

# CRASH TESTING ABENOMICS, ROUND 2: NEW VALUATION REALITY

Jesper Koll — Senior Advisor

02/16/2016

The “crash test of [Abenomics](#)” has entered the second stage, with the Japanese equity market downdraft compounded by sharp currency appreciation: The [TOPIX](#) dropped back to the level seen on January 21, and the yen/U.S. dollar cross surged all the way up to 114.2,<sup>1</sup> a level not seen since November 2014. While we were right on Bank of Japan (BOJ) governor Haruhiko Kuroda’s determination to fight [deflation](#), we were wrong on global markets’ determination to force it. Whether encouraging fears of an imminent Chinese devaluation or exposing domestic deflation risks, clearly the BOJ’s new tool of negative [interest rates](#) has proven ineffective to re-establish market confidence, at least so far in the game. Where do we go from here? In our view, policy makers are unlikely to become complacent, and added reflation actions from both [monetary policy](#) and [fiscal policy](#) are poised to be presented. Here, predicting the timing is trickier than usual. Acting too soon could raise worries that policy makers have grown uncertain of their convictions—that is, they have tools but are not sure how to use them. In my personal view, it will be fiscal rather than monetary policy that will be eased next. Specifically, a delay in next year’s consumption tax hike or the commitment to compile an offsetting supplementary budget may be called for before long. Stay tuned for a more open battle between technocrats pushing for the tax hike for the sake of fiscal consolidation and Team Abe pushing for a delay for the sake of political capital, with both voters and markets worrying about a 2017 tax-hike-induced recession.

**Valuation Reset** While politicians and technocrats will [fight over the next directional catalyst](#), Japanese equities will have to adjust to new realities on valuations. The current earnings season has brought a first drop in current-year [earnings per share \(EPS\)](#) estimates (the Japanese fiscal year ends in March 2016). Specifically, current-year trailing TOPIX EPS has dropped from ¥94 to ¥90.<sup>2</sup> This was forced mainly by financials and trading companies, with the latter revising down due to lower commodity prices. This leaves TOPIX now trading on 14.5x [trailing earnings](#). The good news is that this is still at the bottom end of the Abenomics range of trailing [price-to-earnings \(P/E\)](#) valuations of 14x to 18x.

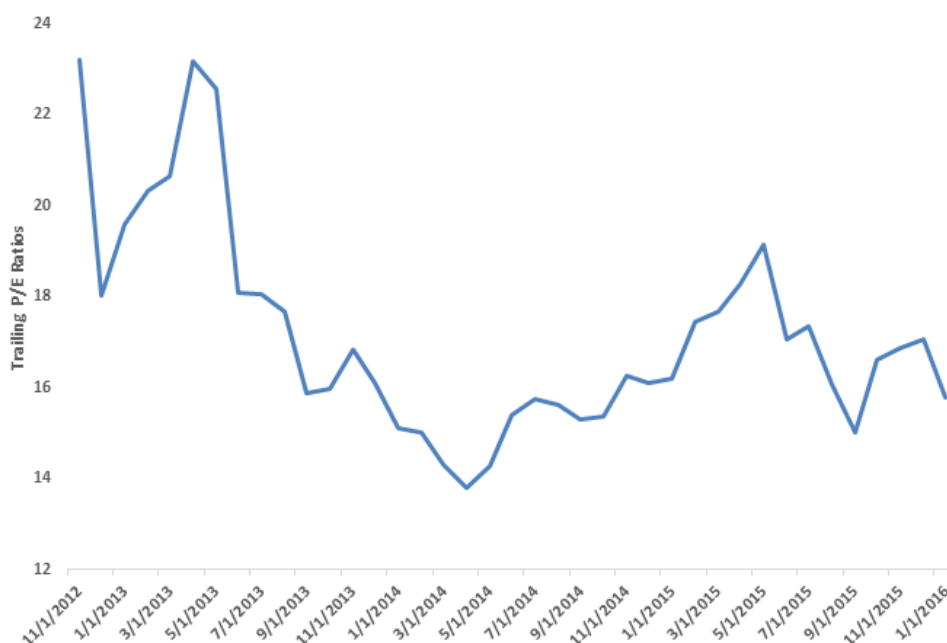
**What about Forward-Looking Earnings?** Given that the two key forces driving corporate earnings in Japan are sales growth and currency, the market is right to worry that consensus earnings expectations for 2016–2017 are too optimistic. Below, we have constructed a simple matrix forecasting TOPIX EPS on various foreign exchange (FX) and sales growth assumptions, and then added P/E multiples for corresponding fair-value TOPIX targets. Our baseline assumes an average FX rate of ¥115/\$ and 2% sales growth. This would yield an EPS of 92, or zero EPS growth for the next fiscal year (April 2016 through March 2017). This contrasts with the consensus, which is calling for 9.8% EPS growth. Note also that the current-year sales growth is likely to be around 2.7%,<sup>3</sup> so we have specifically lowered our baseline sales assumption to account for a global and domestic slowdown. If sales growth were to come to 3% instead of 2%, EPS would grow to 105, up 14.1%; if sales growth came to a mere 1%, EPS would drop to 80, down 13%. Meanwhile, the implied EPS level for the various sales growth and FX assumptions is then multiplied by the P/E range of 12x to 18x; so, our base case of 2% sales growth and ¥115/\$ corresponds to a TOPIX “fair value” of 1,472 at a 16x PE multiple. The yellow highlighted area is TOPIX levels above the February 9, 2016, close. Double-digit earnings growth could be achieved even with ¥115/\$, as long as sales growth runs at around 3% (our baseline of 2% sales growth yields zero earnings growth). Alternatively, if the currency weakens to ¥120/\$, even just 2% sales growth yields 5.4% earnings growth. However, yen appreciation to ¥110/\$ can only yield positive earnings growth if sales growth is around 3%. While this is a busy table, the net result is that Japanese equities are still attractively valued—even on very conservative sales and FX assumptions, in our view. At the same time, however, consensus earnings growth expectations are probably too high and likely will be revised down to about zero growth by the time of the full-year result releases, which are due in early to mid-May 2016.

