled active managers. Regardless of portfolio weights, we recommend that offshore investors in Japanese equities hedge their currency exposure as a weaker yen is both the government's stated goal as well the key for many companies to drive profits higher. ■

Contributors

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T.J. Scavone, Investment Associate

Exhibit Notes

Figure 1. MSCI Japan Performance
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Relative performance graph shows MSCI Japan's performance as a percentage of MSCI World ex Japan's performance.

Figure 2. Central Bank Balance Sheet Expansion as a % of GDP
Sources: Bloomberg L.P., Federal Reserve, and Thomson Reuters Datastream.
Notes: BOJ data are through March 31, 2014. All other central bank data as of February 28, 2014.

Figure 3. The Yen
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All data are monthly.

Figure 4. Japan Inflation
Source: Thomson Reuters Datastream.
Note: Data are quarterly and use the Japan Consumer Price Index (All Items).

Figure 5. Japan Current Account Balance as a Percentage of GDP vs Balance of Trade
Sources: Bank of Japan, International Monetary Fund - World Economic Outlook Database, and Thomson Reuters Datastream.
Note: Estimates for current account balance start after 2012.

Figure 6. MSCI Japan Index Valuations
Sources: MSCI Inc and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Forward price-earnings (P/E) 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. Relative forward P/E graph shows Japan's forward P/E as a percentage of the World ex Japan's forward P/E.

Figure 7. MSCI Japan Earnings
Sources: FactSet Research Systems, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Figure 8. Profit Margin
Source: Bloomberg L.P.

Figure 9. MSCI Japan Sector Exposure
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Figures may not sum to 100 due to rounding.

Figure 10. Japan Corporate Debt-to-Equity
Source: Bloomberg L.P.