The Case for Japan 2016–2017

BY JESPER KOLL

Japanese risk assets[1]—real estate and equities—remain on track for a multiyear structural bull market[2]. The current sharp downfall in equities – today TOPIX was down nearly 25% from its recent high of six months ago (August 14, 2015) – is primarily cyclical, in our view, with both domestic and global down-cycles combining to force a "crashtest" of our bullish-Japan thesis[3]. If we are right and this is merely a cyclical problem, the next business-cycle up-turn should start to come into sight by this summer.

STRUCTURAL BULL-THESIS

In this paper, we aim to contrast the structural bull-thesis to the cyclical downturn. The foundation of the bull-case rests on these basic three pillars:

+ Attractive valuations[4]
+ Corporate leaders focusing on capital stewardship and rising returns
+ Pro-business and anti-deflation[5] policy determination across all policy makers

All three structural pillars remain very solidly in place and, in our view, will prove strong enough to withstand the current challenge from the cyclical downturn.

CYCLICAL REALITIES

The reality of a business cycle downturn is becoming increasingly clear. For Japanese equities, the key indicator here is the first significant downturn in corporate earnings momentum since the start of "Abenomics[6]" in late-2012: TOPIX trailing earnings-per-share (EPS) got cut from ¥94 to ¥90 in the latest quarterly earnings season[7].

ZERO EARNINGS GROWTH IN 2016

From here, the market will have to digest cuts in forward looking earnings estimates. Consensus EPS growth is still forecast to be up around 10% for the next fiscal year (Fiscal Year (FY) 2016, which starts April 1, 2016)[8]. Zero growth is a more reasonable assumption, in our view.

1 Risk assets: Refers to assets outside of government bonds that have returns that are not supported by the full faith, credit and taxation authority of a government entity.
2 Bull market: Period of generally rising markets.
3 Source: Bloomberg, for period from 8/14/15 to 2/10/16.
4 Valuations: 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.
5 Deflation: The opposite of inflation, characterized by falling price levels.
6 Abenomics: Series of policies enacted after the election of Japanese prime minister Shinzo Abe on December 16, 2012, aimed at stimulating Japan's economic growth.
7 Source: Bloomberg, as of 2/10/16.
8 Source: Bloomberg, as of 2/10/16

Why? For TOPIX companies, earnings growth is primarily driven by sales growth and the behavior of the Japanese yen compared to other currencies. This is because almost two-thirds of TOPIX companies are net exporters, and as much as 70% of earnings are generated from either exports or offshore production.[9]

The following matrix outlines different scenarios for earnings under different currency and sales growth assumptions. It then adds TOPIX "fair value[10]" columns using different price-to-earnings (P/E) multiple[11] assumptions.

While it's a busy table, the bottom line is straightforward: On our baseline assumption of sales growth of 2% and an average ¥115/$, earnings are poised to record zero growth in the next fiscal year, beginning April 1, 2016. On a 16x P/E, this scenario suggests a TOPIX "fair value" of 1,472. Circumstances may ultimately play out differently, but based on what we are seeing today, we believe this to be a reasonable guideline.

Against this, if the yen were to average ¥110/$ and sales growth still came in at 2%, earnings would drop 6.5%, which, on the same 16x multiple, would yield 1,376 as fair value. Conversely, earnings could still grow 5.4% if the currency averaged ¥110/$ but sales growth came to 3%.

