

Japan Dips into Recession as “Japan, Inc.” Profits Set New Highs

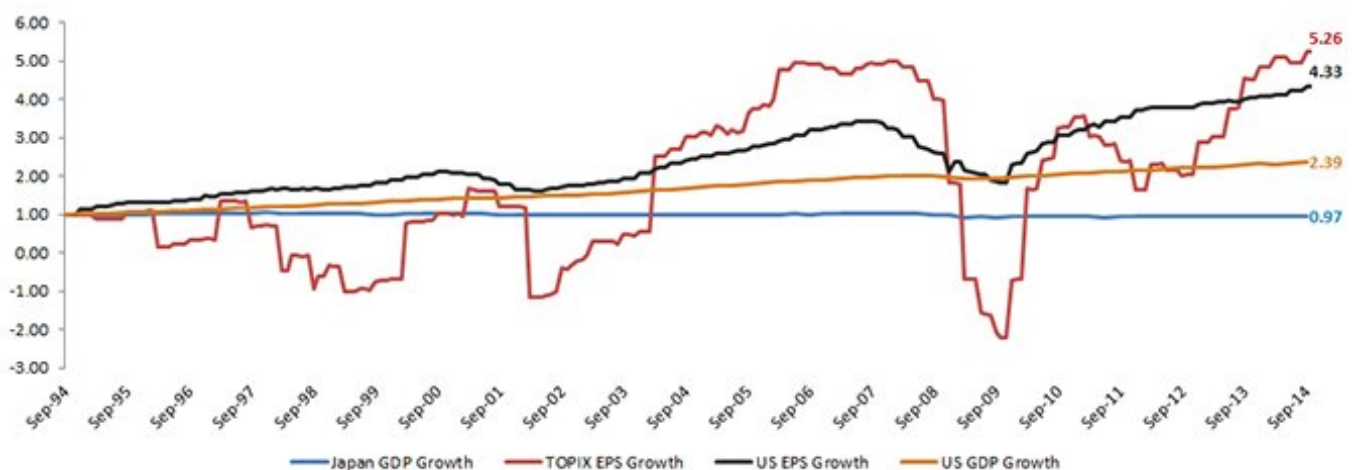
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Jeremy Schwartz, CFA

Global Chief Investment Officer

Japan's economy dipped into a surprise recession in the third quarter, causing many investors to question the economic platform of Prime Minister Shinzo Abe. The initial focus has been on the second stage of the consumption tax hike, which was blamed for the setback. The economic contraction seems to be triggering leadership in Japan, including the Ministry of Finance and the Bank of Japan (BOJ), to re-evaluate how to coordinate through supplemental fiscal budget rather than austerity measures designed to raise tax revenue—as well as even further monetary stimulus. While Japan's economic numbers are interesting for economists to debate policy prescriptions, these numbers are, in our opinion, the wrong data for investors to be focusing on. **Corporate Profits More Important than Gross Domestic Product (GDP) Growth**

When investors buy Japanese equities, they don't really buy a slice of that economy; they buy shares in corporations that operate both in Japan and around the world. “Japan, Inc.” (i.e., Japanese corporations) is showing a profit picture that differs dramatically from the country's economic growth rate. And this is helping to maintain attractive valuations in Japan. Despite having the best price gains—70.7%—from the start of Abe's reign through October 2014, earnings are up nearly 72%, which is more than any other major regional market¹. Additionally, it is also the only major developed region (the U.S., Europe and broader MSCI EAFE Index markets included) to see a contraction in its [price-to-earnings \(P/E\) ratios](#) since the start of Abenomics, while the U.S., Europe and EAFE saw multiples expand 23%, 22% and 14%, respectively². Critically for future returns, what are the prospects for future earnings growth and corporate profitability? We think they're promising: **Higher Profit Margins Paving the Way for Robust Earnings Growth--GDP v.s EPS Growth Japan**



