FOCUS ON JAPAN

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THREE YEARS OF ABENOMICS

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Portfolio Manager

"After three years of Abenomics, the results look rather modest at first sight, but maybe in a few year's time the market will remember Mr Abe as the one able to get Japan out of deflation".

YOKO OTSUKA
Analyst

The following note gives the views of the Portfolio Manager at the time of publication

END OF DEFLATION

Even though economic growth was lagging behind the US and EU, Japan's real GDP grew by +0.7% p.a. over the last three years. The sluggishness of the personal consumption was caused by the headwind of the consumption tax hike – 5% to 8% in April 2014. Everyone had the memory of the previous hike of April 1997 from 3% to 5% when the country fell into deflation. It did not happen this time. Actually the core inflation has been anchored around +0.5% in 2015, meaning that fifteen-year deflation period has ended. It might take few more years for individuals to really accept this fact but surveys show that the mind-sets are slowly but surely moving to this 'new normal' of living in an environment with inflation.

The sustainability of this inflation will depend on salary trends as well as stickiness of pricing by corporations. The first point is well-known with the key role of the "Keidanren" (Japan Business Federation) who pushed its members – the large corporations – to show the example by raising wages and bonuses. The second point is linked to corporations profitability, though. The recent average wage growth in the headlines appears flattish but this is mainly due to the labour mix of regular and part-time workers. Part-time workers where the short term demand is high are paid significantly less than the regular workers who are entitled to bonuses. The evidence of the strong job market – 3.4% unemployment rate, a twenty-year low – is shown by the +1.4% p.a. compensation growth in GDP under Mr Abe's tenure.

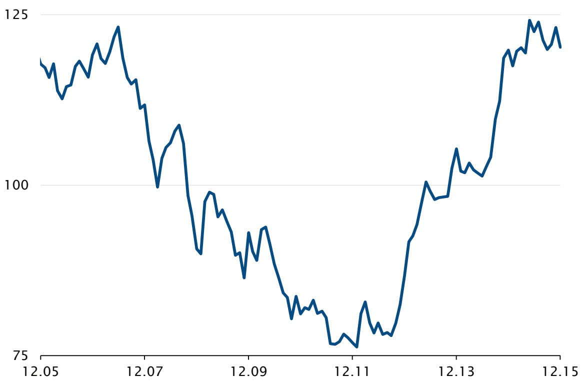
Compensation of Employees Quarterly SA

Source: Bloomberg, SYZ AM. Data as at 31.01.2016

JAPAN ALSO INTRODUCED "WHATEVER IT TAKES" MONETARY MEASURES

The other part of Abenomics was the unconventional monetary policy introduced by the Bank of Japan through two QQE (Quantitative and Qualitative Easing) programs in April 2013 and October 2014. These measures were to support the 2% inflation target rate set by Mr. Kuroda, the governor of the Bank of Japan. Unfortunately it has turned into a fading hope mainly due to falling oil prices. While the real direct impact of these QQE was the ten years Japan government bond yield squeezed to zero, everyone associates them to the 30% drop of the yen against the dollar. Actually, after reaching an all-time high and unsustainable level before Mr. Abe became prime minister, the yen is now just back to pre-global financial crisis level of 2007. This level looks more fair than 75 JPY/USD which was reached in 2012, an all-time high. Nonetheless thanks to the yen weakness Mr. Kuroda's aim has been partly achieved with Japan creeping out from deflation especially through goods imports.

USD/JPY



Source: Bloomberg, SYZ AM. Data as at 31.01.2016

Considering Japan's demographic structure, a 1% inflation target would be more suitable than the Bank of Japan's unrealistic 2% target. Meanwhile moderate salary hikes should keep its momentum due to the structural labour shortage: retirement of baby-boomers and decreasing number of young workers are creating the two main bottlenecks. Personal consumption is likely to improve gradually and the latest adoption of negative interest rates should also not have much impact on the real economy as rates were already very low.