FIGURE 1: THE LINK BETWEEN THE YEN, SALES GROWTH AND EARNINGS PER SHARE FOR THE TOPIX

Yen To U.S. Dollar Exchange Rate[5]	Sales Growth Scenario[1]	Implied Earnings Per Share[2]	Year-Over-Year Percentage Change In Earnings Per Share[3]	TOPIX P/E Multiple[4]						
				12	13	14	15	16	17	18
105	1%	64	-30.4	768	832	896	960	1024	1088	1152
	2%	75	-18.5	900	975	1050	1125	1200	1275	1350
	3%	84	-8.7	1008	1092	1176	1260	1344	1428	1512
110	1%	75	-18.5	900	975	1050	1125	1200	1275	1350
	2%	86	-6.5	1032	1118	1204	1290	1376	1462	1548
	3%	97	5.4	1164	1261	1358	1455	1552	1649	1746
115	1%	80	-13.0	960	1040	1120	1200	1280	1360	1440
	2%	92	0.0	1104	1196	1288	1380	1472	1564	1656
	3%	105	14.1	1260	1365	1470	1575	1680	1785	1890
120	1%	85	-7.6	1020	1105	1190	1275	1360	1445	1530
	2%	97	5.4	1164	1261	1358	1455	1552	1649	1746
	3%	110	19.6	1320	1430	1540	1650	1760	1870	1980
125	1%	94	2.2	1128	1222	1316	1410	1504	1598	1692
	2%	105	14.1	1260	1365	1470	1575	1680	1785	1890
	3%	118	28.3	1416	1534	1652	1770	1888	2006	2124
130	1%	101	9.8	1212	1313	1414	1515	1616	1717	1818
	2%	112	21.7	1344	1456	1568	1680	1792	1904	2016
	3%	128	39.1	1536	1664	1792	1920	2048	2176	2304

[1] Sales growth scenario: Indication of different levels of observed sales growth, assumed here to facilitate hypothetical scenario analysis.
[2] Implied earnings per share: Different levels of hypothetical earnings per share, connected to both the average level of the yen versus the U.S. dollar, as well as to the sales growth scenario. Stronger sales growth with a weaker yen is the situation that facilitates the potential for the strongest growth in earnings per share.
[3] Year-over-year percentage change in earnings per share: Change in earnings per share from the current fiscal year.
[4] TOPIX P/E multiple: TOPIX price level divided by TOPIX earnings per share. Higher levels indicate willingness of investors to pay more for each incremental level of earnings.
[5] Yen to U.S. dollar exchange rate: Average level of the yen versus the U.S. dollar for the fiscal year.
Source: Bloomberg. Scenarios are meant to be illustrative and hypothetical in nature. Actual sales growth and actual implied EPS may be different from the numbers shown.

[9] Source: Bloomberg, as of 12/31/15.
[10] Fair value: In this instance, fair value describes the projected price level of the TOPIX taking into account the specified assumptions.
[11] Price-to-earnings (P/E) multiple: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

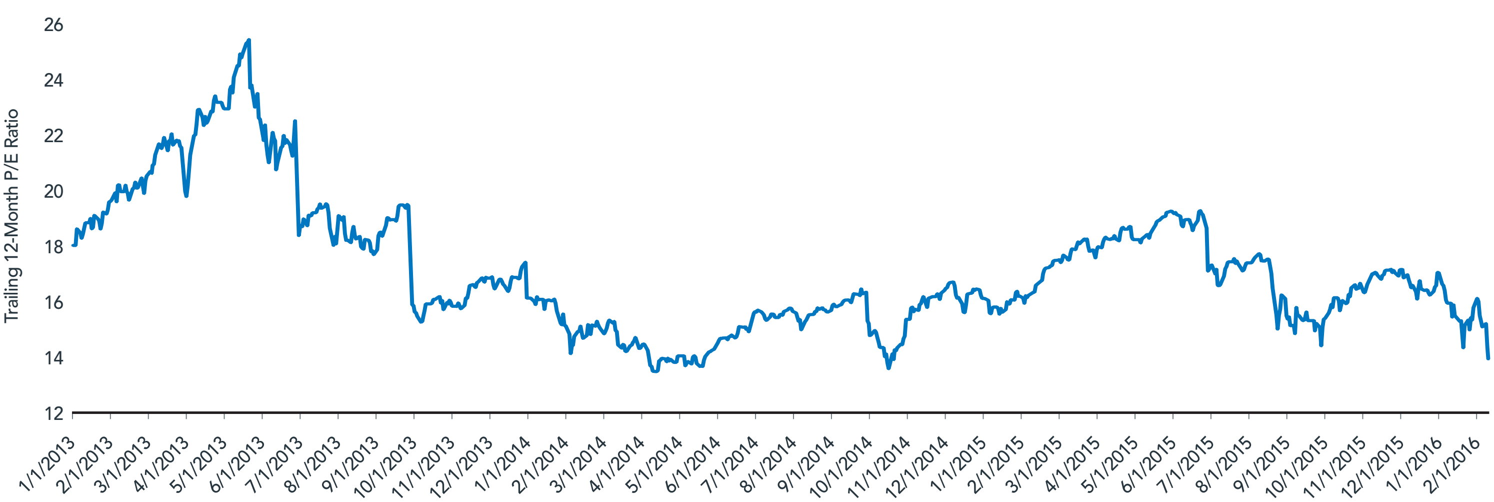
Importantly, the sensitivity to sales growth is much higher than the sensitivity to the currency. Note here that in the current fiscal year, sales growth is running at around 2.7% and that the average exchange rate is poised to be around ¥120/$ (for the fiscal year ending March 2016), absent a major move in the next few weeks prior to March 31, 2016.[12]

