U.S.-JAPAN TRADE DEAL COULD TRIGGER A RALLY

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As the end of the long Japanese Golden Week holidays approaches, several positive triggers for Japanese equities are coming into sight. On the domestic front, the key standout is the full fiscal year 2018 corporate results season over the coming three weeks, which, in our view, is likely to mark the end of the earnings revisions down cycle that started last October. On the international front, the full state visit by President Trump to Japan scheduled for May 25–28 is very likely to bring the successful resolution of a U.S.-Japan bilateral trade agreement. If we get similar positive news from the U.S.-China trade front, Japan in general and exporters in particular could outperform.

Of course, the two pieces—earnings revisions and trade—are highly codependent, with trade and global demand still by far the most dominant force driving corporate profits. Specifically, approximately 64% of TOPIX earnings come from global demand, either through exports or offshore production. Domestic Japan accounts for barely 36%. By region, the U.S. is most important, accounting for approximately 25% of all TOPIX profits. China's importance has grown to approximately 15% and non-China Asia for about 12%. Make no mistake, the U.S. and China combined account for as much of Japanese corporate profitability as the domestic market, and when you add the feedback loops between China and non-China Asia, it was inevitable for Japanese earnings to be hit hard by the China slowdown. Fears of trade wars and tariffs clearly compounded the downshift as corporate leaders canceled or postponed business investment and capacity expansion plans.

For Japanese earnings, the numbers speak for themselves: in July 2018, consensus expectations were for a 12% rise in corporate profits for 2019. Now, expectations are for basically zero growth and, in our view, when the results will come in over the next three weeks, it is likely that reported profits may have declined by as much as 5% for the full-fiscal year 2018 (which ended March 31, 2019).

The good news is that forward-looking Japan earnings expectations are likely to be too conservative, in our view. For example, several of the large car companies are now forecasting for U.S. car sales to actually drop by as much as 10% in 2019; and on the exchange rate, these companies are budgeting for the U.S. dollar to depreciate to ¥103–105. These strike us as very conservative benchmark assumptions, and, in our view, chances are high that by late summer and early autumn, Japanese earnings revision momentum will start to inflect positively.

Of course, successful completion of trade negotiations and certainty of "no punitive tariffs" will be the ultimate key trigger. In our view, a U.S.-Japan deal is a virtual certainty, with Japan very capable and willing to buy more U.S. military hardware, aircraft and agricultural products to satisfy White House demands to see concrete steps to reduce the bilateral trade deficit through rising U.S. exports to Japan. In addition, the transactional value of the U.S.-Japan trade negotiations can easily be increased further by stepped up Japanese investments in the U.S., including possibly a concrete Japan-funded U.S. infrastructure investment fund.

All said, Prime Minister Abe has made it very clear he is willing to cut a deal that makes President Trump look good and—unlike in the U.S.-China relationship—there really are no fundamental disagreements between Japan and the U.S. on, for example, intellectual property protection. In all likelihood, the state visit at the end of May will not just bring President Trump as the foreign dignitary to meet the newly enthroned Reiwa emperor but also usher in a new era of U.S.-Japan bilateral trade and economic relations without fear of tariffs or trade retaliation.

There is one caveat, however. The U.S.-Japan trade deal is highly likely to include an option for the U.S. to “weaponize the dollar—i.e., a clause in the deal will specify that any signs of “currency manipulation” detected by the U.S. Treasury can actually become grounds for commercial and trade retaliation. What this means in practice remains to be seen, but it certainly indicates that U.S. policy makers will have gained a new tool they can use at their discretion (although, for now, nobody knows how, when or if it will ever be used).

When all is said and done, the cycle is ready to turn for Japan. Negative earnings momentum is bottoming and, if we’re right and both the U.S.-Japan and U.S.-China trade deals come into play, the stage could be set for Japan underperformance to turn into outperformance, in our view. Brace for positive earnings momentum during the late summer and early autumn.

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