eastspring investments

A member of Prudential plc (UK)

MARCH 2018

JAPAN'S SHUNTO – CROUCHING BEAR OR CHARGING BULL?

After bouncing off its mid-February low, Japan's equity market experienced a fresh round of jitters in early March in the wake of looming global trade war fears.

In both sell-offs this year, Japan has suffered more than the other major developed markets.

It is not as if there is a raft of bad news looming. It is quite the opposite, in fact; the economy has been expanding for seven straight quarters[1], business confidence[2] is at its highest in 11 years, the reappointment of the Bank of Japan's governor (who clearly signalled the Bank's easy money policy remains intact) cheered investors, the yen remains ferociously competitive (despite recent strength), and the profit forecasts continue to rise.

What is there not to like, particularly as Japan's companies are among some of the most cash rich, globally?

Yet, concerns reign supreme; this good news has only been begrudgingly discounted. As a result, some of the most attractive developed market valuations are to be found in Japan (refer to Fig.1).

(One possible concern could lie in 2019's proposed consumption tax hike; many investors still recall the fall-out following 2014's increase. But a 2014 repeat seems unlikely; 2019's hike is forecast to amount to only 0.4% of nominal GDP, well below 2014's 1.2%).

Otherwise, few clouds seem on the horizon. It is arguably this very fact, this Goldilocks scenario, that lies at the core of investor uncertainty. After 2017's 20% rise, investors seem reluctant to believe their good fortune; they are looking for the loop-hole in the outlook, and in doing so, are arguably exaggerating and magnifying any potential bears.

Japan investors are not alone in this respect, of course; the trigger for February's global equity selling, for example, was the rise in the US weekly hourly wage rate, the highest annual rise since 2009. But the US weekly hourly wage rate only rose because the number of hours worked in January fell more than the fall in the average total weekly wage bill. In other words, both the total wage bill and the number of hours worked fell, with the hours worked falling more. This is hardly a sign of impending inflation. Yet investors have used this "fact" (and still are), in flogging the inflation bear.

Similarly the early March sell-offs were triggered by US' tariff threat on steel and aluminium imports. It is again notable that, amongst the developed markets, Japan was the hardest hit; as at early March, the US Standard and Poor's index was more or less level pegging being 2% higher, the Euro Stoxx was down some 4% but Japan's Topix was down 5½%.

US resilience, it could be argued, has been boosted by Mr. Trump's tax cuts and proposed budget deficit that investors seem to think will feed growth more than inflation. Rising confidence in Europe's economic recovery could lie behind the Eurozone's better relative performance.

But in Japan, any major development that could renew investor interest has been notably absent.

Against this background, Japan's impending Shunto spring wage offensive could take on an added significance

Fig.1: Japan looks good value vis-a-vis its peers

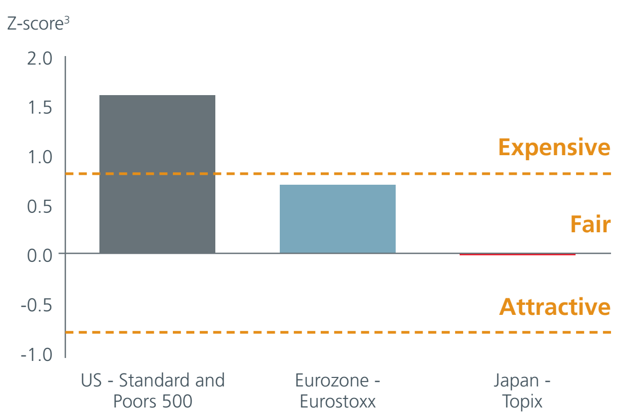
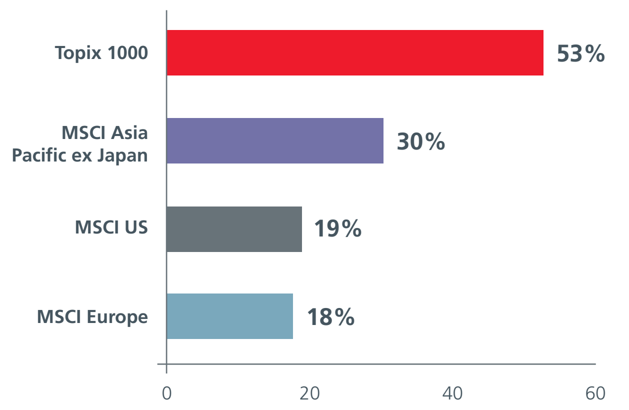


Fig.2: More Japanese companies are "cash rich"



Source: [1]The economy expanded at a 1.4% annualised rate in July-September 2017 period (Financial Times, as at November 2017). [2]Bank of Japan quarterly Tankan Index was 25 in the fourth quarter of 2017. Fig.1. Eastspring Investments, MSCI and IBES from Datastream, as at 6 March 2018. [3]The "Z" valuation is a composite measure giving equal weighting to the deviation of both the historical price to book and prospective price earnings ratios from their long-term trends. The "Z" score is based on 12-year data. Fig.2. JP Morgan, % of net cash companies in major markets, as at 31 December 2017.

and urgency. Japan's April Shunto is the annual national wage negotiation between companies and enterprise-based labour unions. But this year, it is slightly different in that it is increasingly being viewed as another barometer as to the success (or otherwise) of Abenomics. Mr. Abe has firmly nailed his colours to the mast of a Shunto wage agreement of around 3%. In this, he is supported by the Keidanren (Japan's business federation).

And so as to encourage companies to utilise their growing cash piles, by either raising salaries or increasing investment, the Abe government is adopting a "carrot and stick" approach offering attractive tax rate reductions for companies that rise to the 3% wage increase challenge. Companies that choose not to follow suit, despite having recorded higher profits, will earn a tax increase.

In short, whether justified or not, the success or otherwise of this year's Shunto could impact the credibility of "Abenomics". In the current uncertain environment, this could have a magnified impact on the equity market.

A desirable outcome (i.e., one that achieves the 3% wage hike target), could provide the confidence to push Japan's already attractive valuations, higher. An undesirable outcome (i.e. not only below the 3% target but also in line with past outcomes of 2% - or lower), could undermine investor confidence resulting in another "Abenomics is not working" consolidation or sell-off.

Keep a close eye on the forthcoming wage negotiations is our counsel. But, and this is a big "But", we would also keep a close eye on developments at the corporate level.

Japan's companies have been restructuring over the last ten years; they are generally in good shape. The return on assets of non-financial companies has risen, profitability has improved as have cash flows — all of which are giving companies more flexibility in repaying debt, boosting dividends and instigating share buy-back schemes (refer to Fig.2).

It is these factors that underpin the rise in equity prices, we argue. The macro factors, including any of those falling bears, are providing the excuses to either buy or sell an underlying attractive story but are not the underlying reasons in themselves.

In short, should the Shunto fall short of expectations, which is a definite possibility, this could provide another attractive re-entry point. But if the Shunto is gauged a "success", this could be the key to unleashing the good value evident within Japan.