Research Note
February 2015

Japan: Micro More Compelling Than Macro

Better earnings growth and attractive relative valuations support a slight overweight to Japanese equities versus US equivalents

- The multi-faceted nature of the Japanese earnings recovery has made Japanese equities more attractive. Further, structural reforms in Japan have been more successful than many thought would be the case early last year, and prospects for further success in shareholder reforms look promising.
- Regardless of portfolio weighting, non-local investors should currency hedge their exposure to Japanese equities as the level of the yen is a wildcard and hedging will likely reduce the volatility of returns.
- Risks to our view include a deceleration in Japanese profit growth, continued demand for US equities that further pushes up valuations for that already overvalued market, and that macro risks once again trump the micro progress in Japan.

Global equity markets have been jittery in recent weeks, as investors struggle to comprehend what plunging commodity prices imply about global growth, and the specter of deflation looms over many regions. Amid this backdrop Japanese stocks have been directionless, with a renewed focus on macro risks offsetting positive earnings and policy news. This by-now-familiar pattern offers investors an opportunity to increase exposure to Japanese equities, as better earnings growth and attractive relative valuations should lead to outperformance versus more expensive US equivalents. In our recent *VantagePoint* publication we advocated for a small overweight to Japanese equities at the expense of US equities, and in this note we expand on the rationale for that view.

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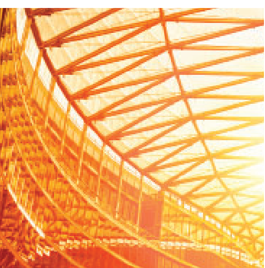


