MAY 2017

GOOD NEWS FROM CORPORATE JAPAN

Declared profit growth has surged into 2017.

This good result was achieved not only against the backdrop of a stronger yen (Fig.1) but also against sluggish sales (Fig.2). Earnings per share have risen to within striking distance of their 2015 record high.

This result is significant on several levels, (not only that it reflects a longer term trend).

First, rising profits on a stronger yen/dollar rate exposes the argument that this rate is the primary profit driver. This belief has exerted a powerful grip on investors' imaginations as they reasoned "A Strong Yen/Dollar = Lower Profits = Sell Japan" and, conversely, "A Weak Yen/Dollar = Higher Profits = Buy Japan".

This argument is highly flawed; it focuses on the yen dollar exchange rate only. If one focuses on the wider real trade weighted exchange rate, the yen is hovering above a thirty five year low[1]. The yen, whichever way one splices it, is super competitive.

Second, ongoing company restructuring has resulted in profit growth extending into 2017 despite soft sales, which suggests a strong improvement in net margins. Indeed, these have risen from 4¼% in early 2016 to just under 5% (from an early 2012 low of 2¼%).

Investors have apparently overlooked this improvement given Japan's market performance this year[2]. Despite strong corporate fundamentals, the market continues to lag despite a late April spurt on the better profit announcements.

Japan's corporate restructuring has been a major driver of profitability. But focused on the success (or otherwise) of Abenomics, and the yen/equity trade, investors have seemingly lost sight of this fact.

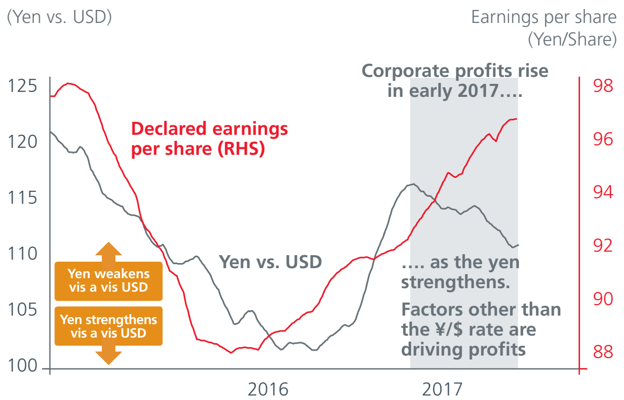
There is room for margins to improve further. In Germany, where the index is broadly comparable with that in Japan, companies regularly record net margins of between 6~6¼%. Japan seems on track to also achieve this level of profitability[3].

The wide valuation gap between each market highlights investor perceptions in stark relief; whereas Germany's "Z" score is expensive, Japan still lies deep in "value" territory[4].

Put another way, if investors like German equities, they have got to love Japan!! Profit growth in Japan has outstripped growth in Germany (and US) since early 2014[5].

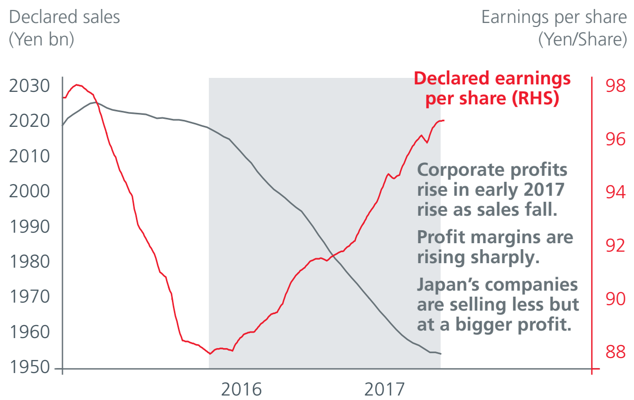
When recognition dawns, Japan's upside could be significant. Until then the best strategy seems to be "Buy and tuck away".

Fig.1. Profits surge into 2017 despite a stronger yen. Other sources of profit growth are in play



Source: IBES reported data based on the Topix index from Datastream, as at 28 April 2017. Note that both series are exponentially smoothed with a smoothing factor of 0.075.

Fig.2. Corporate restructuring pays off; surging profit margins lift profits even though sales fell



Source: IBES reported data based on the Topix index from Datastream, as at 28 April 2017. Note that both series are exponentially smoothed with a smoothing factor of 0.075.

[1]Having peaked at 151 in mid-1994, the real effective trade weighted exchange rate (based on consumer prices) fell to 67 by mid-2015. It has since recovered to 76, which is in line with the levels recorded in 1980~1985, i.e. the yen's value is at the lows of 35 years ago. All data is according to JP Morgan. [2]In the year to date, Japan's Topix index fell around 4% until the reporting season began in mid-April. The good news clearly caught investors by surprise. While rebounding, the market was still only up some 1% at the time of writing, the US' Standard and Poors composite index was up 6½% while Germany's DAX index was up 8%. [3]At the operating level, Japan's manufacturing sector has seen the operating profit to sales margin average around 6% since 2013. In contrast, the same ratio for non-manufacturing has risen from just under 4% to just under 6%. With costs under control, a net profit margin of 6% in Japan seems achievable. [4] The "Z" valuation measure gives equal weighting to the variation of the historical price to book ratio from its 10 year trend and the same for the prospective price earnings multiple. As at 28 April 2017, Germany's "Z" score was above 0.97, higher than 70% of all world valuations. That for Japan was around -0.4%, deep in value territory. [5]Since then profits in Japan have risen 31.5%, Germany 25.5% and US 11.5%.

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