ARE JAPAN'S PROFITS TIED TO GROWTH IN JAPAN'S ECONOMY?

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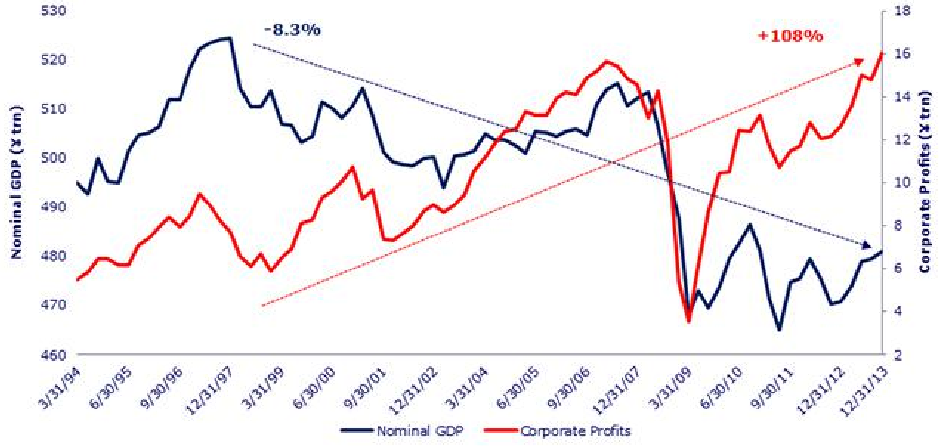
Since the start of Abenomics, Japanese corporate profitability has surged on the back of easy monetary policies and a weaker yen. Further gains in profits have been anticipated on the heels of pro-business structural reforms that are part of Abe's economic growth strategies, which include a cut in corporate tax rates. Because of the strong gains in profits, Japan remains one of the lowest-priced regional markets on a price-to-earnings basis and was the only major regional developed market that had earnings outpace price gains since Abe was elected.[1] I wrote here why I believe the drop in Japan's stock prices in 2014 offers an attractive entry point. One set of concerns for Japan regards the implementation of a consumption tax hike from 5% to 8% and the expected fallout for Japan's local economy. Yes, a tax hike is typically short-term negative for local consumption and negative in regards to economic growth. But a key question is whether any drag on economic growth will translate into weaker profit growth from Japan in the aggregate. And here the data is quite illustrative: overall corporate profits for Japan have historically shown no relationship to the growth in the Japanese economy. **Profits Not Correlated with Gross Domestic Product (GDP)** Our friend Nicholas Smith, Japan Strategist at CLSA, recently published a research report summarizing the effects of Abenomics thus far and providing CLSA's outlook for Japan's future.[2] In the report, he highlighted an important relationship between GDP and corporate profits: *Since the end of 1997, Japanese nominal GDP dropped 8% while corporate profits rose 108%. The correlation between GDP and profits was 1%, which is geek-speak for saying that the two moved in opposite directions quite as often as they moved together. Corporate profits are absolutely not a simple derivative of GDP growth. As long as global conditions are improving, companies should be able to deliver fair growth."* Figure 1 helps illustrate these findings. **Figure 1: Japan GDP vs. Corporate Profits**



Source: CLSA, 05/04/14; published with the permission of CLSA. Past performance is not indicative of future results.

- **Consumption Tax Fears May Be Exaggerated** – Although raising the consumption tax was always expected to be a drag on Japan's GDP, the effect might be more muted on corporate profits than originally feared. As the chart highlights, corporations succeeded in increasing profitability over past periods of declining GDP growth. CLSA also noted in its research that consensus earnings expectations have continued to increase despite the consumption tax hike. • **Overseas Production Helps Profitability, Not Necessarily GDP** – One reason for the lack in correlation between profits and GDP is that a growing number of companies are shifting production overseas. Profit margins in these foreign operations can be two to three times the profit margins in Japanese operations. While this shift in overseas production does not show up in higher exports (despite the more competitive position from a weakening of the yen) and thus also does not translate to GDP growth, the gains on sales from overseas production do translate to higher corporate profits for Japanese firms. This is one reason the lack of a relationship between GDP growth and profits is especially important today. **Japan's Profits Tied to Global Growth** At the CLSA conference that I attended in February, Nicholas made a point that really stood out for me: Japan's economy and markets have one of the highest sensitivities to global economic growth—even more than most emerging markets export countries. The underperformance for Japan in 2014 could thus be ascribed less to concerns about what is happening in Japan's local economy and more to concerns about slowdowns in U.S. and global economic growth. As the market cuts through the noise of the consumption tax hike and its impact on Japan's economy and starts to look to the underlying growth in profits for Japan's companies, I believe there will be more support for Japan's equity markets. Potential catalysts to reinvigorate this attractively priced market: further news from Abe on tangible steps for his third-arrow growth strategies, further monetary policy support from the Bank of Japan to reach its 2% inflation target and/or a pickup in global economic growth. I expect some combination of these factors in the latter half of 2014 to come to fruition. [1]Source: Bloomberg (11/30/12–4/30/14) [2]Source: "Abenomics Health Check", CLSA, 5/04/14

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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.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

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

Profit margins : 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.

Inflation : Characterized by rising price levels.