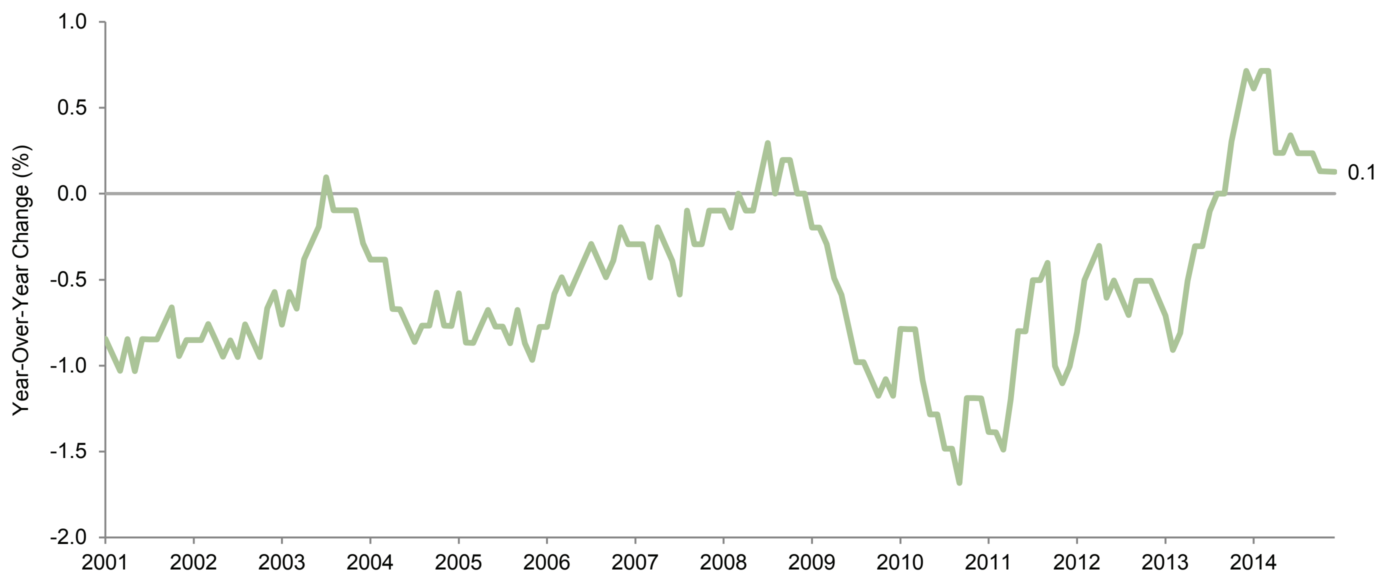
Macro Backdrop

It is difficult to put a positive spin on recent economic data from Japan. After a robust start to 2014, the 3 ppt increase in the consumption tax (to 8%) on April 1 caused consumption to collapse and led to weaker-than-anticipated second and third quarter GDP data. The consensus now expects the Japanese economy to have barely grown in 2014 and only sees a slight increase to 1.1% in 2015, despite what should be a significant boost to the economy from cheaper oil prices and the weaker yen. Even this level of growth requires the government to continue to run massive deficits; Japan is expected to have a deficit of around ¥50 trillion for its 2014 fiscal year, almost 10% of GDP. Japan's gross government debt to GDP level is the highest in the developed world and continues to balloon.

Inflation data have also come in well below the government's targets. Despite the Bank of Japan (BOJ) effectively monetizing Japan's sovereign debt issuance, core inflation has faded in recent months and adjusted for the VAT increase is barely above 0% (Figure 1). The BOJ expects core CPI to be just 1.0% in the fiscal year beginning in April, and 2.2% in the following year.

Weakness in the recent growth and inflation data prompted the BOJ to make a surprise "shock and awe" announcement at the end of October that it would accelerate its rate of asset purchases from the previous levels of ¥60 trillion to ¥70 trillion per year to around ¥80 trillion. This will take its balance sheet to roughly ¥380 trillion by the end of 2015—an extraordinary 70% of GDP (Figure 2). For comparison, the US Federal Reserve tapered

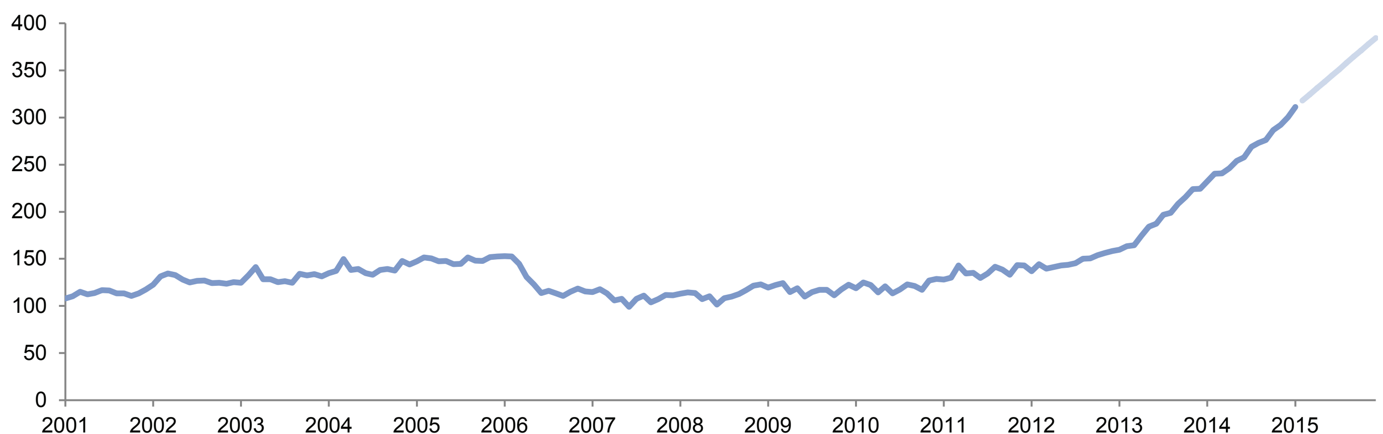
Figure 1. Core Japanese Inflation
January 31, 2001 – December 31, 2014



its purchases in the autumn when its balance sheet hit $4.5 trillion, or 25% of GDP. The yen, which had been holding steady against the US dollar for most of 2014, promptly depreciated around 10% in the weeks following the BOJ's announcement and now stands just below 120, the lowest level since mid-2007. The 35% depreciation of the yen versus the US dollar since the start of 2012 and faltering progress in other areas have prompted some to question whether the three pillars of Abenomics[1] are little more than an elaborate smokescreen masking what is really an attempt to depreciate the currency.