In other words, we think our baseline assumptions are conservative.

YES, ATTRACTIVE VALUATIONS

The good news is that the market appears to have discounted already much of the coming cyclical deterioration in earnings growth: On trailing earnings (i.e., assuming zero earnings growth), TOPIX traded on a 13.8x P/E multiple. Throughout Abenomics, the market has traded in a 14x to 25x P/E multiple range, with a break below 14x marking a solid bottom for the market.[13]

FIGURE 2: VALUATIONS IN JAPAN ARE NEARLY AS COMPELLING AS THEY'VE BEEN AT ANY POINT SINCE ABENOMICS BEGAN



Source: Bloomberg, from 1/1/13 to 2/10/16. Universe is the TOPIX. Period reflects start of first calendar year after Prime Minister Shinzo Abe's election, 12/16/12.

TRIGGER-HAPPY JAPAN

A more detailed look at valuations shows that, since the start of Abenomics in December 2012, Japanese equities have demonstrated relatively good traction to valuation triggers.

Specifically, since December 2012, TOPIX has been trading on an average trailing P/E multiple of 17.2x, with a high of around 25x and a low of just below 14x. In fact, every time the trailing P/E dropped to 14x, the market consequently rallied.[14]

[12] Source: Bloomberg, with current fiscal year going from 4/1/15 to 3/31/16.
[13] Source: Bloomberg, from 1/1/13 to 2/10/16.
[14] Source: Bloomberg.

Most recently, this mark was hit at the end of September 2015—and TOPIX rallied 14% over the next three months. Other 14x trailing earnings trigger points were mid-October 2014, with TOPIX surging 40% over the next six months; and mid-May 2014, after which TOPIX rose 15% over four months.[15]

To be sure, the 14x trailing P/E "value signal" did get fully switched on by consequent forces. The mid-October 2014 signal got hugely amplified by the Bank of Japan's "surprise ease" at the end of that month.[16] It also coincided with the Government Pension Investment Fund's (GPIF) big-splash portfolio rebalancing announcement.[17] At the time, it would have been hard to imagine better proof that "relentless pro-growth policy support and coordination" is indeed at work.

Against this extraordinary set of macro policy circumstances, the other 14x trailing P/E trigger points got switched by micro forces, corporate stewardship in general and rising visibility of earnings in particular: Mid-May 2014 brought a full-year corporate results season in which almost 80% of companies beat their forecasts, and from mid-September 2015 there was again an upturn in corporate earnings visibility that pulled up the market.[18]

Now that the trailing P/E is back again down to below 14x, what will "switch on" the flows to dispel fears of Japan becoming a "value trap[19]"?

CYCLICAL BOTTOM IN MAY/JUNE

A key catalyst should be the full-year earnings results, due in May 2016. Companies are poised to present very conservative, if not outright negative, forward guidance for the next fiscal year.

In other words, we expect that the downward momentum on earnings revisions should start to bottom out in May/June. In our view, this is poised to mark the next cyclical upturn in Japanese equities.

CAPITAL STEWARDSHIP AND SHAREHOLDER RETURN FOCUS

Structurally, the outlook for corporate earnings and rising returns on capital[20] remains very strong, in our view. Here, from a capitalist's perspective, it is exactly the fact that, despite the increasingly super-tight labor market, corporate Japan is capable of restricting wage increases to a bare minimum that bodes well for profit margins[21]. Unit labor costs[22] are unlikely to rise, and as soon as the business cycle picks up, productivity is set to outpace labor costs once again.