Above all, one should remember that the weight of the manufacturing sector is 27% in the GDP vs. 57% in the main Tokyo Stock Exchange index. Also overseas production of listed companies, which account for a large percentage of Topix earnings, is not included in the GDP. For example, Toyota - 4% of the Topix - produces more than half of its cars overseas with no impact on the domestic GDP. Likewise, the GDP growth and the growth of listed companies are very different indeed. The revenue growth of the 500 largest companies excluding financials grew by +2.3% p.a. over the past decade compared with an unchanged nominal GDP. The cumulative effect is striking that the corporates revenues grew by +27% over the last decade while the GDP remained flat. These facts illustrate that, despite the persisting confusion, the investors should be well aware of the differences between economy structure and those of the listed companies.

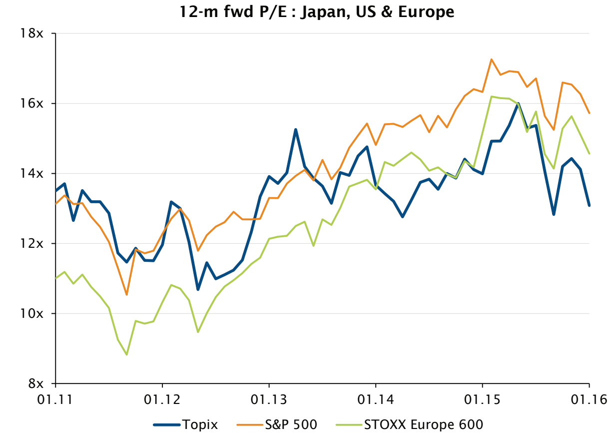
ERRATIC ECONOMIC GROWTH, BOOMING STOCK MARKET

Under the three years of Abenomics, the Japanese stock market posted substantial double-digit returns, superior in local currencies to US or European stock markets returns. So the wise investors were the ones hedging their Japanese currency exposure, not impacted by the drop of the yen against the euro or the us dollar.

The returns were achieved thanks to strong earnings growth. Obviously exporters, notably automobile makers and global leading electronic components makers, have benefited from the yen weakness. The additional tailwinds were the healthy US consumption and the rapid growth of the smartphone market, iPhone in particular. Domestic companies' growth was generally lower than exporters as they did not have the uplift from weak yen but was nevertheless significantly better than what macro data suggests. Listed domestic companies have a disproportionate exposure to metropolitan areas where the population is growing. Again GDP is a very poor proxy of the "Kabutocho" (Tokyo Stock Exchange).

Strong market performance accompanied by robust earnings growth left the price earnings multiples basically unchanged. Consensus estimates another double digit earnings growth for fiscal year 2016 (starting in April), substantially higher than the low to mid-single digit figure in the western markets. But Topix valuations suggest that market participants have already priced in lower growth: 12.1x 12-m forward P/E, the largest discount ever to the 15.6x for the S&P500 and the 14.1x for the STOXX Europe 600.

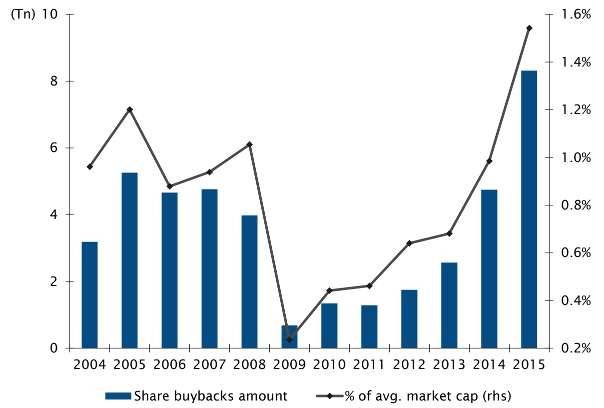
12-m fwd P/E : Japan, US & Europe



Source: Bloomberg, SYZ AM. Data as at 31.01.2016

From this year, earnings growth will likely normalise at mid to high single digit assuming the IMF 3.4% global GDP growth. The corporate tax cut from 32% to 30% will boost domestic companies' earnings by +3%. Another factor will come from share buybacks stand at 1.5% of market capitalisation in 2015. Buybacks are now part of the management's strategy to enhance shareholder returns and return on equity thanks to strong earnings, balance sheet as well as newly introduced corporate governance code. Japanese companies also deliver 2% dividend yield.