This criticism of Abenomics is understandable but overlooks Prime Minister Shinzō Abe's weak starting position given that Japan's rapidly aging population is a significant headwind to growth. It also does not take into account the progress on the third pillar—structural reforms—which is potentially the most important for investors. A variety of initiatives have been announced or enacted on this front and several are starting to bear fruit. Most large institutional investors have signed on to a stewardship code that encourages them to engage with company management and offer guidance on topics such as capital management and growth. A corporate governance code has been drafted (and should be passed later this year) that looks to protect shareholders' rights through reforms such as more independent boards and reduced cross shareholdings. The new JPX-Nikkei 400 Stock Index reinforces these reforms because eligibility for listing is contingent on meeting targets and standards for profitability and governance. Last December Abe's ruling coalition won a landslide victory in local elections, which should allow him several more years to refine his economic policies and encourage him to double down in successful areas.

[1] Monetary easing via expanding the central bank's balance sheet, fiscal expansion, and structural reforms.



Outlook for Earnings

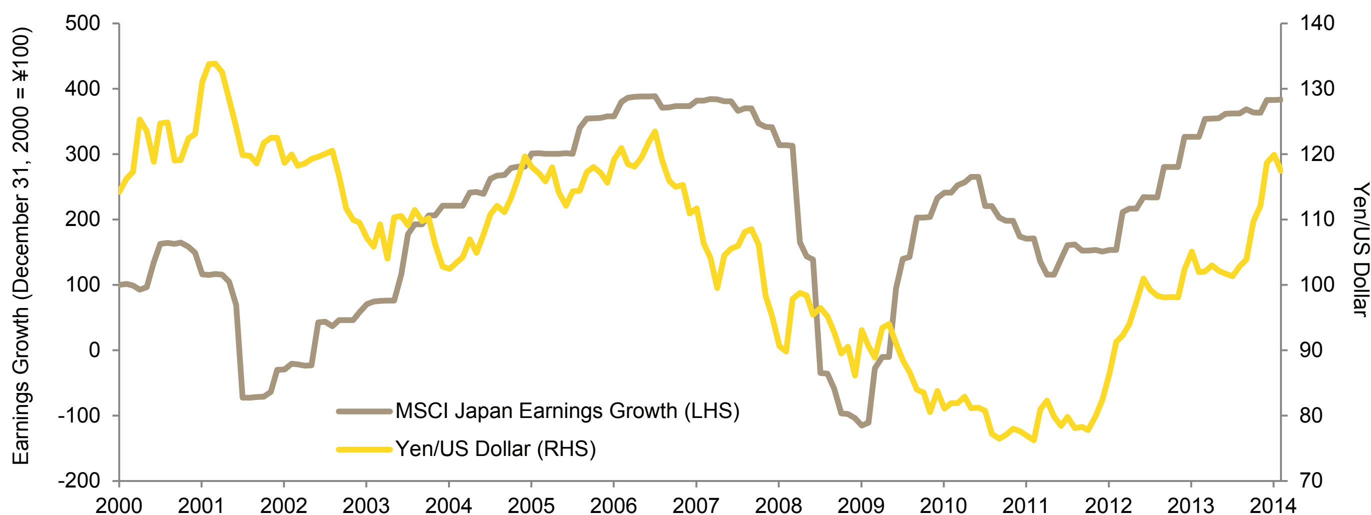
Japanese companies are currently enjoying a resurgence of profitability. Earnings rose 17% over the course of 2014 and returned to pre–financial crisis levels. This number may sound unimpressive when compared to the 25% rise in US earnings since 2007, but compares very favorably to Europe, where earnings are still down roughly 30% from that period. The earnings recovery in Japan has been driven by a combination of more favorable exchange rates, better global economic conditions, improved operating efficiency, and better corporate governance. Consensus forecasts are also encouraging; after rising an expected 11% for the fiscal year ending March 2015, another 9% rise in growth is expected for the following fiscal year. The current positive trend in earnings revisions (the percent of companies receiving upgrades versus downgrades) for Japanese firms is fairly unique among developed world equity markets.