**TOPIX Earnings Scenarios with Different Sales Growth and FX Assumptions, and Implied Fair Value on Different P/E Multiples (for Next Fiscal Year, April 2016 to March 2017)**

\$/Y	Sales Growth Scenario	Implied Earnings Per Share	% Year-over-Year	TOPIX at Price to Earnings (P/E) Multiple:						
				12	13	14	15	16	17	18
105	1%	64	-30.4	768	832	896	960	1024	1088	1152
	2%	75	-18.5	900	975	1050	1125	1200	1275	1350
	3%	84	-8.7	1008	1092	1176	1260	1344	1428	1512
110	1%	75	-18.5	900	975	1050	1125	1200	1275	1350
	2%	86	-6.5	1032	1118	1204	1290	1376	1462	1548
	3%	97	5.4	1164	1261	1358	1455	1552	1649	1746
115	1%	80	-13.0	960	1040	1120	1200	1280	1360	1440
	2%	92	0.0	1104	1196	1288	1380	1472	1564	1656
	3%	105	14.1	1260	1365	1470	1575	1680	1785	1890
120	1%	85	-7.6	1020	1105	1190	1275	1360	1445	1530
	2%	97	5.4	1164	1261	1358	1455	1552	1649	1746
	3%	110	19.6	1320	1430	1540	1650	1760	1870	1980
125	1%	94	2.2	1128	1222	1316	1410	1504	1598	1692
	2%	105	14.1	1260	1365	1470	1575	1680	1785	1890
	3%	118	28.3	1416	1534	1652	1770	1888	2006	2124
130	1%	101	9.8	1212	1313	1414	1515	1616	1717	1818
	2%	112	21.7	1344	1456	1568	1680	1792	1904	2016
	3%	128	39.1	1536	1664	1792	1920	2048	2176	2304

Source: Jesper Koll, as of 2/9/15. Implied earnings per share is the earnings implied by a certain P/E level.

## Topix Trailing 12M P/E



Sources: Jesper Koll, Bloomberg as of 1/31/16.

<sup>1</sup>Source: Bloomberg, as of

2/9/16. <sup>2</sup>Source: Bloomberg. <sup>3</sup>Source: Jesper Koll, as of 2/9/16.

### Important Risks Related to this Article

The sources, opinions and forecasts expressed are as of February 9, 2016, and may not actually come to pass. This information is subject to change at any time based on market and other conditions and should not be construed as a recommendation of any specific security. Past performance is not indicative of future results.

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

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

## **IMPORTANT INFORMATION**

**U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.**

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ([www.msci.com](http://www.msci.com))

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

## **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.

**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.

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

**Interest rates** : The rate at which interest is paid by a borrower for the use of money.

**Monetary policy** : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

**Fiscal Policy** : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

**Earnings per share** : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

**Trailing Earnings** : The amount of profit that a company produces during prior fiscal year.