

JAPAN FOCUS: POSITIVE EARNINGS POWER

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Japan is not a value trap. Against a backdrop of very attractive equity [valuations](#)—at 13.7x, the [TOPIX price-to-earnings \(P/E\)](#) multiple has dropped back to the lowest 5% level reported over the past decade—the trigger for upside performance must come from positive earnings surprises. Our analysis suggests the probability of a sharp positive inflection in earnings visibility is about to be delivered in Japan, possibly as early as the upcoming fiscal half-year results season, which is about to get going by the end of October (FANUC reports October 25; Toyota, November 7; Mizuho Bank, November 13).

All said, we maintain our forecast for TOPIX earnings growth of 20%, against consensus expectations of 2.5% (according to Bloomberg).

Why?

Corporate guidance and consensus estimates are based on, in our view, extremely cautious baseline assumptions. Most important, top-line sales growth is forecast to drop from 6.7% last year to a mere 3.7% in the current FY 3/2019. Now, we know that sales growth has a high [correlation](#) with nominal [gross domestic product \(GDP\)](#) growth; and here in Japan as well as in Japan's major export markets—America, China and Asia—nominal GDP growth is actually accelerating. Given the high operational gearing of Japanese companies, the sensitivity of earnings to sales growth is very high. Basically, a 1% difference in baseline sales adds (or subtracts) as much as 10% to the bottom line of listed companies in Japan.

The exchange rate assumptions are the second factor making positive earnings surprises likely. Corporate guidance and consensus estimates are still based on an average of ¥105 to the U.S. dollar for the fiscal year ending March 31, 2019. Now, the fiscal-year-to-date has averaged ¥110.6 to the dollar (April 1 to September 27). That difference alone should add approximately 5% to earnings.

To be sure, Japanese corporate managers may have been wise to operate on very cautious baseline assumptions this year. At the start of the year, the threat of tariffs and other geopolitical risks were very high indeed. Personally, I doubt that managers will go all-out [bullish](#) and abandon their instinctive conservatism quite yet. However, the reality of better-than-expected top-line sales growth and a more favorable exchange rate are likely to compound into fact-driven positive earnings revisions momentum. Against the backdrop of attractive valuations, this should very much help create more positive equity market momentum in the coming months.

The following matrix looks to combine various sales growth and foreign exchange (FX) assumptions into a “fair value” grid for the Japanese market, TOPIX. For example, the current consensus assumes an FX rate of ¥105 to the dollar and 3.5% sales growth. This gives an implied [EPS](#) of 129, up 2.4%. On a 14x multiple, TOPIX fair value is 1,806; a peak-cycle P/E of 19x would suggest 2,451 as fair value on these sales and FX assumptions.

Our own target is based on sales growth of 4.5% and an FX assumption of ¥115 to the dollar, which yields a fair-value TOPIX target of 2,128—i.e., 17% upside from today's level. And that's on a 14x P/E multiple. In my personal view, that's

conservative given that, yes, the risks of a trade war against Japan and a nuclear war with North Korea has de- facto been mitigated.

All said, watch for a positive inflection of corporate earnings revision momentum in Japan in coming months.

Forecast for FY 3/2019

\$/¥	Sales Growth Scenario	Implied EPS	%yoy	TOPIX at P/E Multiple						
				13x	14x	15x	16x	17x	18x	19x
100	2.5%	101	-19.8	1313	1414	1515	1616	1717	1818	1919
	3.5%	112	-11.1	1456	1568	1680	1792	1904	2016	2128
	4.5%	120	-4.8	1560	1680	1800	1920	2040	2160	2280
	5.5%	129	2.4	1677	1806	1935	2064	2193	2322	2451
105	2.5%	117	-7.1	1521	1638	1755	1872	1989	2106	2223
	3.5%	129	2.4	1677	1806	1935	2064	2193	2322	2451
	4.5%	137	8.7	1781	1918	2055	2192	2329	2466	2603
	5.5%	147	16.7	1911	2058	2205	2352	2499	2646	2793
110	2.5%	124	-1.6	1612	1736	1860	1984	2108	2232	2356
	3.5%	136	7.9	1768	1904	2040	2176	2312	2448	2584
	4.5%	146	15.9	1898	2044	2190	2336	2482	2628	2774
	5.5%	155	23.0	2015	2170	2325	2480	2635	2790	2945
115	2.5%	131	4.0	1703	1834	1965	2096	2227	2358	2489
	3.5%	144	14.3	1872	2016	2160	2304	2448	2592	2736
	4.5%	152	20.6	1976	2128	2280	2432	2584	2736	2888
	5.5%	160	27.0	2080	2240	2400	2560	2720	2880	3040
120	2.5%	139	10.3	1807	1946	2085	2224	2363	2502	2641
	3.5%	150	19.0	1950	2100	2250	2400	2550	2700	2850
	4.5%	161	27.8	2093	2254	2415	2576	2737	2898	3059
	5.5%	172	36.5	2236	2408	2580	2752	2924	3096	3268

Source: Bloomberg, as of 9/27/18. Note : 9/27/2018 Bberg consensus FY3/19 EPS = 129 ; sales growth = 3.7% ; FX = ¥105/\$

Unless otherwise noted, data source is Bloomberg as of September 27, 2018.

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DEFINITIONS

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.

TOPIX Small Index : 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 excluding the TOPIX 500 stocks and non-eligible stocks.

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.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

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

Bullish : a position that benefits when asset prices rise.

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.