The massive weakening of the yen in recent years has helped increase Japanese corporate profitability by boosting the value of foreign sales and assets (transaction and translation effects). Japanese companies earn almost 40% of their revenue from foreign sources, with the percentage slightly higher for larger capitalization companies. The importance of the currency to a particular company depends on many variables. The auto industry, for example, manufactures roughly 70% of its cars overseas. A cheaper yen means a higher value in yen terms for foreign sales, but it also means higher foreign costs, making the impact on profits more ambiguous.

Some analysts now believe the yen is undervalued, given its roughly 35% decline against the US dollar over the past couple years. Yen depreciation could slow or even reverse, but this may not be as detrimental to profits as some imagine for at least two reasons. First, only one-third of foreign sales come from North America; the yen has not sold off to the same extent versus the currencies of other trading partners. Second, if the reason for the yen's rise is due to a broad-based domestic recovery, this could portend positive trends for domestically oriented businesses. *Why* the yen rises matters, as the historical correlation between the yen and corporate profitability has not been consistent (Figure 3). While negative today (weaker yen equals stronger profits), the relationship was positive immediately after the global financial crisis as the currency rallied alongside profits; this was also the case earlier last decade.

Rates of earnings growth across different parts of corporate Japan provide another reason to be less fixated on exchange rates. Perhaps surprisingly, over the past three years, average and median earnings growth for companies with *no* foreign revenue have actually been *higher* than that of companies with international operations. Per Bloomberg company data, of the 500 largest companies in the Tokyo Stock Exchange (which account for the lion's share of the revenue and market capitalization), the 208 companies with no foreign revenue saw median earnings growth of 17% per year over the past three years, which is well above the 11% for the companies with foreign revenue. Sector data also illustrate

Figure 3. MSCI Japan Earnings Growth vs Yen/US Dollar Exchange Rate
December 31, 2000 – January 31, 2015



this theme—of those with the fastest earnings growth, only one (consumer cyclicals) had high international revenue exposure.[2] Operating leverage is clearly a big driver; for the current fiscal year (through March 2015) the consensus expects overall Japanese corporate profits to rise at almost three times the pace of sales.

Expected reductions in tax rates will also boost earnings. Effective corporate tax rates fell in 2014 as the one-off surcharges that were imposed following the tsunami were scrapped. In December Abe went further and announced his intention to lower the statutory tax rate another 3.3% over the next two years. Whether this will hurt debt dynamics is an open question. The government hopes that a wider base will help compensate for the lower rate; less than 30% of Japanese companies pay any corporate income tax, according to Bloomberg. In the meantime, this tax cut will boost margins and thus profits.

Headwinds such as Japan's aging demographics and debt levels are a legitimate source of longer-term concern for investors. Japan's working age population has shrunk around 1% per year since 2007, the fastest rate in the developed world. Labor force problems may be solved by expanding the workforce to include more women (which is now happening) and opening up the country to greater immigration. In the short and intermediate term, growth will receive a boost from other factors. One is the steep drop in prices of crude oil imports, which amount to around 3% of GDP. While this went mostly unnoticed, the BOJ recently boosted its growth forecast for the upcoming fiscal year given the benefit from cheaper oil

[2] Technically, the "diversified" sector also had high foreign sales and faster median earnings growth, but it only consists of one company.

and postponement of the expected increase in the value-added tax. Unemployment has steadily fallen and the ratio of job openings to applicants has risen, potentially allowing workers to push for higher wages and thus generate inflation. Finally, even if Japan continues to stagnate, the larger global economy provides a bigger pond in which companies with international operations can fish. Large companies such as Shimano, Sony, and Toyota earn more than 70% of their revenue abroad.

