

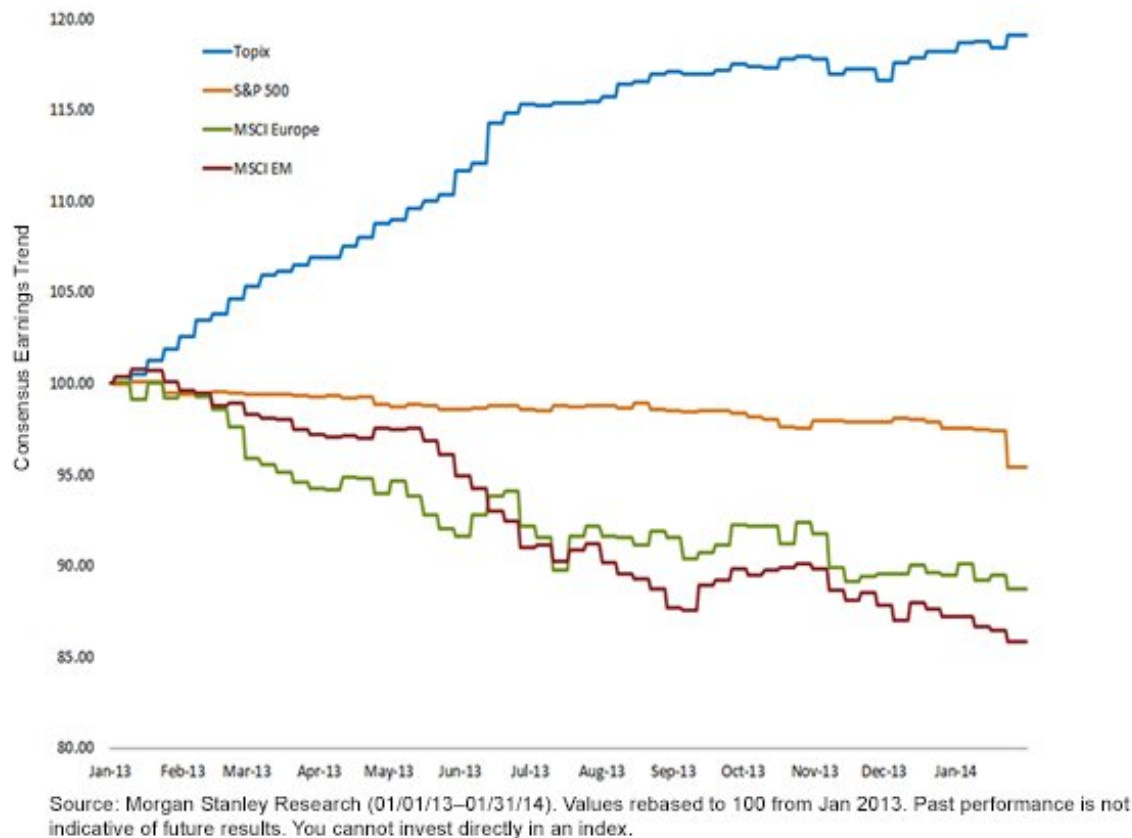
Japan Continues to Raise the Earnings Bar

Published April 1, 2014

Jeremy Schwartz, CFA

Global Chief Investment Officer

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 Garner¹ 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**



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 definitions 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. 1Jonathan Garner is a Managing Director and Chief Asian and Emerging Markets Equity Strategist at Morgan Stanley 2Source: Bloomberg; refers to the TOPIX from 01/01/13 to 01/31/14. 3Source: Bloomberg; refers to the MSCI Emerging Markets Index from 01/01/13 to 01/31/14.

Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. ALPS Distributors, Inc., is not affiliated with J.P. Morgan or Morgan Stanley