JAPAN OUTLOOK PAST GOLDEN WEEK—SHOW ME THE MONEY

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We maintain our view that Japanese risk assets—equities and real estate—are on track for a multiyear structural bull market. 2017 is poised to bring a positive reversal of earnings momentum, with a pickup in top-line sales growth and a weaker currency capable of delivering 25% to 30% earnings growth (after last calendar year's drop of around 8%).[1] Given the relatively attractive valuation backdrop—TOPIX is trading at a modest discount to its 10-year averages on both trailing and forward price-to-earnings (P/E) multiples—the rising visibility of earnings is likely to be the principal driver of Japan's market performance. In contrast, policy action and initiatives are expected to be relatively less important market drivers for Japan, with the Bank of Japan (BOJ) expected to stay put and maintain its zero-rate 10-year bond yield target for the foreseeable future.

Focus on Corporate Results

Now that the U.S.-Japanese bilateral economic, trade and investment dialogue is off to a good start—last week's first round of meetings went well and constructive engagement has been agreed upon—the next key to propelling Japanese markets out of the disappointing downward adjustment is poised to be the upcoming corporate results season. As that overlaps with the annual "Golden Week" holidays, Japan's performance is expected to rise in coming weeks, in our view.

Specifically, we expect a steady stream of upward revisions as companies report their full fiscal year earnings end-April/early May. This is because baselines are still very conservative, with companies and analysts still "budgeting" for an average ¥/$ exchange rate of around 105 and top-line sales growth of just below 2%. Note that for every 10 yen of yen depreciation, listed companies receive a windfall profits boost of around 8%. Given that the actual realized exchange rate in the January-March quarter was around ¥113, that would suggest a rise in profits of around 15%, rather than the 8% anticipated by the corporate consensus.[2]

Of course, forward guidance is going to be key. Here, we anticipate another year of conservative benchmarking with companies likely to budget for around ¥108–110/$ and sales growth of around 2%. Our models suggest this implies potential earnings growth of around 17.1% for the new fiscal year (starts April 1, 2017, and runs through March 31, 2018). However, if top-line sales growth—which is basically global economic growth—rises by 3%, profits should rise by 30.5%, even if the currency averages the same ¥110/$. Given the recent acceleration in global growth and inflation momentum, Japanese corporate earnings momentum could surprise positively throughout 2017–18, in our view.

The table below outlines the relationship between different foreign exchange assumptions and sales assumptions for FY3/2018 profits growth for TOPIX companies. In addition, it presents fair-value levels for TOPIX under different P/E multiples. In our view, 25% to 30% earnings growth could be achievable in FY3/2018.

Japan Equity "Fair Value" Matrix with Different Foreign Exchange Rate and Sales Growth Scenarios

$/Y	Sales Growth Scenario	Implied EPS	%yoy	TOPIX P/E Multiple					
				14	15	16	17	18	19
105	1%	74	-9.8	1036	1110	1184	1258	1332	1406
	2%	85	3.7	1190	1275	1360	1445	1530	1615
	3%	94	14.6	1316	1410	1504	1598	1692	1786
110	1%	85	3.7	1190	1275	1360	1445	1530	1615
	2%	96	17.1	1344	1440	1536	1632	1728	1824
	3%	107	30.5	1498	1605	1712	1819	1926	2033
115	1%	90	9.8	1260	1350	1440	1530	1620	1710
	2%	102	24.4	1428	1530	1632	1734	1836	1938
	3%	115	40.2	1610	1725	1840	1955	2070	2185
120	1%	95	15.9	1330	1425	1520	1615	1710	1805
	2%	107	30.5	1498	1605	1712	1819	1926	2033
	3%	120	46.3	1680	1800	1920	2040	2160	2280

Sources: WisdomTree, Bloomberg, as of 3/31/17.

On the Home Front–Stability Premium

On top of the expected cyclical upturn in corporate earnings, two added factors should lend structural support to Japanese risk assets: modest but steady increases in domestic demand and nominal gross domestic product (GDP), and stable but simulative fiscal and monetary policy.

The former is driven by the structural tightness of the labor market, which is delivering not just modest wage increases but, more importantly, a sharp upturn in the quality of jobs created–full-time jobs are rising smartly, with Japan creating 1 million full-time jobs over the past 18 months (the first net full-time job creation in almost 20 years). We maintain our view that a "new middle class" is rising in Japan and that the structural labor market outlook has the potential to deliver an endogenous domestic demand growth cycle, uncorrelated to the global business cycle.

On the policy front, Japan is committed to being a "bastion of stability" by comparison to America and Europe. Specifically, fiscal policy has turned out to be a modest plus to aggregate demand in 2017–18 due to supplementary spending budgets, and monetary policy is committed to maintaining the zero-yield upper bound on Japanese government bonds. In our view, the decoupling of Japanese monetary policy from U.S. Federal Reserve (Fed) policy is one of the key global macro and allocation flow drivers over the coming 6–12 months. Certainly, Japanese institutional asset allocators are expected to respond to the rising interest rate differentials by increasing non-yen security allocations, in our view.

Risk Scenario

We see two principal risk scenarios on the economic policy front. The first one would be the BOJ following the Fed rate hike cycle earlier than anticipated (i.e., before the BOJ's 2% inflation target comes into sight). This seems unlikely, given the BOJ's commitment to keep current policy until inflation overshoots the 2% target (see policy board decision, September 2016). The second one would be a squeeze on profit margins from rising labor costs. Structurally, this is a serious issue. The good news is that labor market reform is focusing on this and, at the same time, corporations are acting fast with, for example, a domestic merger and consolidation wave helping ease cost-push inflation worries.

Meanwhile, geopolitical risk has become a more acute source of possible volatility, with the unpredictability of the North Korean regime a growing concern for both global and local risk allocators.

[1]Sources: WisdomTree, Bloomberg.

[2]Source: Nikkei, from 12/31/16 to 3/31/17.

Important Risks Related to this Article

Investments focused in Japan increase the impact of events and developments associated with the region, which can adversely affect performance.

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DEFINITIONS

Bullish : a position that benefits when asset prices rise.

Valuation : 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.

Tokyo Stock Price Index (TOPIX) : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Inflation : Characterized by rising price levels.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Interest Rate Differentials : The Difference between the 2 Year interest rate swaps of the United Kingdom vs. the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.