Other Prospects for Shareholder Returns

The combination of strong balance sheets and recent earnings growth gives Japanese firms flexibility to return more capital to shareholders. Japanese companies currently sit on an astonishing ¥280 trillion of cash (Figure 4). Still, notwithstanding an expected 40% increase in buybacks during the current fiscal year, Japanese companies are still only expected to return ¥13 trillion ($108 billion) to shareholders for the current fiscal year, or around one-third of their profits. In comparison, it looks like S&P 500 peers will have returned more than 8 times this amount in 2014 (over $900 billion), more than 90% of profits. Less than 1% of Japanese earnings (equating to 6% of growth) is driven by buybacks (Figure 5), compared to around 3% of absolute earnings (around 35% of growth) for S&P 500 equivalents. If Japanese companies become more willing or are pushed more to put their cash to work, buybacks could soar and boost earnings growth.

Recent structural reforms should encourage Japanese companies to continue to focus on boosting profitability and shareholder returns (Figure 6). Eligibility for the new Nikkei JPX 400 Stock Index is based on part on which companies have generated the highest average

Figure 4. Aggregate Cash & Equivalents for Companies in the Topix Index
2000–14 • Yen (trillions)

Figure 5. Dividends and Buybacks for Companies Listed on the Tokyo Stock Exchange
2006–14

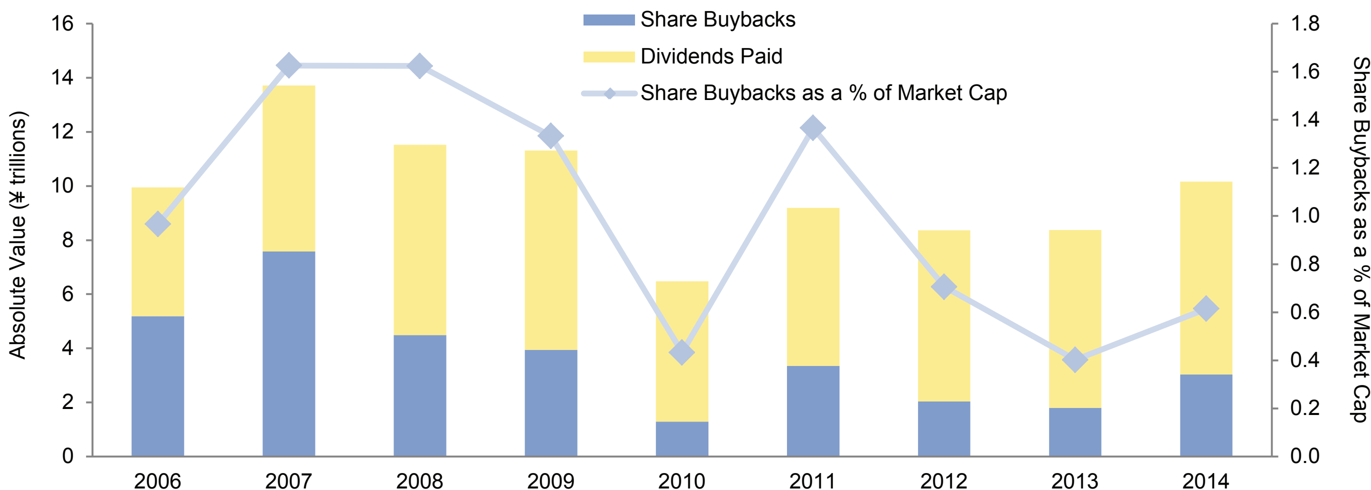
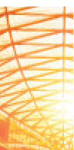