	GDP Growth*			Growth in EPS			Profit Margin			ROE	
	Japan	U.S.		TOPIX	S&P 500		TOPIX	S&P 500		TOPIX	S&P 500
1 Year	0.80%	3.93%	1 Year	16.48%	7.33%	10/31/2014	4.44%	9.58%	10/31/2014	8.46%	15.17%
3 Year	0.60%	4.00%	3 Year	30.13%	6.86%	10/31/2013	4.10%	8.92%	10/31/2013	8.22%	14.34%
10 Year	-0.42%	3.55%	10 Year	5.71%	5.89%	10/31/2011	2.32%	9.10%	10/31/2011	4.71%	15.26%
20 Year	-0.17%	4.44%	20 Year	8.65%	7.59%	10/29/2004	3.09%	7.66%	10/29/2004	7.42%	15.74%
						10/31/1994	0.90%	5.27%	10/31/1994	2.34%	14.53%

Sources: WisdomTree, Bloomberg, 10/31/94–10/30/14. *GDP growth of the nominal/"current" data series, seasonally adjusted annualized, for the stated periods ending June 30, 2014. Start date coincides with longest data availability provided by the Economic and Social Research Institute of Japan. Past performance is not indicative of future results. ROE: Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

For definitions of terms and Indexes in the chart, visit our [glossary](#). • **GDP Growth ` Profit Growth:** Despite lackluster GDP growth that trailed the U.S. by more than 4.5% annually for 20 years, Japan's earnings per share (EPS) growth for TOPIX not only rivaled but surpassed that of the U.S. during that time—with especially compelling growth in the last one and three years with the revival of the weakening yen and coinciding with the start of Abenomics. • **More Room for Profit Margin Expansion?** In the United States, profit margins grew from 5.27% in 1994 to 9.58% in 2014—and many worry that the United States is at a cyclical peak in profit margins, causing future pressure on EPS growth. Japan's margins have surely grown, but at rates that are less than half those of the United States; it is possible for Japan to show even more room for improvement. • **Improving Profitability and Corporate Governance:** While the U.S. return on equity has increased marginally over the last 20 years, Japan's has increased markedly and remains below that of global peers. There are signs of pressure on Japan to be more competitive globally on a return-on-equity focus. In January, the government encouraged the development of the JPX-Nikkei 400 Index, which sought to reward and emphasize more profitable, higher-ROE companies. The Index is ultimately intended to serve as a new benchmark for large allocations from both the Japanese pension funds and the Bank of Japan in their exchange-traded funds (ETF) purchases. Some have referred to this Index as a "shame index," highlighting companies not included and pressuring them to increase ROE. We are already seeing signs of increased dividends and buybacks to better manage balance sheets. • **Japanese earnings have grown 526%** cumulatively from October 1994 to October 2014: Such envious growth was achieved against a backdrop of lackluster Japanese economic growth averaging -0.17%. Let's contrast this with the 433% cumulative growth achieved under "more normal" conditions in the U.S., averaging a 4.44% GDP growth number in nominal terms. This suggests that Japan has vast earnings growth potential that has yet to be unlocked. It's important to note that over the last 20 years, none of these earnings metrics has shown any correlation to Japanese GDP's relative stagnation. To reiterate, Japan, Inc. has grown profits from its global operations, while Japan's local economic performance has languished. In a nutshell, performance in the Japanese equity markets thus far has been strongly supported by earnings growth. When people talk about the Japanese economy and whether it can weather another bout of a consumption tax hike in the future, remember an important formula: **GDP growth ` profit growth** or stated differently, **GDP growth ` equity market potential**. Japan, Inc.'s overall profit profile is clearly being boosted by its global nature. This is one reason WisdomTree has focused on the exporters of Japan that we think are bound to reap longer-term gains from the more competitive yen exchange rates. This is a new trend that we see in place for the coming years based on shifting monetary accommodation at the Bank of Japan and the U.S.

Federal Reserve. We thus think investors should stay favorable to Japan despite the recession headlines. 1Sources: WisdomTree, Bloomberg, 11/30/12–10/30/14, numbers are based off of the forward earnings filed on Bloomberg. 2Sources: WisdomTree, Bloomberg, 11/30/12–10/30/14, numbers are based off of the on forward P/E filed on Bloomberg.

Important Risks Related to this Article

Investments focused in Japan are increasing the impact of events and developments associated with the region, which can adversely affect performance.