beyondtheheadlines

3 May 2016

OUT OF DATE BUT NOT OUT OF FASHION! – THE “BUY YEN, SELL EQUITIES” TRADE

Japanese equities are feeling the heat.

The Yen’s appreciation since late 2015 has coincided (yet again) with a sell-off in the broader equity market. A close relationship has always existed between the two (usually in opposing directions), but as Fig.1 illustrates, that relationship has, if anything, strengthened since 2012. Should it not have weakened? There are solid grounds for this given corporate Japan’s significant structural changes.

On what are investors focusing? One has to ask, “Why”? What should they really think of the Yen/equity trade?

Four inter-connected pillars support the argument that investors are attaching too much credence to the Yen when valuing Japan’s equities, to wit:

- The trade-weighted Yen remains ferociously competitive vis-à-vis Japan’s major trading partners[1],
- US’ share of Japan’s exports has dropped significantly over the last 30 years – the direct impact of the dollar-Yen rate on profits is not as great as a decade ago,
- Many sector profits are insensitive to Yen fluctuations[2], and
- Surging profit margins resulting from on-going corporate restructuring have been overlooked

The Yen remains ferociously competitive when measured against ALL trading partners

The Yen is highly competitive against its key trading partners (Fig. 2). In part, this is due to rigorous corporate restructuring as companies outsourced operations taking advantage of new markets and cheaper costs (Fig. 3). As a result, Japan’s Cabinet office estimates that the Yen could strengthen to ¥103 before it bites into corporate profitability.

Excessive importance has apparently been attributed to the absolute level of the dollar-Yen rate. Insufficient importance has been given to the shifts in trading patterns over the last 3 decades.

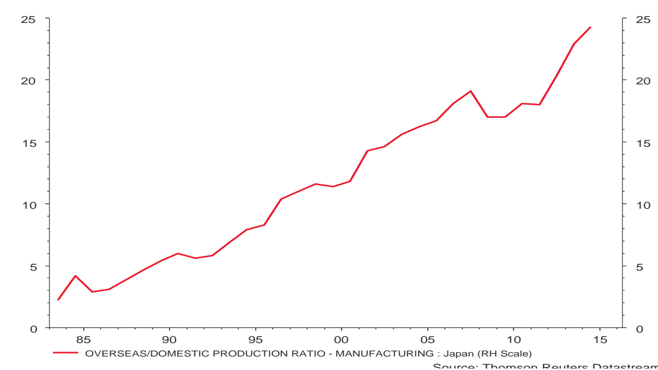
Whereas Japan’s exports to US, for example, accounted for around 30% of its total in the 1990s, it is only 18% today having fallen as low as 14% in 2011.

In other words, the influence of trade with the only country with a direct dollar-Yen impact has almost halved. The dollar-Yen rate has little impact on the dynamics of Japan’s other trade (82% of its exports) in which its role is primarily an accounting vehicle.

Fig. 1. The Yen / Japan equity link has strengthened; something’s fishy

Fig. 2. The Yen is well below its 10-yr average despite the recent rally

Fig. 3. Increased outsourcing has changed profit dynamics



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Further from the truth is the implicit assumption that Japanese exports compete solely on price.

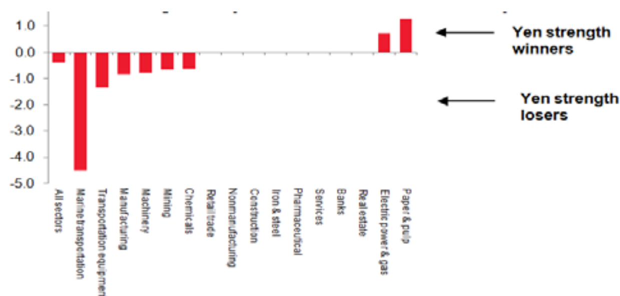
The "Made in Japan" label continues to invoke images of high quality and outstanding design. The concept of *monozukuri*, broadly translated to the endless commitment to improving and optimising design and production processes, remains steeped in the DNA of Japanese manufacturers. The Chinese consumer, quickly becoming Japan's key customer, has become more sophisticated in a short period of time. Quality, design and branding – attributes associated with many Japanese products – are now more important than "value for money".

2016's profit downgrades reflect factors other than the strong Yen

It is tempting, as many apparently do, to attribute the higher profits of recent years to the weaker Yen that has prevailed since mid-2012 until recently. Naturally, the Yen's rally since late 2015 has fuelled panic.

The reality is that only a few sectors are directly impacted by the Yen (Fig 4)[3]; profits in most sectors are currency insensitive. Moreover, there are winners and losers when the Yen strengthens. At the end of the day, a 1.0% rise in the Yen dollar rate does reduce all-sector operating profit growth by around 0.4%.[4] There is an impact, but the changes highlighted above suggest that impact has been exaggerated. A close scrutiny of 2016's profit forecast downgrades strongly suggests that factors other than the Yen are present.

Fig. 4. Many sectors are insensitive to the Yen

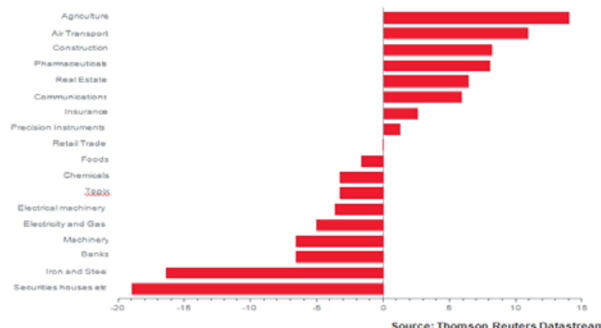


Source: Nomura calculations on Topix sectors

Based on this sensitivity, the circa 11% rise seen in the Yen since last December should have led to a reduction in profits of around 4.5%.

But profit forecasts have fallen much more. Other factors are clearly in play and these are evident below (Fig. 5).

Fig. 5. Profit forecasts have been cut in non-Yen sensitive sectors



The largest declines in the profit forecasts since the start of 2016 have been:

- Securities houses; reflecting not only slumping equity markets but also the pull back of various investment banks,
- Iron and steel - owing partially to the Yen's strength but more, we suspect, to massive surpluses, especially in China, exerting downward pricing pressure amid poor global demand,
- Commercial banks slashing forecasts owing to fears of the impact of negative interest rates.

These reasons lie outside the impact of the stronger Yen, contrary to the market's reaction.

Driving through the rear vision mirror

Investors seem to be pricing Japanese equities today based on yesterday's understanding of the drivers of profit. Profits today are less reliant on the Yen. Japan's exports are increasingly driven by factors other than pricing. Profit downgrades have reflected events unrelated to the currency. Japan's corporate restructuring, too, has had significant impact on profit margins.

Investors are apparently valuing the market on perception rather than reality. That "buy Yen/sell equities" trade should be weaker, not stronger. It will clearly take a lot to change those perceptions, but until they do change, there could be more downside if the Yen rallies further. When perceptions do change, Japan's under-valued equities could spring back – fast.

[1]On a real effective trade-weighted basis the Yen remains around a 40 year low according to JP Morgan from Datastream as at 20 April, 2016.
[2]Nomura calculations as of 22 March 2016
[3]The y-axis shows the percentage change in estimated operating profit for FY16 of key Japanese sectors for every 1% appreciation in the dollar-Yen. The calculations show that the impact of appreciation on the marine transportation, transportation equipment and manufacturing sectors are most severe while paper & pulp and electricity power & gas actually benefit.
[4]Nomura calculations as of 22 March 2016

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