[15] Source: Bloomberg.
[16] Source: "Expansion of the Quantitative and Qualitative Monetary Easing," Bank of Japan, 10/31/14.
[17] Source: "Adoption of New Policy Asset Mix" announcement document, Government Pension Investment Fund, 10/31/14.
[18] Source: Bloomberg.
[19] Value trap: Situation where equities based on certain metrics may look relatively inexpensive but may continue to remain so for a potentially extended period.
[20] Return on capital: Measure of how well a company generates cash flows on the money that has been invested.
[21] Profit margin: Net income divided by total sales. Higher values indicate a greater fraction of each dollar of sales being left to the firm and its owners after expenses are accounted for.
[22] Unit labor cost: Measure of economic productivity, indicating the efficiency of labor utilization in an economy.

BAD FOR LABOR, GOOD FOR CAPITAL

The hard-nosed refusal of corporate leaders to share record profitability with labor can be interpreted as a verification for better capital stewardship from corporate leaders. Although it's probably an unintended consequence not foreseen by the political leaders who drafted the governance and stewardship code changes, it's clearly a boon for a structural bull case for rising returns on capital in Japan.

The track record of TOPIX companies on managing for shareholder returns speaks for itself: Over the past four years—since March 2012—earnings have surged 139% on sales growth of 17.2%. The price-to-book value ratio[23] stayed constant at just about 1x, and dividends surged 53%, or nearly 12% per annum.[24]

FIGURE 3: : TOPIX COMPANIES' PERFORMANCE SINCE START OF "ABENOMICS"

	March 31, 2012	March 31, 2015	February 10, 2016	% Growth March 31, 2012 to February 10, 2016	
				Cumulative Growth	Avg. Annual Growth
Price Level	854	1552	1260	47.5%	10.6%
Earnings per Share	37.9	86.8	90.65	139.2%	25.3%
Sales per Share	1715	1971	2010	17.2%	4.2%
Dividends per Share	18.6	26.4	28.4	52.7%	11.6%
Book Value	842	1177	1192	41.6%	9.4%
P/E Ratio	22.5	17.9	13.9	-38.3%	-11.7%
Price to Book Ratio	1.0	1.3	1.1		
Yen to U.S. Dollar Exchange Rate	79	110.3	120	-34.2%	-10.2%

Source: Bloomberg. Yen to U.S. dollar exchange rate refers to the average level of the yen to U.S. dollar exchange rate for the period of one year prior to the date shown. The negative cumulative and average annual growth for the yen to U.S. dollar exchange rate indicates depreciation of the yen versus the dollar over this period.

