Equities

Japan's self-help story has further to go – stocks still attractive

While Japan's problems are well known, doubts persist over its reforms. But domestic economic data is improving and companies are increasing payouts to shareholders.

The tide has turned for Japanese equities and the region is witnessing renewed investor interest. Japan has outperformed developed and emerging markets by a significant margin since the summer of 2016. With Europe's populist threat ongoing and the U.S. having a new president, Japan seems to be the political calm spot in 2017. The Japanese yen (JPY) has depreciated more than 11% to 116 USD/JPY[1] since the U.S. election and we expect it to touch 120 by end of the year. Our case for Japanese companies is further strengthened by our expectation of a noticeable earnings recovery based on improving both foreign and domestic economic conditions. The latter should benefit from resilient consumption, supported by record employment figures and strong corporate margins.

In this report, we identify factors supporting Japanese equities despite the obvious demographic challenges and seemingly ineffective monetary-policy response from the central bank. As Lilian Haag, responsible for Japanese equities at Deutsche Asset Management, puts it: "Japanese stocks benefit from a substantial change in corporate governance with long-lasting effects on return on equity and pay outs to shareholders. Yes, Japanese stocks have rallied by more than a quarter since mid-2016, which increases the risks of short-term corrections, especially in case of a risk-off-induced yen rally. But it does not affect our positive strategic view."

Japan's homemade challenges

Shinzo Abe's three arrows to counter aging population

The unfavorable demographic profile is at the core of Japanese economic woes, directly impacting the consumption pattern. The Bank of Japan's (BOJ's) and the government's concerted efforts have had limited success in boosting consumption. An adverse global environment and certain policy missteps (sales-tax increase) only added to the challenges. Despite wide-held skepticism we believe that there are clear signs of Shinzō Abe's third arrow, structural reforms, taking shape. The introduction of a taxpayer ID system, the increase of the female employment rate as well as agriculture reforms, easier immigration procedures and a strong increase in tourism bear testimony to this.

The Japanese equity market started its recovery with the introduction of Abe's reform agenda in 2013. The domestic

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Our expectations in a nutshell

- We believe that Abe's third arrow benefits Japan's economy in a sustainable way.
- Japanese equities enjoy strong fundamentals and are increasing their payouts.
- Despite the recent rally, stocks have still potential, but expect short-term volatility.

[1] Source: Bloomberg Finance L.P., as of 1/12/17

corporate sector is in excellent shape, as cash piles continue to grow. Focus on corporate governance has improved shareholder return and made companies more conscious about profitability and return on equity (RoE). Renewed prospects of a further yen depreciation after the unexpected U.S. election results add to the optimism.

Stagnating economy

The recent recovery in private consumption indicators looks fragile. Persistently low inflation expectations and the introduction of the negative-interest-rate policy (NIRP) has only further encouraged saving rather than consuming. This explains the tepid household-spending growth despite recent improvement in the otherwise sticky wage growth. Tourism has been a brighter spot in the economy but remains too small to move the needle by much.

The first two of the three arrows of Abenomics have had limited success in boosting domestic demand and increasing inflation expectations. The BOJ's 2% inflation target, first set in 2013, has been ever elusive. Repeated postponements of the target, instead of abandoning it, may have led to some loss of credibility for the central bank. It remains to be seen if the recent shift in the monetary-policy regime from "monetary-base targeting" to "yield-curve control" can deliver the desired results. We doubt it.

The global economic situation and political happenings are to be partially blamed for Japan's woes on two counts: 1) Global trade and exports have remained sluggish, with only slight improvements visible in Asian trade recently. 2) The yen, a perceived safe haven, in 2016 appreciated some 13% against the U.S. dollar until the U.S. elections despite the BOJ's massive JPY 80tn government-bond purchase program. A stronger yen most visibly hurts export-oriented businesses but it also subdues the inflation expectations. Hence, sufficiently depreciating the JPY will always be at the center of Japan's monetary policy in our view.

However, the central bank seems to be getting some help from the recent changes in the U.S. political landscape. President-elect Mr. Donald Trump is expected to usher in massive infrastructure spending, which could boost inflation. He has been critical of the U.S. Federal Reserve's (Fed's) ultra-low policy rates, making a strong case for more aggressive Fed rate hikes. U.S. 10-year Treasury yields jumped up sharply since the election-result announcement and now stand at 2.4%[1], a level last seen in July 2015. Dirk Aufderheide, Chief Currency Strategist of Deutsche Asset Management, explains: "The BOJ's latest policy move to maintain Japanese government-bond (JGB) yields near zero has led to a widening yield spread, which we don't expect to narrow in the near term. While this means more cash is burnt to maintain zero policy rates, it also puts a sustained downward pressure on the yen." Since the U.S. elections the yen has weakened by 12%[1] against the dollar.

