2017 Japan outlook: poised to perform

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Japanese risk assets – equities and real estate – remain on track for a multi-year structural bull market. For the new year, we anticipate strong performance, driven by an upturn in the business cycle in general, the earnings cycle in particular. From a starting point of attractive valuations – TOPIX currently trades on a PE that is at a discount to both its own long-term average and to Wall Street multiples – we think Japanese equities could rise as much as 20%, i.e. TOPIX could climb back up to the 1,800 level last seen one decade ago, in 2007.

Specifically, we see the following five positive factors:

+ Rising visibility of positive earnings growth surprises – boosted by accelerating sales growth and currency depreciation

Japanese equities are a highly cyclical asset class, sensitive to the domestic and global business cycle. For 2017, a positive inflection appears likely on both fronts. As this gets compounded by Yen depreciation/USD strength, the net effect should be a steady stream of upward revisions to corporate earnings. Against a conservative consensus call for 10% earnings growth in 2017, we forecast a rise of 25%. Our forecast is based on an average exchange rate of Y115/USD, while the consensus call appears to be based on Y103/D at the time of this writing. De-facto, every 10-yen of sustained Yen depreciation adds back approximately 8% to listed companies earnings.

In terms of timing, positive earnings revision momentum should be particularly strong in the run-up to the full fiscal year corporate results season end-April/early-May, i.e. positive market momentum could well accelerate in the first months of the year.

+ Portfolio re-balancing by domestic investors – private institutions and retail investors to shift from bonds to equities

Two years ago, Japan's public pension fund, GPIF, changed asset allocation and raised domestic equity holding from around 14% to around 24%. In 2017, we expect private institutional investors and retail investors to follow suit. They did not do so in 2016 because of global uncertainty and domestic policy confusion – the BoJ introduced its negative rate policy in January 2016 which cast a negative spell on Japanese risk assets in general, financials in particular. In September 2016, the BoJ took countermeasures and changed its regime. Its "zero-rate bond yield anchor" is now working to assure investors that equities are the primary domestic asset choice. In addition, financial sector profit margins are poised to have bottomed as a result of the new BoJ policy. This bodes well for the financial sector and its ability and willingness to take more risks.

In terms of timing, the major institutional investors typically set the asset allocation for the new financial year – Japan's fiscal year starts April 1 – around mid-March. For retail investors, both base-pay and summer

bonus decisions are important determinants of risk appetite. The former gets decided around mid-March and the latter sometime in June.

+ Corporate focus on capital stewardship – both dividend and buyback stream accelerating

On top of a cyclical upturn in corporate earnings, structural improvements in capital stewardship in general, shareholder yield in particular, are poised to create significant support for Japanese equities. Last year, in 2016, despite an earnings recession, both dividends and buybacks streams accelerated – a historic first. This year, in 2017, as earnings growth accelerates, we expect accelerated growth in both dividends and buybacks.

Here, the general shareholders meetings should offer concrete trigger points and they are usually held in June/July.

+ Steady policy mix – fiscal dominance while BoJ caps yield curve at a de-facto zero rate

Prime Minister Abe committed to a large-scale fiscal boost, promising Y28 trillion to be spent over the coming three years, i.e. a fiscal boost of around 0.75% to 1% to GDP every year from 2017 to the Tokyo Olympics year 2020. In turn, the Bank of Japan changed its policy target to cap JGB bond yields at de-facto zero. A key theme for the new year, 2017, will be rising market speculation about when this rate-cap policy could end.

In our view, no change is likely until Japanese inflation begins to move decisively towards the 2% inflation target set by Governor Kuroda. At the earliest, this could be the case by late-summer/early autumn. Until then, Japan's unique combination of fiscal dominance and zero-rate cap is poised to make the Japanese Yen a structurally weak currency, undermined by a rising fiscal deficit as well as rising Japan-US interest rate differential.

+ Upturn in the global business cycle in general, China and US capex cycle in particular

The likely turn in the policy mix towards fiscal spending by Japan's two major trading partners, US and China, is poised to turn 2016 global headwinds into tailwinds. In addition to de-facto "New G3" (US, Japan, China) policy coordination, the Yen's depreciation has boosted both competitiveness as well as profitability for Japanese capital goods makers.

In terms of timing, the immediate issue should be the exact content and timeline of the new US fiscal agenda, followed by the run-up to China's Communist Party Congress in the autumn of 2017.

Sector allocation

Against a general preference for blue-chip exporters and dividend payers, we expect sector alpha generation from the financial sector and the capital goods sector. In addition, we remain structurally overweight Japanese small caps.

Risk factors

We see two fundamental risks to our positive Japan outlook. On the domestic front, cost-push inflation from an increasingly tight labour market could cut profit margins sooner than we expect. On the global front, a China devaluation could not just undermine Japan's export competitiveness but also trigger the next "risk off" move in global capital flows.

Important Risks Related to this Article

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