Figure 6. MSCI Japan Return on Equity
December 31, 2000 – January 31, 2015 • Percent (%)

return on equity (ROE) over the past three years. Further, beginning in February a prominent proxy advisor (ISS) will recommend voting against management teams where companies have generated an average ROE below 5% over the previous five years, which builds on previous changes to encourage more outside directors. Companies have substantial incentives to meet these goals; the main government pension fund (GPIF) will target JPX Nikkei 400 stocks as it increases equity purchases, and other institutions are expected to follow suit. From a technical perspective, these purchases should help put a floor under asset prices. The GPIF alone is expected to increase its holdings of domestic stocks by roughly ¥10 trillion (or 8% of its



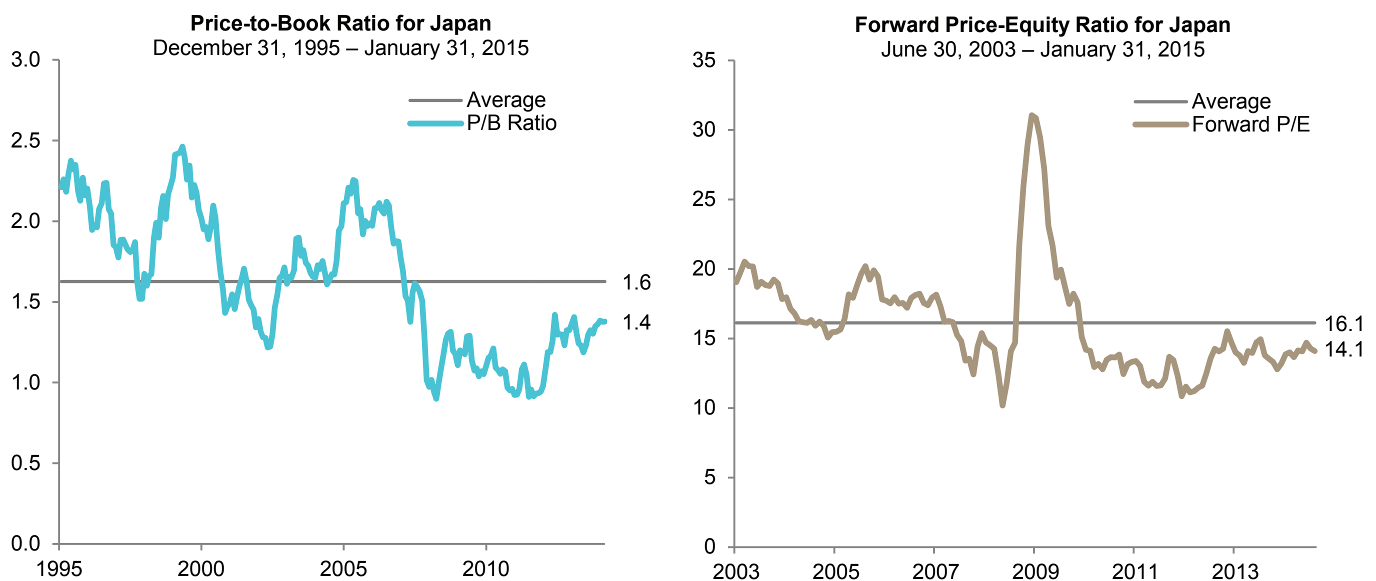
current ¥130 trillion in assets). Reforms and a healthier operating environment appear to be working; the ROE for the Topix is expected to near 9% by March 2015.

Valuations

Despite their strong performance over the past couple of years, improved earnings mean many valuation measures for Japanese equities have become more attractive. However, assessing whether today's valuations are compelling on an absolute basis is not straightforward, as high historical valuations skew averages and have been associated with fairly lackluster returns. For example, the median trailing price-earnings (P/E) ratio for Japanese stocks is around 22 over the past 45 years, 40% higher than the multiple for the World ex Japan index. This goes a long way toward explaining why the average nominal annual return for Japanese stocks over this period was 6.3%, 30% lower than that of other developed market stocks. For similar reasons, the median ROE-adjusted P/E over this period of 29.4 also does not seem a good representation of "fair value."