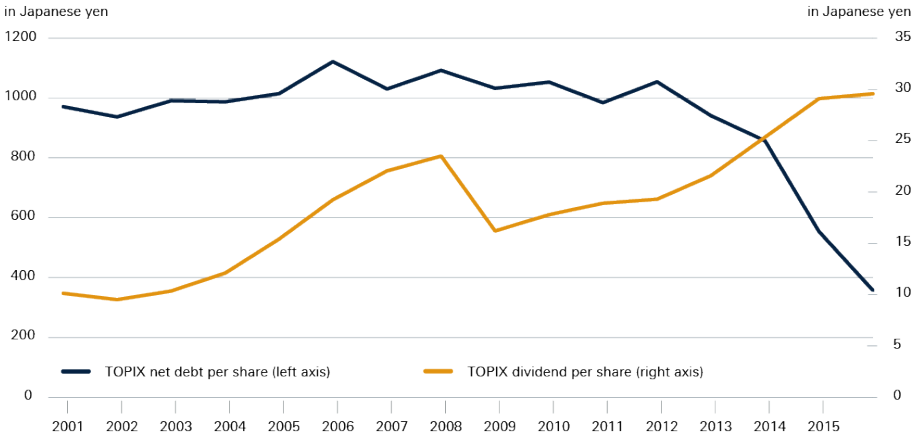
Healthy corporate sector

Rising capital efficacy

The major factor boosting corporate-sector health is its huge cash stockpile. The cash positions are at a record level, built over the years of rising profit margins as commodities, essentially oil, corrected downwards. It is important to note that sales have remained flattish during this period. The rising profitability, however, has not resulted in higher investments. This reluctance to invest can be attributed to the uncertain domestic-demand environment.

The implementation of the corporate-governance code in 2015 forced firms to improve capital efficiency. And the introduction of the JPX-Nikkei Index 400 incentivized firms to increase dividend payouts and share repurchases in an effort to report higher RoEs.

Net debt shrinking while cash distribution increasing



Source: Bloomberg Finance L.P., as of 1/12/17

We expect dividend payouts and buyback announcements to increase further as 54% of the TOPIX companies sit on net cash. Japan's dividend-payout ratio pales in comparison to the U.S. and Europe. The negative interest rates and lackluster domestic environment should strengthen the case for higher allocations towards payments to shareholders in the coming months.

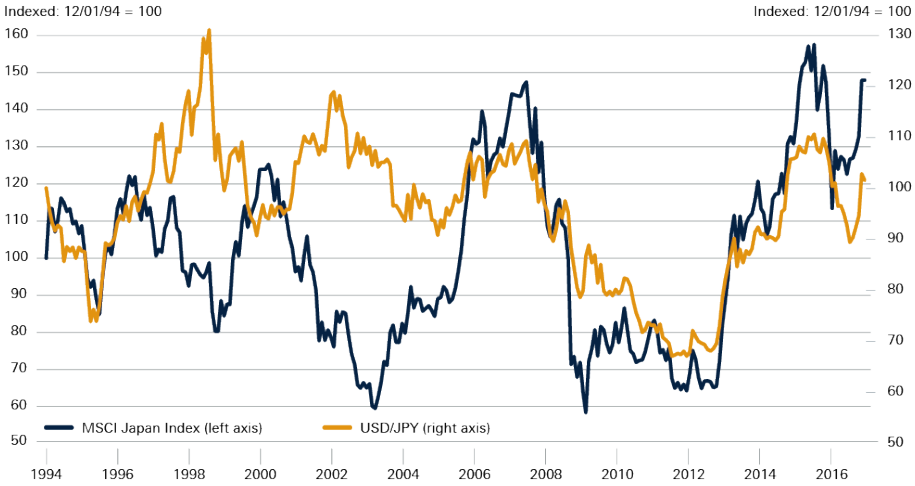
Mergers and acquisitions (M&A) is another area witnessing a rising allocation of capital. The new corporate-governance code warrants an unraveling of Japan's infamously complicated cross-shareholding structure. In 2015, Japanese companies were engaged in M&A worth JPY 16tn, the highest level in nine years and a more than 75% increase year-over-year (yoy). Most of these investments went outside Japan.

Earnings trend positive

Of course, a stronger yen remains a constant issue for export-oriented companies. Overseas revenue accounts for almost 50% of the Nikkei 225, resulting in a high correlation between equity market and yen movement. Since 2004, the correlation between Nikkei 225 and the USD/JPY development stands at 0.92. Recent earnings revisions have not yet reflected the renewed weakness of

the yen compared to the dollar. However, this relationship is not set in stone as the longer-term graph below shows.