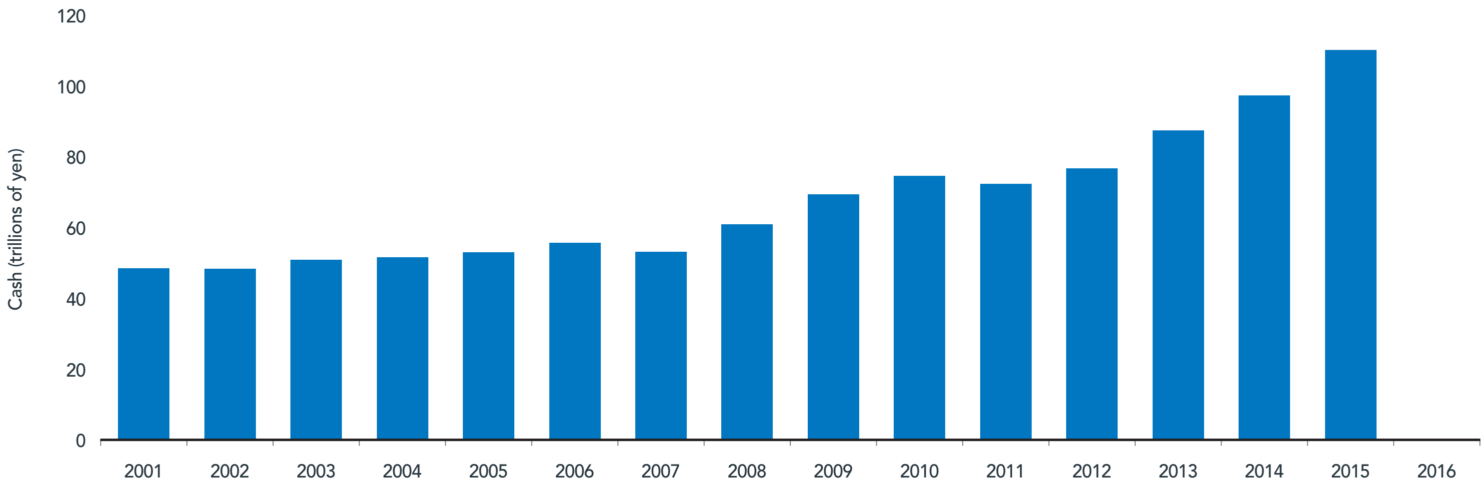
VERIFICATION TEST—CASH FOR SHAREHOLDERS

From here, the 2016 cyclical downturn is poised to become a real verification test, showing whether corporate governance and stewardship have really changed toward a greater focus on raising shareholder returns. Specifically, we expect to see retained earnings[25] to be deployed as a buffer against the cyclical slowdown in sales and corporate cash-flow generation. In other words, dividend growth and share buybacks are expected to continue to grow in 2016. Certainly the buffer of retained earnings should prove sufficient enough to allow this.

Again, the full-year earnings reports and forward guidance coming in May/June should provide verification of the capital stewardship thesis—in our view, corporate Japan will, for the first time ever, mobilize retained earnings to push up shareholder returns despite a cyclical slowdown in profit growth.

[23] Book value: Indicates the value remaining per common shareholder after all assets are sold and all debts are paid.
[24] Source: Bloomberg.
[25] Retained earnings: Portion of earnings that is not paid as dividends but held by the company for future investment opportunities.

FIGURE 4: TOPIX COMPANIES—RETAINED EARNINGS BALANCES [Trillions of Yen]



Source: Bloomberg, with data from 2001 to 2015, shown annually.

POLICY FOCUS & DETERMINATION

Japanese policy has been guided by two key principles. First, to end deflation, and second, to promote private enterprise and private risk taking. If successful, the net result should be a reallocation of private sector savings. For corporations, this implies a pickup in business investment, mergers and acquisitions (M&A) or new entrepreneurship; for households, this implies a shift from deposits and cash toward equities and real estate.

Against this yardstick, it has not succeeded: Neither business investment nor corporate entrepreneurship is picking up, and evidence of a household sector portfolio shift remains hard to find. Mortgage lending is rising at a modest 2% to 2.5%, which suggests some releveraging from a younger generation, but households have remained steady net sellers of domestic equities throughout the past six, 12, 24 and 36 months. Meanwhile, the financial agents of households—trust banks, insurance companies and other wealth managers—have also remained net sellers of equities.[26]

So far throughout Abenomics, the only consistent net buyers of domestic equities were public entities—the Bank of Japan (BOJ) through its exchange-traded fund (ETF) buying program and the GPIF. The message is clear: So far, Abenomics has failed to deliver. However, this does not mean that it will not succeed. Indeed, the determination of policy makers to keep pushing for pro-business and anti-deflation measures was underscored by the BOJ's introduction of negative interest rates in late January. While we were right on BOJ governor Haruhiko Kuroda's determination to fight deflation, we were wrong on global markets' determination to force it. Whether encouraging fears of an imminent China devaluation[27] or exposing domestic deflation risks, clearly the BOJ's new tool of negative interest rates has proven ineffective to re-establish market confidence, at least so far in the game.

[26] Sources: Bank of Japan, Tokyo Stock Exchange, measured as of most recently available data as of 2/10/16.
[27] Devaluation: Deliberate downward adjustment to the value of a country's currency compared to another currency.

WHERE DO WE GO FROM HERE?