Given these issues, we use a variety of valuation tools to triangulate into a fair value for Japanese equities, incorporating metrics like price-to–book value; we also require a discount to historical averages for various earnings multiples. This technique suggests that today Japanese stocks are fairly valued. The price-to-book multiple stands at 1.4, in line with its historical average since 1995 (Figure 7), while the ROE-adjusted P/E is around 21, 30% below its historical median. The historical median of the latter is certainly associated with low returns, but

Figure 7. Japanese Equity Valuations



recent profitability in effect inflates this multiple, as the trailing P/E stands at just 16.1.

Advice

We preferred to remain on the sidelines during the first stage of the rally in Japanese equities that ended in the first half of 2013 given uncertainty over whether Abenomics would generate the desired growth and inflation as well as whether structural reforms would succeed. Markets seemed to race ahead of fundamentals, and the risk was that stock prices had fully priced in an earnings recovery that faced many risks. In hindsight our skepticism about some pillars of Abenomics was justified; growth and inflation have disappointed. However, earnings growth did improve. The result is that after their initial surge, Japanese share prices seem attractive on a relative basis and retain the potential for superior earnings growth as structural reforms come into effect.

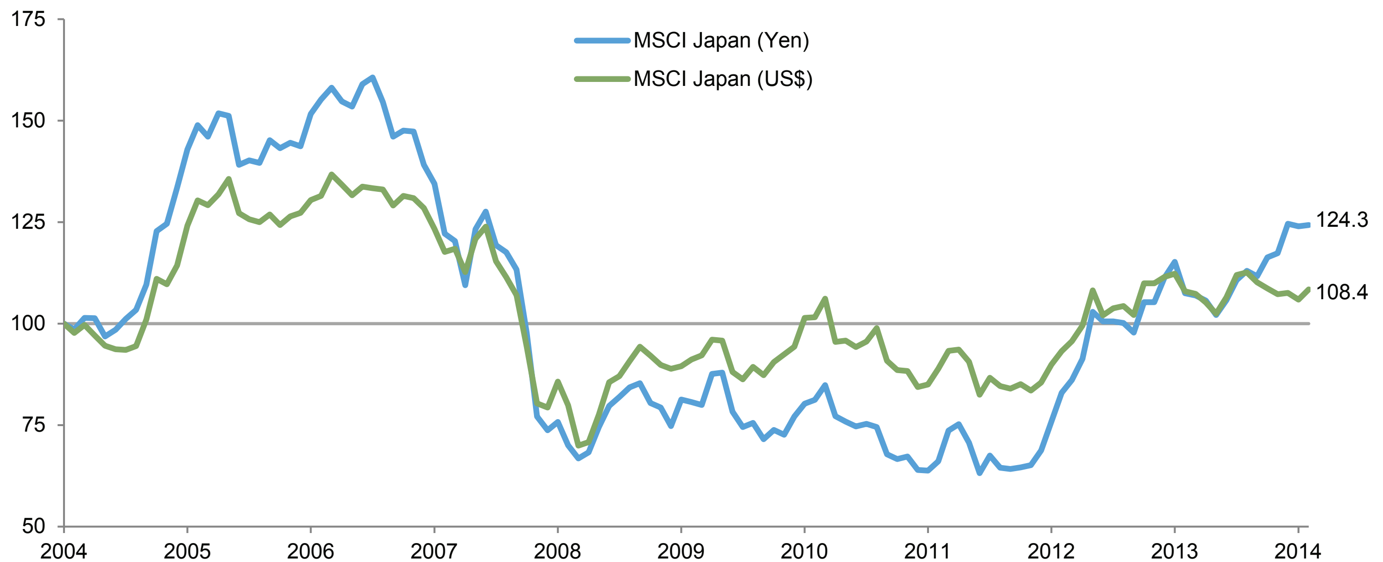
The exchange rate is a wildcard for earnings, but evidence of a broad-based earnings recovery across domestic-focused business suggests this is not the only driver of the recent rebound. Further, given that many companies with foreign sales are using much more conservative estimates for exchange rates in their earnings projections (i.e., $/¥ levels for the current fiscal year that are well below today's 118), earnings may have further upside even if the currency strengthens.[3] Cheaper oil will benefit Japan, not just by lowering import costs and leaving consumers with more cash, but also by alleviating pressure on the balance of payments and thus allowing the BOJ more flexibility. It may not be a coincidence that the BOJ decided to go "all in" in late October just as crude was starting to crash. As noted earlier, operating leverage has increased and will benefit from stronger domestic and/or international growth; global growth is expected to accelerate modestly in 2015. Finally, Japanese companies have recently begun boosting payouts to shareholders, and share buybacks may reach an all-time high in the current fiscal year.

