

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

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03/29/2018

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 cyclical. 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.