In our view, policy makers are unlikely to become complacent, and they are poised to present added reflation[28] actions on both monetary and fiscal policy. Here, predicting the timing is trickier than usual. Acting too soon could raise worries that policy makers have grown uncertain of their convictions—that is, they have tools but are not sure how they are supposed to work. Still, we expect at least two or three added cuts in negative rates over the coming three to six months, and do not rule out a boost to the current ¥80 trillion annual balance sheet growth target.

More immediately, in my personal view, I think it will be fiscal rather than monetary policy that will be eased next.

Specifically, a delay in next year's consumption tax hike or the commitment to compile an offsetting supplementary budget may be called for before long. Stay tuned for a more open battle between technocrats pushing for the tax hike for the sake of fiscal consolidation and "Team Abe" pushing for a delay for the sake of political capital, with both voters and markets worrying about a 2017 tax-hike-induced recession.

The good news is that clarity of next year's fiscal policy setting is poised to be in place by mid- to late March at the latest. Budget debates are running to a close then, and the rising visibility of both domestic and global recession risks is raising the sense of urgency for immediate countercyclical needs.

Team Abe is not only eager to fight off a recession, but also determined to be a praise-worthy host and leader for this year's G7[29] Summit (which will be held in Japan at the end of May).

INVESTMENT CONCLUSIONS

The cyclical downturn is real and is poised to result in further downgrades of earnings expectations. The full-year earnings season in May 2016 is poised to mark the climax of downgrades, in our view. Financials and trading companies are poised to be hit particularly hard, in our view. Until then we want to focus on "quality[30]"—dividend and dividend growth strategies are poised to get further tailwinds as corporate management delivers rising dividends despite the earnings slowdown. Here, large cap exporters are poised to lead the charge of demonstrating best-in-class capital stewardship, in our view.

By sector, we favor real estate and health care, as well as small caps. While health care remains a structural growth story relatively isolated from the cyclical downturn, real estate and small caps are poised to lead the next cyclical upturn. This is so because the positive effect from the drop in interest rates on both real estate and small companies is being underestimated, in our view. Watch for bank credit and loan growth data to accelerate in the coming three to six months, led by real estate and small/medium companies borrowing. Moreover, if we are right on a likely fiscal boost coming, domestically focused small/medium companies are poised to benefit most immediately.

[28] Reflation: The term is used to describe the first phase of economic recovery after a period of contraction. This period is typically characterized by the act of stimulating the economy through accommodative central bank policies and reducing taxes to bring growth and inflation back up to the long-term trend.
[29] G7: Stands for the "Group of 7" countries consisting of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.
[30] Quality: Refers to companies with the potential for more consistent earnings growth, lower debt and relatively higher returns on capital, equity or some other measure of efficiency.

For large-cap exporters, we are neutral for now, but do expect a positive inflection in fundamentals to come within the coming two-to-four months. A likely trigger is the full-year earnings season in May 2016. By then, cyclical headwinds against earnings momentum from the inventory overhang and currency appreciation should be fading; and the structural tailwinds of better capital stewardship and rising productivity should start to force a positive turn in largecap exporters revisions momentum from this summer.

The principle risks are primarily external, in our view. The pace of a Chinese currency devaluation is one—a sharp one-off depreciation would likely mark a "risk-off[31]" selling climax, triggering almost immediate reflation counterpolicy; against this, a continuation of the steady renminbi depreciation and China reserve bleed would likely cause more lasting damage to the global and Japanese risk appetite, in our view.

In addition, U.S. domestic demand in general, and U.S. car sales in particular, demand careful monitoring. With almost half of Japan's industrial earnings coming from cars, car parts and car-related industries, U.S. car sales are a key leading indicator for a possible second downleg to industrial profits for 2016–2017. The good news here is that Japan's leading car companies are already assuming a de facto stagnating U.S. car market, after last year's record sales.[32]

On the positive risk side, a decisive fiscal boost from Chinese policy makers could also become a positive trigger for exporters.

[31] Risk off: Refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.
[32] Source: Drew Harwell and Steven Mufson, "U.S. Car Sales Hit Record High in 2015," The Washington Post, 1/5/16.

Unless otherwise stated, data source is WisdomTree.

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