Share buybacks

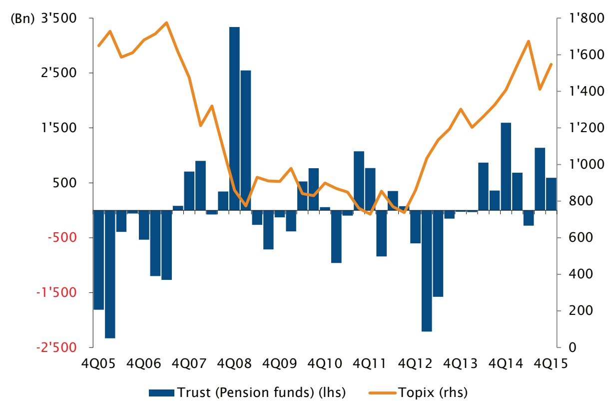


Source: Bloomberg, SYZ AM. Data as at 31.01.2016

LOCAL AND FOREIGN INVESTORS BUY JAPANESE SHARES

After a decade of disastrous supply-demand imbalance for Japanese equities, an unprecedented change occurred in October 2014. Domestic institutions, in particular the world's largest pension fund GPIF (Government Pension Investment Fund), changed asset allocation and became net buyers of equities. Foreigners, who neglected the asset class for years, are also back in the game putting their ownership highest ever: 32% in 2014. Also companies are putting buyback programmes in place that were almost stopped after the global financial crisis.

Trading volume by Pension Funds & Topix, quarterly



Source: Bloomberg, SYZ AM. Data as at 31.01.2016

Going forward, however, it is likely that new net purchases by pension funds will diminish as they are not far from their target allocation. Together with continuous buybacks, the supply-demand balance should also normalise from this year on. Investors with a long experience generally underestimate the positive impact of the lower volatility which improve significantly the risk-reward profile of this asset class. Indeed this normalisation of profit growth, lower volatility and valuations provides good diversification to European investors as Japanese companies limited sales in Europe.

OPPORTUNITIES CAN BE FOUND EVERYWHERE, BE SELECTIVE!

Amidst the turbulence of global equity market since the beginning of the year, exposure to the best companies via stock picking is of paramount importance. Earnings visibility of the auto sector and its attractive valuations look interesting. Cyclicality is not as high as one might think as the demand largely depends on replacement. Global players, especially with high exposure to - or gaining share in - the US, should be able to maintain strong earnings momentum given that the US consumption remains solid. Another advantage of these companies is that they have shifted to local production, close to the end users, making them less vulnerable to yen movement.

The strong job market has been one of the main investment themes for years. Thanks to diminishing young work force and increasing demand in labour intensive service sectors, labour shortage has become structural. Staffing companies are the main beneficiaries. In the greater Tokyo area the growing working population is a tailwind for railway companies thanks to increasing commuters. Growth visibility is significantly higher than average for these industries.

Conversely, exposure to Chinese and Emerging markets has been avoided as economic conditions are deteriorating in these countries. Exposure to commodity players was a no-go despite very low valuations as recovery of commodity market is highly uncertain and asset write-offs are looming.

A strong macro environment is of course a nice-to-have support for the Japanese stock market, but it is not a must-have. Investment opportunities can be found everywhere, at any time, independently of the economic background. Having the right investment process allows to find jewels in any part of the market; cyclicals, defensives, domestic, export-led, small, mid, large companies. Without dogma.