Japan's equities and USD/JPY don't always move in sync



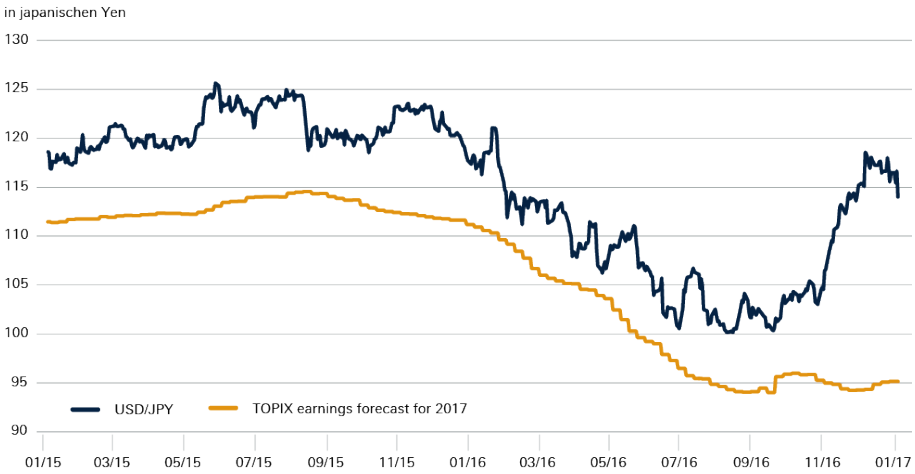
Source: Bloomberg Finance L.P., as of 1/12/17

The recent earnings season supports our view. 54% of the TOPIX companies have beaten consensus estimates by a wider range than seen in the last few quarters. Earnings per share (EPS) rose marginally by 0.4% yoy vs. a decline of 19.5% yoy in the first quarter of 2016. The consensus expects double-digit EPS growth in the coming quarter[1].

Overweight Japanese equities

Japanese equities remain one of our favorite asset classes globally. While they have been in correction mode for the first half of 2016, owing to China's growth concerns, a stronger yen and downwards earning revisions, things have been improving since the third quarter. We believe the tailwinds will continue in 2017, as China's growth is likely to remain stable and Japan's earning revisions have started to turn positive.

Earnings forecasts have yet to follow the yen-weakness



Source: Thomson Reuters Datastream, Deutsche Asset Management Investment GmbH; as of 1/12/17

The U.S. election outcome has been a game changer, accelerating the reflation trend and strengthening the dollar. Prospects of pro-

growth policies in the U.S. have substantially bucked up Fed rate-hike expectations. The yield spread between 10-year U.S. Treasuries and JGBs has widened to a multi-year high, putting downward pressure on the currency.

Domestic drivers such as the Government Pension Investment Fund (GPIF) buying and BOJ's ETF purchases should continue to support markets. The valuation is still interesting and we see scope for further expansion. In the last few years, Japan has closed the productivity gap with the developed world but the valuation multiples have yet to catch up. Nonetheless, stock picking is essential to maximize the return in Japanese equities as the broad macro environment remains difficult. Over the next 3 to 9 months our preferred themes are:

- Domestic names with visible growth potential, related to consumption and/or services
- Selected export companies with high global market shares and secular growth perspectives
- Companies with already improved / potential to improve shareholder policies.

Glossary

Abenomics

Abenomics is a growth-oriented economic policy conducted by the Japanese government under Shinzō Abe.

Bank of Japan (BOJ)

The Bank of Japan (BOJ) is the central bank of Japan.

Corporate governance

The methods by which corporations are run and controlled

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a companies' net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Government Pension Investment Fund (GPIF)

The Government Pension Investment Fund (GPIF) is the pension fund for Japanese public sector employees established by the Japanese government, which is the largest fund in the world.

JPX-Nikkei Index 400

The JPX-Nikkei Index 400 was established in January 2014 and is composed of 400 companies that a) are amongst the 1000 highest capitalised companies in Japan, b) have the best rankings for Return on Equity, operating profit and market value and c) have the best scores for corporate governance and disclosure.

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Mergers and acquisitions (M&A)

Mergers and acquisitions (M&A) are the two key methods of corporate consolidation. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

Nikkei 225

The Nikkei 225 is a price-weighted index of Japan's 225 most important listed companies.

Return on equity (ROE)

The Return on equity (ROE) is the amount of net income returned as a percentage of shareholders' equity.

TOPIX

The TOPIX (Tokyo Stock Price Index) captures all companies (almost 2000) of the First Section of the Tokyo Stock Exchange.

U.S. Federal Reserve (Fed)

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

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