NOTES FROM THE CLSA JAPAN FORUM: STAY POSITIVE ON JAPANESE EQUITIES

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I attended the CLSA Japan Forum[1] in Tokyo the week of February 24 and came away with some great insights from CLSA strategists and companies that presented there. Readers of our research will be familiar with the Japan strategist roundtable we released in February. Nicholas Smith is CLSA's Japan chief investment strategist and I am delighted to share some of Nicholas' insights as a continuation of that initial strategist discussion. Below are some highlights from his presentation on Japan. **A tourist's market; foreigners utterly dominate:** Nicholas commented that the TOPIX trades largely like an emerging market index because local institutions and retail are a small percentage of trading volume and foreigners from outside Japan dominate activity. He commented that it was appropriate for Japan's institutional "gentleman to prefer bonds" during a deflationary environment, as has been the case for the last 15 years. But in an inflationary environment, Nicholas called it "scandalous" for Japanese institutions to remain under-invested in equities. For every $10,000 Japanese citizens have in their savings accounts (where over half the Japanese assets are parked), only $1 of interest is paid. If, instead, they used that $10,000 to buy Japanese equities with an approximate 2% dividend yield (the average dividend yield of the Japanese stock market[2]), they could collect $200 (accepting stock price volatility, of course)[3]. **Japan is geared to play on global growth:** Nicholas mentioned that when looking at global industrial production for Japan, the world, advanced economies and emerging markets, Japan fell more than emerging markets during the global financial crisis of 2009—but he believes it can rise faster in a recovery. A takeaway: If global growth is improving this year, as many expect, Japan's economy is one of the best positioned and most sensitive to that global recovery. **Trade drives the yen, not the reverse:** One of the primary factors impacting the yen has been the global trade balance. Because Japan shut down its nuclear reactors following the Fukushima earthquake and tsunami, Japan's oil imports have soared, a situation made worse by the weakening yen, which made imports more expensive. Prime minister Shinzo Abe plans to restart nuclear reactors, despite it being a relatively unpopular position with many Japanese. Nicholas expects 12 to 15 nuclear reactors to come back online this year, which will likely improve the terms of the trade and remove some pressure from selling yen to buy oil. Because of this dynamic, Nicholas does not think the yen will weaken much past ¥105 to the U.S. dollar. Despite the fact that the weak yen has corresponded to higher recent equity prices, Nicholas does not believe the stalling of the yen's weakness will adversely impact profits of Japan's corporations. He commented that prior to the global financial crisis, Japanese companies made more money when the yen was strong than when it was weak because periods with a strong yen tended to be periods of strong global trade. His conclusion: The yen is not as important as most people believe. **Breakeven point slashed to ¥84/US$:** Due to relentless cost-cutting by Japanese companies in the face of deflation and the strengthening yen, the Japanese have cut unit labor costs by 20% since the first quarter of 2000, while the U.S. unit labor costs have increased by about 20%. Japan has been forced to become more competitive, and the current yen levels allow for some reasonable profits above their breakeven points, which Japan's Cabinet office survey says is **¥84/US$**.[4] **Consumption Tax Hike Appropriate, More Increases Necessary** Nicholas discussed a number of examples of other countries that raised the consumption tax 3 percentage points, as Japan is set to do on April 1. He thinks this is a very appropriate policy action, noting that other developed economies, such as Germany, have been able to raise their consumption tax 3 percentage points and have seen their economies grow and their stock markets continue to rise. Nicholas ultimately thinks the 5%–8% increase taking place on April 1 is just an appetizer of what is needed. He believes that ultimately a consumption tax closer to 18%, as in much of Europe, is what is needed. The consumption tax is typically easier to collect, as three out of four companies currently pay no tax in Japan. The current head of the Bank of Japan (BOJ) came from the Ministry of Finance and supports consumption taxes, so he will likely do what it takes to support this tax policy from the BOJ's perspective. Abe wants to lower the corporate tax rate to the low 20% range, and from other discussions I had this week, it seems Abe may potentially be on course for a 2% annual reduction in corporate taxes over next five years until he gets close to a

25% rate. **Last Year's Inflation Increase Was Tenuous** Nicholas believes the 1.6% increase in inflation for calendar 2013 was just tenuous, with a large part (at least 0.60% of the 1.6%) coming from higher electricity rates (due to the shutdown of the nuclear reactors) and energy import inflation due to yen weakness. He thinks the BOJ will have to take more measures to support the fledgling inflation levels, as the BOJ would not want to see Japan return to deflation. **Bank of Japan Transmission Mechanism Working: Buy Real Asset Plays Like Real Estate** Nicholas showed that the massive deleveraging of banks following the 1997 Asian financial crisis (and the last time Japan tried a consumption tax hike) had largely bottomed out in 2006 and the banks have started to increase their lending again—showing the BOJ policy measures and transmissions are working as one would expect. He stated that the Bank of Japan is working to stimulate land prices and that it would be rude not to participate in real estate investments and other asset reflation plays, given BOJ intentions. **Closing note** The BOJ, as discussed in the case of real estate, is also trying to reflate equities more generally with its purchases of exchange-traded funds. I'll repeat his view: It would be rude not to participate when the BOJ is so clearly telling us its intentions to inflate both equity and real estate prices. Who are we to fight the BOJ? The path of least resistance, in my opinion, is for Japan equities to trade higher. Earnings expectations are on the rise, and I agree with Nicholas' analysis, which suggests that current analyst estimates for earnings are too low and will eventually rise, providing support for the market. I want to thank CLSA for putting on a fabulous Japan investment conference. If you trade Japanese equities, I suggest you try to attend their conference next year. And a big thank-you also to Nicholas Smith for agreeing to let his comments be published. [1]The CLSA Japan Forum 2014 was a conference hosted by CLSA for institutional investors interested in Japan. [2]Refers to the TOPIX. [3]Source: CLSA, Nicholas Smith comments. [4]Source: Cabinet office, http://www.esri.cao.go.jp/en/stat/ank/h24ank/h24ank_summary.pdf.

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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.

Inflation : Characterized by rising price levels.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Unit labor costs : Measure of economic productivity, indicating the efficiency of labor utilization in an economy.

Deleverage : Bring down levels of debt.

Reflation : The term is used to describe the first phase of economic recovery after a period of contraction. This period is typically characterized by the act of stimulating the economy through accommodative central bank policies and reducing taxes, to bring growth and inflation back up to the long-term trend.