

From Our Japan Strategist Roundtable: A Potential “Return Revolution” Discussion with Naoki Kamiyama

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Jeremy Schwartz, CFA

Global Chief Investment Officer

WisdomTree has compiled a [Japan Strategist roundtable](#)—a compilation of views from three of the most widely followed Japan investment strategists. In separate one-on-one interviews, we asked these strategists to share their views on Japan’s equity markets, the economy, government initiatives and the currency. The post below features a discussion with **Naoki Kamiyama, Head of Japan Equity Strategy at Bank of America Merrill Lynch**, and some of his long-term thinking for Japanese equities, along with sectors he likes over the shorter-term. ***Let’s talk about your “Return Revolution” report, which is for Japan ROE to reach 15% in 2019 and the TOPIX to exceed 2,500 in 2017. Naoki Kamiyama:*** The most important point—the reasons of low margins in Japan. Quite many believe low margins are caused by labor market structure, lifetime employment, the seniority system and high fixed costs due to social structure. My point is that this labor market is not a big issue. If low margins really came from labor costs, during the 2002–2007 global economic expansion, Japan should have been the highest-margin country in the world. It was not. My conclusion: The primary issue is, pricing strategy is wrong in Japan. Companies have preferred sales volume over profitability. Once Japan’s management changes its mindset, we can change quickly. That’s why I called the report “Return Revolution.” We can change suddenly. We do not have to stress labor market reform—we need to change the mindset of the corporate management and pricing strategies. As long as corporates can sell higher prices and higher margins, they should stay in a business. But once the company loses competitiveness, companies need to move on. Flexibility is the key there. Japan can do that, we can change. But I am not sure we are changing yet. This would be a bull scenario for this mindset change. Once management changes its thinking, we can see U.S. or European levels of margins in the next five years. ***What factors led to this type of pricing strategy?*** **Naoki Kamiyama:** Banking-led governance of companies was a historical tradition. Banks do not need growth. Banks want companies to emphasize size, reliability of payback, stability. Equity holders need growth and profitability. Banking governance was strong from the 1950s to the 1960s up to the banking crisis in the late 1990s. Many management teams suffered from banks’ involvement in management. Now things have changed. After 1998, banks have gotten weaker, management paid back loans and management is cash rich and doesn’t care about banks. But management doesn’t care about profitability metrics yet. They keep cash on the balance sheet. ***What are catalysts for this return revolution?*** **Naoki Kamiyama:** The stewardship code is one. The stewardship code was introduced in the United Kingdom. I think this is an important catalyst to change governance from banking relationship to equity holders. It is quite natural to adopt a stockholder way of thinking due to the

aging population and globalization. Intentional growth is really important and more important than before. The change in mindset can be provided by stockholders' communications using the stewardship code for institutional investors and management to be more responsive to stockholders' governance over the next several years. There are good signs. Some companies are being more conscious of profitability. Size is not just the most important thing, profitability is also the key. The trends are going the right way. I am not sure of the speed at which this will occur, but this is a focus point for the next several years. ***Kamiyama-san, thanks for the big-picture take on the market and your outlook. What are your favored positions for 2014?*** **Naoki Kamiyama:** I am quite positive on exporters in the first half of the year—technology and autos—on the back of a weaker yen as well as expanding sales volume because of a global recovery. In the Technology sector, we also have some structural changes from the micro perspective, like a reduction in oversupply. In semiconductors or consumer electronics, that should be beneficial to margins. In the second half, I have a bigger expectation for inflation. Expectations for higher inflation are good for real estate, banks and other financials. The second half I thus see as good for domestic industries—like retail and others. But our central focus should be on financials, with better loan growth. Interest rates are starting to go up, and people are trying to borrow more money—to build houses or buy condos before the interest rates increase too much. So far, analysts are not that optimistic yet for the financials, including real estate, but in the second half, domestic industries and financials will be supporting the market. ***You also have a sector model. How does that model work?*** **Naoki Kamiyama:** My sector model is quite short-term—three months—driven and not a year outlook. The model is quite systematic. The Japan Cycle Indicator (JCI) is quite important as a top-down analysis tool to favor sectors. The JCI has six inputs; the most important one is U.S. employment numbers, but also included in it are U.S. and Japanese interest rates, foreign exchange rates, volatility indicators and earnings revisions. This month, U.S. employment was much weaker than expected, so there was a down trend in the Cycle Indicator. From that perspective, we are negative to cyclical-sensitive sectors—so sectors like steel, which are correlated to cyclical. Steel was thus very negatively ranked by the JCI indicator. Autos today are quite well-balanced in both top-down model and my bottom-up model—and it is my most preferred sector. I don't see that changing in the short term. Banks or real estate are not highly ranked yet, because we don't have much confidence in the inflationary environment yet. We think this will be in the second half of the year—this is related to interest rate sensitivity. Once we get more confidence in inflation, interest rate ranking will move up, and then banks and real estate will go up. Wage increases are a starting point for inflation expectations. Wage season is coming in April. If wages go up, as many expect, more people are likely to go out and buy houses, condos, real estate and more businesses to expand. **We very much thank Naoki Kamiyama for his participation in our roundtable. You can read the full commentary with more comments from Naoki Kamiyama and other Japan strategists [here](#).**

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