JAPAN EQUITIES—PERFORMANCE POWER THAT CAN LAST

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Japanese equities have been made great again by the Trump victory; they have outperformed most global markets since November 8, with the TOPIX up 7.8%, compared with the 3% rise in the S&P 500 Index.[1] In my personal view, Japan's recent performance is not just a one-off adjustment but has the potential to develop into a broad-based outperformance rally throughout the next 12 to 18 months. Personally, I think the TOPIX may rise above 2,000 and the yen weaken towards ¥120 over the next four to six months. In the coming weeks, any consolidation after the recent strong rally offers a great opportunity for reconsidering a sizable Japan allocation to capture positive momentum for dollar investors.

The post-election rally has demonstrated that, clearly, Japanese equities are the asset class most geared to rising U.S. rates and rotation out of low-volatility into cyclicals growth. But it is not just this global macro inflection that is pushing up Japanese equities. Unlike Europe, Japan has endogenous forces supporting a bullish stance on risk assets, equities and real estate.

Specifically:

Corporate earnings momentum is poised to turn positive over the coming three months. This is because both domestic and global sales growth targets are now too conservative. In addition, exporters are budgeting for ¥103, and every five yen of depreciation adds back about four percentage points to earnings. In other words: Against a projected drop in profits of 2% in the fiscal year that ends in March 2017, profits should rise by around five percent this current fiscal year; and an added rise of 15% is likely for 2017 (assuming 2.5% global growth and ¥110).

The Bank of Japan (BOJ) is actively promoting a weaker yen. Specifically, it adopted a "zero upper bound" policy and will cap the 10-year Japanese government bond (JGB) yield at zero. This means that Japan could have the flattest yield curve among developed countries, which in turn points to a weaker yen. The BOJ will likely keep the zero-yield policy in place until CPI inflation overshoots the 2% target. In other words: The zero yield is poised to be in place until at least the summer of 2018. The desynchronization between U.S. rising rates and fixed-at-zero Japanese rates suggest the yen could weaken well beyond the ¥125 level seen last year, in my view.

Domestic portfolio rebalancing is poised to accelerate. As the BOJ's zero-yield fix gains credibility, domestic insurance and pension funds may have no choice but to raise equity allocations. In 2016, the primary allocation shift was from bonds to non-yen securities. In 2017, domestic equities are set to become the Japanese asset of choice. Why? Rising earnings visibility and attractive valuations. The trailing price-to-earnings (P/E) is now around 17.5x, and forward P/E stands at around 12.5x.[2] Against zero-bond yield, the equity market earnings yield gap stands at historic highs. Moreover, corporate governance changes are not just retrorockets but quantifiable reality; despite the earnings recession over the past 15 months, the dividend and buyback stream has actually risen. This is the first time in the history of corporate Japan that shareholder yield went up during a profits down-cycle.

There are added reasons to be bullish about Japan, again independent of the U.S. reflation trade—rising evidence of accelerating wage and income growth, proactive fiscal spending, an accelerating housing and real estate appreciation cycle, etc.

Moreover, technically, the market is also attractive, with global investor positioning at the lowest level in over five years. This creates upside potential while the downside is de-facto protected by the BOJ—it recently doubled its market ETF buying budget from ¥3 trillion to ¥6 trillion. Add to this corporate buybacks running at around ¥9 trillion, and you get committed buying power equivalent to about 4.3% of TOPIX market cap. To our knowledge, there is no other equity market in the world that offers this sort of fundamental downside protection from central bank and corporate buying commitment.

In our view, 2017 could well become the year when Japan benefits from both domestic investor and global investor buying.

[1]Source: Bloomberg 11/8/16–11/28/16.

[2]Source: Bloomberg as of 11/28/16.

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DEFINITIONS

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.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Bullish : a position that benefits when asset prices rise.

Zero-bound policy rates : central bank policy rates close to the 0% level.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Cleveland Median CPI : Instead of calculating a weighted average of all of the prices, as the BLS does, the Cleveland Fed looks at the median price change—or the price change that's right in the middle of the long list of all of the price changes. According to research from the Cleveland Fed, the Median CPI provides a better signal of the inflation trend than either the all-items CPI or the CPI excluding food and energy.

Inflation : Characterized by rising price levels.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Earnings yield : The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each dollar invested in the stock that was earned by the company.

Dividend : A portion of corporate profits paid out to shareholders.

Buyback : When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

Shareholder Yield : A data point that references the combination of dividend yield and buyback yield.

Reflationary : Characterized by an environment of rising price levels.