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# DEEP VALUE AND CONSERVATIVE BASELINES CREATE ROOM FOR UPSIDE EPS SURPRISES IN JAPAN

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Fears of trade wars and political uncertainty cannot distract from the fundamental improvement in the profitability of corporate Japan. In fact, the surge in Japanese earnings has far outpaced that of U.S. companies: Over the past five years, [S&P 500](#) companies delivered a 24% rise in [EPS](#), while [TOPIX](#) companies' EPS surged 135%, from ¥51 in March 2013 to ¥120 in March 2018. Importantly, approximately two-thirds of Japan's earnings recovery has been due to rising top-line sales growth, with the exchange rate adding compounding tailwinds as well as cyclicity. This is due to the high operational gearing, which is forced by the high fixed-cost base of corporate Japan.

From here, the outlook for corporate earnings growth remains positive, in our view. Consensus estimates have turned very conservative: four months ago, the consensus TOPIX EPS growth target for the upcoming fiscal year 2018 (April 2018 to March 2019) was up 13%. Now it is down to 4.5%, based on approximately 3.5% sales growth and a ¥105/\$ FX assumption (see Bloomberg estimates).

In our view, 15% EPS growth should be achievable, driven by higher-than-consensus sales growth: Last year, sales rose 6.5% and, unless global economic growth begins to moderate significantly, the consensus expectation for a slowdown to 3.5% strikes us as a very conservative baseline assumption.

The following matrix aims to pull it all together. It shows the implied fair-value TOPIX level given various combinations of sales growth and FX assumptions, and [price-to-earnings \(PE\)](#) multiples. The current consensus calls for 3.5% sales growth and ¥105/\$, which puts the current TOPIX level on a "fair value" PE of 13.5x. Given the PE range of between 13x and 19x in recent decades, we are currently at the bottom of the PE valuation band, even with-in our view-conservative sales and [FX](#) assumptions.

The message is straightforward. Japanese equities at current levels appear attractively valued relative to the recent past; and the threat from FX appreciation appears exaggerated due to the top-line sales and valuation cushion. To wit: even if the yen were to appreciate to ¥100/\$ and sales growth were to drop from up 6.5% last year to up 4% this year, TOPIX "fair value" could still leave almost 14% upside if the PE multiple reverts back to the 10-year average of 16x.

Key trigger points for the year should come during the next earnings season, which gets going by the end of April. We expect conservative corporate guidance to set the stage for a new positive-earnings-revisions up-cycle to start from late-summer/early autumn.

**TOPIX Earnings and Fair Value Target Matrix under Various FX and Sales Assumptions:**

| \$/¥ | Sales Growth Scenario | Implied EPS | %yoy  | TOPIX at PE Multiple |      |      |      |      |      |      |
|------|-----------------------|-------------|-------|----------------------|------|------|------|------|------|------|
|      |                       |             |       | 13x                  | 14x  | 15x  | 16x  | 17x  | 18x  | 19x  |
| 90   | 2%                    | 87          | -27.5 | 1131                 | 1218 | 1305 | 1392 | 1479 | 1566 | 1653 |
|      | 3%                    | 95          | -20.8 | 1235                 | 1330 | 1425 | 1520 | 1615 | 1710 | 1805 |
|      | 4%                    | 106         | -11.7 | 1378                 | 1484 | 1590 | 1696 | 1802 | 1908 | 2014 |
|      | 5%                    | 116         | -3.3  | 1508                 | 1624 | 1740 | 1856 | 1972 | 2088 | 2204 |
| 95   | 2%                    | 94          | -21.7 | 1222                 | 1316 | 1410 | 1504 | 1598 | 1692 | 1786 |
|      | 3%                    | 103         | -14.2 | 1339                 | 1442 | 1545 | 1648 | 1751 | 1854 | 1957 |
|      | 4%                    | 114         | -5.0  | 1482                 | 1596 | 1710 | 1824 | 1938 | 2052 | 2166 |
|      | 5%                    | 124         | 3.3   | 1612                 | 1736 | 1860 | 1984 | 2108 | 2232 | 2356 |
| 100  | 2%                    | 98          | -18.3 | 1274                 | 1372 | 1470 | 1568 | 1666 | 1764 | 1862 |
|      | 3%                    | 111         | -7.5  | 1443                 | 1554 | 1665 | 1776 | 1887 | 1998 | 2109 |
|      | 4%                    | 121         | 0.8   | 1573                 | 1694 | 1815 | 1936 | 2057 | 2178 | 2299 |
|      | 5%                    | 130         | 8.3   | 1690                 | 1820 | 1950 | 2080 | 2210 | 2340 | 2470 |
| 105  | 2%                    | 105         | -12.5 | 1365                 | 1470 | 1575 | 1680 | 1785 | 1890 | 1995 |
|      | 3%                    | 116         | -3.3  | 1508                 | 1624 | 1740 | 1856 | 1972 | 2088 | 2204 |
|      | 4%                    | 126         | 5.0   | 1638                 | 1764 | 1890 | 2016 | 2142 | 2268 | 2394 |
|      | 5%                    | 134         | 11.7  | 1742                 | 1876 | 2010 | 2144 | 2278 | 2412 | 2546 |
| 110  | 2%                    | 121         | 0.8   | 1573                 | 1694 | 1815 | 1936 | 2057 | 2178 | 2299 |
|      | 3%                    | 130         | 8.3   | 1690                 | 1820 | 1950 | 2080 | 2210 | 2340 | 2470 |
|      | 4%                    | 140         | 16.7  | 1820                 | 1960 | 2100 | 2240 | 2380 | 2520 | 2660 |
|      | 5%                    | 148         | 23.3  | 1924                 | 2072 | 2220 | 2368 | 2516 | 2664 | 2812 |

Sources: WisdomTree, Bloomberg, as of 3/26/18. Bloomberg consensus for FY 3/19: EPS = 128.

*Unless otherwise stated, data source is Bloomberg, as of March 26, 2018*

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**S&P 500 Index**: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

**Earnings per share**: Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

**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.

**Foreign Exchange (FOREX, FX)**: The exchange of one currency for another, or the conversion of one currency into another currency.