Given these factors, and equity valuations that look reasonable on an absolute basis as well as attractive relative to those in other developed markets, we recommend investors increase exposure to Japanese equities. Specifically, we advise investors to have a slight overweight to Japanese stocks at the expense of US equivalents.[4] Several risks to our view exist, which accounts for the small size of our suggested overweight. These risks include that Japanese profit growth decelerates, markets continue to push up valuations for already overvalued US equities, and that macro risks once again trump the micro progress in Japan. Mitigating these risks are factors including the multi-faceted nature of the earnings recovery as well as the potential for new drivers (like buybacks) to provide a second wind. Our confidence in the US equity underweight is also supported by that

[3] For example, one asset manager notes that Japanese firms anticipate the exchange rate to be 101 yen to the US dollar.

[4] Please see Celia Dallas, *VantagePoint: First Quarter 2015*, Cambridge Associates, January 20, 2015.

Figure 8. Japanese Equity Price Returns in Yen and US$ Terms
December 31, 2004 – Janaury 31, 2015 • Rebased to 100 at December 31, 2004



market's combination of stretched valuations as well as an earnings cycle that looks long in the tooth; we question whether multiple rerating and buybacks can be as potent going forward as they have in the past.

Regardless of portfolio weighting, non-local investors should currency hedge their exposure to Japanese equities; advice we have provided for some time[5] (Figure 8). Hedging exposure is unlikely to boost returns over the long term, but should reduce their volatility; in the meantime doing so leans of favor of the BOJ's stated goals. While some metrics suggest the yen is fairly or even undervalued, diverging central bank policies may place the yen under further pressure. There is also the small but non-negligible chance that the BOJ missteps and generates too much significant inflation or a balance of payments crisis occurs, exerting upward pressure on the yen. Investors have several options to implement our advice to hedge exposure, including currency-hedged exchange-traded funds that track major Japanese indexes as well as overlaying existing or new exposures with currency hedges from a specialist provider. ■

[5] Please see Wade O'Brien et al, "Japan: Still Awaiting Confirmation on Fundamentals," Cambridge Associates Asian Market Commentary June 2013, as well as our *Asset Class Views* publication on Japanese equities, which has advocated hedging currency exposure since June 2013.

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Exhibit Notes

Core Japanese Inflation
Sources: Bank of Japan and Thomson Reuters Datastream.
Notes: Beginning April 2014, 2% is deducted on a monthly basis from Core Japanese Inflation. This calculation is based of the assumption that two-thirds of the items in the Core Japanese CPI are affected by the 3% VAT rate hike.

Bank of Japan Balance Sheet
Sources: Bank of Japan and Thomson Reuters Datastream.
Note: Projections begin after January 31, 2015.

MSCI Japan Earnings Growth vs Yen/US Dollar Exchange Rate
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Aggregate Cash & Equivalents for Companies in the Topix Index
Source: Bloomberg L.P.

Dividends and Buybacks for Companies Listed on the Tokyo Stock Exchange
Source: FactSet Research Systems.
Note: Data based on TSE-1 listed companies.

MSCI Japan Return on Equity
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.

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

Japanese Equity Price Returns in Yen and US$ Terms
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

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