JAPAN CONTINUES TO RAISE THE EARNINGS BAR

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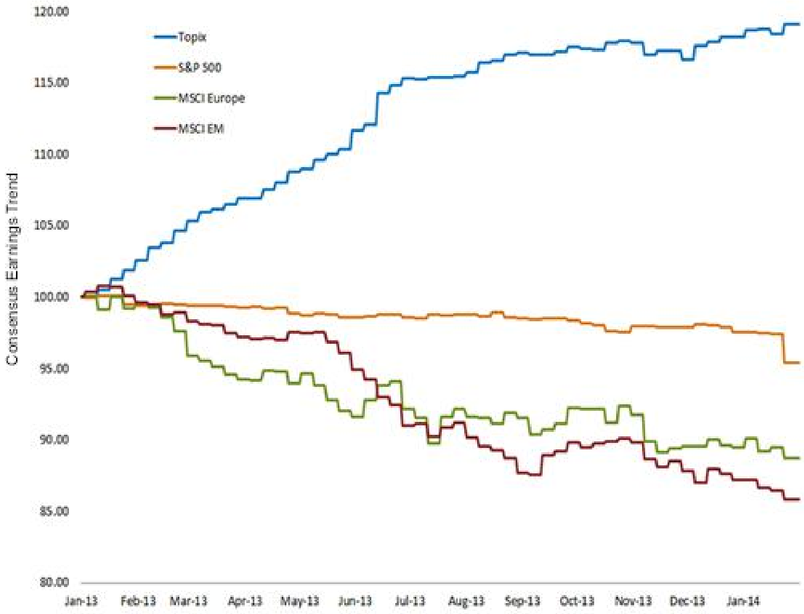
In 2013, Japanese markets led the global markets and had their best showing since Japan’s equity bubble burst in 1990. Much of the optimism for Japan’s stock market stems from “Abenomics” policies, which are all aimed at one thing: promoting economic growth in Japan and ending the long-standing deflationary regime that has characterized Japan’s economy and financial markets for the last decade. I would say the first and second arrows of Abenomics, aggressive monetary and fiscal expansion, have been right on the mark. But can the positive momentum seen in equity prices in 2013 continue into 2014? There are many skeptics of the progress Prime Minister Abe has made on his third arrow–the “growth strategy” of structural reform to the economy and Japan’s markets has languished in early 2014. While the structural reform will take longer to implement than the first two arrows, I believe investors should take Abe’s word that he is committed to Abenomics and that important changes are in the works. Also, I believe the first two arrows have provided some time for structural reforms to be implemented, because we have already begun to see the start of a “virtuous economic cycle” in the form of higher earnings that is supporting companies raising wages for the first time in many years. Higher wages can then, in turn, support more consumption and better profits, keeping a positive feedback loop. **Continued Separation from Regional Markets** Jonathan Garner[1] and his team recently highlighted in a research piece that “Japan is the only regional market where current fiscal year consensus expectations have been raised since the end of last earnings season (November 2013), in contrast with the US, Europe and Emerging Markets.” Mr. Garner and his team were also kind enough to share the chart below, which plots consensus earnings trends over the past year for different regional markets. Consensus earnings estimates are the average of all the current estimates made available by analysts. Typically, consensus earnings estimates are raised when companies are either increasing profitability or providing positive guidance for future earnings, and lowered in the opposite case. **Figure 1: Consensus Earnings Trend**



Source: Morgan Stanley Research (01/01/13–01/31/14). Values rebased to 100 from Jan 2013. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms in the chart, please visit our Glossary. • Japan Leads Regional Markets – Based on record government stimulus and yen weakness, it is not surprising that the earnings trend for Japan has been the largest of the above regional markets. What I find most impressive is the fact that the consensus earnings trend continued to rise for Japan even though other regional market earnings were revised downward by about 10% for Europe and 15% for the emerging markets. • Earnings Have Driven Price-to-Earnings (P/E) Ratio Lower – Japan's earnings improvement has been so dramatic that the trailing price-to-earnings ratio has actually improved, even after a gain of over 40% for equity markets.[2] The only other regional market to see an improvement in its price-to-earnings ratio over the period were the emerging markets, and unfortunately the change was driven by lower prices instead of higher earnings.[3] **Figure 2: Analysis on Profits, Prices and P/E Ratios**

	TOPIX	MSCI EAFE	S&P 500	MSCI EUROPE
Profit Increase	60.8%	11.2%	13.1%	1.7%
Price Increase	54.4%	23.3%	31.9%	18.7%
P/E Start (11/30/12)	15.0x	13.0x	13.6x	12.2x
P/E End (3/12/14)	14.4x	14.4x	15.9x	14.2x
Expansion in P/E	-3.9%	10.9%	16.6%	16.8%

Source: Bloomberg. Period from Shinzo Abe Election to Current (11/30/12—3/12/14). Past performance is not indicative of future results. You cannot invest directly in an index.

For definitPerioions of terms in the chart, please visit our Glossary. **Can Earnings Trend Continue?** When one looks at similar estimated P/E ratios for Europe and Japan (as measured by the TOPIX) and lower valuations than the United States, the question becomes, which region has better prospects for earnings growth going forward? In a Japan strategist roundtable in February, I shared the views of Jesper Koll, Director of Japan Equity Research at J.P.Morgan Japan, who has an above-consensus outlook on earnings based on potential margin expansions, which you can read more about here. His base case is that margins get past their levels of prior to the financial crisis and head towards 5.4%. I tend to agree with him that Japan has more room than most for margin expansion, whereas many are expecting U.S. margins to face pressure in the future. I disagree with that forecast, but it is worth pointing out that Japan faces a better situation on the margin front and thus, I think, has more room for potential earnings growth. The weaker yen has helped start the economic engine, but I feel we are still in the early innings of Japan's transformation. A more positive virtuous cycle has been kick-started with the weakening of the yen and signs of inflation instead of deflation in price levels. I expect some positive wage developments to occur over the coming years—which can support the earnings momentum that we have seen above. [1]Jonathan Garner is a Managing Director and Chief Asian and Emerging Markets Equity Strategist at Morgan Stanley [2]Source: Bloomberg; refers to the TOPIX from 01/01/13 to 01/31/14. [3]Source: Bloomberg; refers to the MSCI Emerging Markets Index from 01/01/13 to 01/31/14.

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DEFINITIONS

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.

Deflation : The opposite of inflation, characterized by falling price levels.

First arrow policies : This refers to the component of Abenomics policy that is focused upon what the Bank of Japan can do from a monetary policy standpoint to attempt to stimulate growth.

Second arrow policies : This refers to the component of Abenomics policy that is focused upon spending that the Japanese government can undertake from a fiscal standpoint to attempt to stimulate growth.

Third arrow policies : The part of Japan's Abenomics process of reform that is focused on structural changes intended to promote economic growth.

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.

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.

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.